

**European Commission’s Consultation on Renewed Sustainable Finance Strategy:
ICI Global Final Response**

The full list of consultation questions is available at https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en and ICI Global’s summary of the consultation is available at <https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo32378.global>.

Final responses are highlighted below in yellow.

SECTION II: QUESTIONS TARGETED AT EXPERTS

- Question 7: Overall, can you identify specific obstacles in current EU policies and regulations that hinder the development of sustainable finance and the integration and management of climate, environmental and social risks into financial decision-making? Please provide a maximum of three examples.

The most prominent obstacle is the lack of proper sequencing and timing of implementation deadlines.

First, the Disclosure Regulation will require asset managers to disclose detailed adverse impact data on investee companies although investee companies are not currently under any obligation to disclose this information. Investee companies are the primary source of data for asset managers’ disclosures about investments in those companies. We have concerns that some of the asset manager and financial product disclosure will be required even though there is no corresponding requirement for investee companies to provide this data.

Second, the Disclosure Regulation will require financial product disclosure related to the Taxonomy Regulation’s concept of “do no significant harm,” but the compliance deadline for this Disclosure Regulation provision is not properly sequenced with the Taxonomy Regulation’s technical screening criteria (which include criteria for determining “do no significant harm”). The Disclosure Regulation compliance deadline is in March 2021 while the Taxonomy’s technical screening criteria are still under development. The “do no significant harm” analysis further links to the adverse impact indicators that are being currently developed in the Disclosure Regulation RTS—a link that is problematic given the lack of sequencing between the two Regulations. As an added complication, the Disclosure and Taxonomy Regulations’ definitions of “sustainable investment” are inconsistent.

Third, the Taxonomy Regulation will require asset managers to begin disclosing information about investee companies’ degree of Taxonomy-alignment at the same time as it requires companies to make that same disclosure about their Taxonomy-alignment. The company disclosure should be sequenced first so that asset managers have the opportunity to obtain that data from investee company disclosures and aggregate them into their own disclosure.

Section 1.4: Other standards and labels for sustainable financial products

- 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 at this stage.

Additional comments on Question 28:

The focus should be on transparency and investor choice rather than minimum standards (e.g., in line with the EU Taxonomy). This will allow the market to continue to drive the evolution of sustainable investing.

We caution that a minimum standard would likely narrow the existing diversity of sustainable investing strategies and reduce investor choice, without corresponding investor protection benefits. The diverse spectrum of strategies exists to meet a wide range of client demand. Each asset manager has a proprietary investment process, and the variety of approaches to sustainable investing reflect managers' unique value propositions. Standardizing sustainable investing also would not take into account the variety of approaches funds take to sustainable investing, including engagement with portfolio companies. Narrowing the scope of sustainable or green funds may also reduce investor demand for these funds if they are viewed as niche rather than mainstream products.

Investors benefit when sustainable funds provide clear disclosure for an investor to be able to understand the distinctions among different types of strategies so they can choose the strategy that best fits their needs. We note the Commission already has required extensive sustainable fund disclosure under the new Disclosure Regulation requirements. It should evaluate whether this enhanced transparency assists investors before jumping to the conclusion that more action is needed.

We have additional concerns about the effectiveness of restrictive standards given the current size of the universe of pure "sustainable" or "green" investments. For example, the current universe of Taxonomy-aligned investments is expected to be quite small. It is important for managers to be able to incorporate a broader understanding of sustainability considerations across a larger segment of the market, rather than focusing solely on a few small green companies. Crowding investors into niche products with a small investable universe runs counter to the Commission's objective of mainstreaming sustainable finance.

As a final point, we caution that creating prescriptive standards risks codifying today's understanding of sustainability. Sustainable investing is an area that is evolving quickly, and a minimum standard has the potential to hinder product innovation. Before concluding that regulatory action is needed, we urge the EC to first study of fund labels in the EU to determine whether there is a market failure and, if any, the merits of regulatory intervention such as the imposition of minimum standards.

- Question 29: Should the EU establish a label for investment funds (e.g. ESG funds or green funds aimed at professional investors)? Yes/**No**/Do not know.

Professional investors do not need such a label to distinguish ESG or green funds and often have bespoke or specific investment demands that lead to tailored solutions. The diverse spectrum of existing strategies exists to meet a wide range of client demand, and there is no evidence that a label is needed at this time. We also note that the EU has already imposed extensive disclosure requirements on sustainable funds.

If the EU does choose to undertake any work in this area, we urge it to follow broadly a similar approach to existing label frameworks in different Member States so that firms can leverage the work already done on labeling their products.

Section 1.6: Corporate governance, long-termism and investor engagement

- Question 45: Questions have been raised about whether passive index investing could lower the incentives to participate in corporate governance matters or engage with companies regarding their long term strategies. 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]

Investors who are seeking a specifically ESG-focused investment strategy have the ability to choose from a variety of available strategies, whether active or tracking an index.

Within index investing, ESG factors are taken into account as part of an ESG-focused investment strategy or through engagement with companies on ESG issues.

Asset managers take into account material ESG factors in their engagement activities. Asset managers engage with companies held in a variety of mandates to encourage them to adopt robust business practices consistent with sustainable long-term performance. Managers of index strategies may be particularly focused on stewardship because of limitations on the ability to sell a security if the manager is dissatisfied with that investment.

Section 2.1: Mobilising retail investors and citizens

- Question 49: Although retail investors today are increasingly aware that their own investments and deposits can play a role in achieving Europe's climate and environmental targets, they are not always offered sustainable financial products that match their expectations. In order to ensure that the sustainability preferences of retail investors are truly integrated in the financial system, it is crucial to help them to better identify which financial products best correspond to these preferences, providing them with user-friendly information and metrics they can easily understand. To that end, the European Commission will soon publish the amended delegated acts of MIFID II and IDD, which will require investment advisors to ask retail investors about their sustainability preferences.

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**/Do not know. If necessary, please provide an explanation of your answer. [box max. 2000 characters]

Advisers have a duty to act in their clients' best interest, are best positioned to know their clients, and need flexibility to have an effective conversation with a client to ensure they can appropriately address

their client's needs, including sustainability preferences. Investors have a very wide range of different sustainability preferences, and a generic questionnaire approach would be a tick-the-box exercise that would not engender thoughtful conversation. It is key for advisers to have the flexibility to use their judgment in determining a client's needs and preferences.

Section 2.2: Better understanding the impact of sustainable finance on sustainability factors

- Question 52: In your view, is it important to better measure the impact of financial products on sustainability factors?
 - Please express your view by using a scale of 1 (not important at all) to 5 (very important). For scores of 4 to 5, what actions should the EU take in your view? [BOX max. 2000 characters] [2].

Additional comments on Question 52:

Given the lack of data and continued development of this area, we strongly urge caution around any further work to measure the impact of financial products on sustainability factors. Requiring disclosure of data that is not yet well-developed will result in meaningless disclosure at high cost with no benefit to investors.

The concept of sustainability impact is still developing. For example, there are significant concerns around how to define or measure different sustainability impacts, how to weigh or balance one sustainability impact in relation to another, and the potential for conflict when considering various sustainability impacts in relation to an investor's economic interests or other preferences (see our response to Question 91). The data that would be used to measure sustainability impact is still being developed, with the NFRD review beginning to contemplate how companies can measure and report sustainability impact. We note that the NFRD does not currently require companies to disclose the sustainability impact related information that asset managers will need to meet the new disclosure requirements under the Disclosure and Taxonomy Regulations. This lack of data is extremely problematic in the context of the proposed Disclosure Regulation RTS, which would require asset managers to disclose over 30 different impact-related indicators for all of their investments.

- Question 53: Do you think that all financial products / instruments (e.g. shares, bonds, ETFs, money market funds) have the same ability to allocate capital to sustainable projects and activities?
 - Yes/No/Do not know. If no, please explain what you would consider to be the most impactful products/instruments to reallocate capital in this way.[box max. 2000 characters]

There are important differences in the ability of financial products / instruments to allocate capital to sustainable projects and activities. For example, UCITS funds typically channel savings from savers/investors to listed companies. UCITS investment strategies, however, are designed according to the investment objectives that are established in the fund documents and in compliance with investor protection-driven, regulatory investment restrictions—in particular, liquidity, diversification, and other requirements. Therefore, UCITS can allocate capital to sustainable projects and activities, but they are constrained in their ability to invest in certain types of sustainable projects/activities.

Private market investments may be best suited for focused 'impact' investment, as these investments can be narrowly tailored to specific sustainability projects/activities and negotiated directly with investors (e.g., private loans for financing a new wind farm, solar plant, or biomass manufacturing facility). Not all financial products, however, are able to invest in private market investments or in significant amounts. As a result, financial products that do not have liquidity and other constraints on investing in unlisted securities may be better placed to allocate capital to sustainable projects/activities.

Another limitation faced by all financial products/instruments in allocating capital to sustainable projects/activities is the relatively small universe of available investments that actually focus on these types of projects and activities. For instance, within fixed income, relatively few fixed income investments require that proceeds from capital be allocated to sustainable activities and investments. Currently, the universe of green bonds, while growing, still remains a small fraction of the overall fixed income universe. These size and liquidity limitations may be constraining for financial products (such as UCITS) with capacity or liquidity requirements.

Section 3.2: Financial stability risk

- Question 91: Traditionally, the integration of material sustainability factors in portfolios, with respect to both their selection and management, has considered only their impact on the financial position and future earning capacity of a portfolio's holdings (i.e., the 'outside-in' or 'financial materiality' perspective). However, asset managers should take into account also the impact of a portfolio on society and the environment (i.e., the 'inside-out' or 'environmental/social materiality' perspective). This so-called "double materiality" perspective lies at the heart of the Disclosure Regulation, which makes it clear that a significant part of the financial services market must consider also their adverse impacts on sustainability (i.e. negative externalities).

Do asset managers 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)?

- Yes/**No**/Do not know. If yes, what solution would you propose? [BOX max. 2000 characters]

Additional comments on Question 91

We recognize the EC's interest in increasing asset managers' focus on sustainability impacts, but we do not see merit in amending rules on fiduciary duties, best interests of investors/the prudent person rule, or 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.

Asset management is based on an agency relationship: asset owners hire asset managers to invest assets on their behalf. Asset managers act as fiduciaries, which means acting in the best interests of the client and faithfully executing the investment mandate provided by the client. Asset managers invest within the guidelines specified by their clients for a given mandate as set out in the investment management agreement. For regulated funds, a fund's manager invests in accordance with investment

objectives and policies that are established by the fund's offering or constituent documents. In both contexts, the client or fund investor assumes the risk of investing rather than the asset manager. It is therefore essential that asset managers make investment decisions on behalf of their clients/investors only and invest in a manner that they assess will best achieve a client's mandate or a fund's stated investment objectives.

Sustainability impact, on the other hand, is a separate and distinct concept from fiduciary duty; integrating this notion with fiduciary duty shifts the focus from the client/investor to the EU's broader policy objectives. Incorporating adverse impacts of investment decisions on sustainability into general obligations of asset manager to their clients therefore would fundamentally alter an asset manager's core duty to put the client first. In fact, an asset manager's fiduciary duty generally means it must, at all times, serve the best interest of its client and not subordinate its client's interest to its own interest or other interests. We are concerned that changes to that basic covenant between an asset manager and client could reduce the client's confidence in an asset manager. At a time when retail participation in the capital markets is critical to a robust recovery from the COVID-19 crisis and to the EU's objective of diversifying funding beyond banks, we do not believe that reducing clients' confidence in those who can help navigate their participation would be in the EU's interest.

In addition, it is essential that the Commission carefully consider all the potential ramifications before introducing a radical and fundamental change to a well-established legal doctrine and potentially creating conflicts with an asset manager's duty to act in a client's best interest. Without an adequate framework for addressing potential new conflicts, it is unclear how asset managers would navigate this new legal obligation. For example, if an asset manager must consider adverse impact on sustainability, regardless of a fund's investment objective, how should an asset manager balance these obligations or weigh them against each other, especially in relation to an investor's economic/financial interests or other preferences?

Moreover, we are concerned that directly requiring asset managers to consider and integrate adverse sustainability impacts into investment decisions could create legal conflicts for EU asset managers advising clients in other jurisdictions. A European asset manager advising a non-EU client would be forced to reconcile two different concepts of fiduciary duty—one that focuses solely on the investor's best interest, and the other that more broadly includes environmental and social sustainability impact (separate from investment returns). European asset managers would have to manage these potentially conflicting obligations, particularly if the clients have not indicated a preference to incorporate adverse impacts into investment decisions. A change of this magnitude has the potential to impact negatively the European asset management sector.

Mandatory inclusion of adverse sustainability impact in fiduciary duty also risks damaging European asset managers' competitiveness. Mandatory inclusion of adverse sustainability impact would eliminate the ability for an investor to choose whether and how an asset manager considers adverse sustainability impact in the client's investments. Instead, the EU would impose those considerations for all investors, irrespective of their preferences. Non-EU clients who do not want a policymaker-mandated approach to consideration of adverse sustainability impact in their investment portfolio may choose non-EU asset managers and markets that permit wider ranges of product offerings and a less prescriptive approach to sustainable investing.

We urge the EU to continue its current approach of incorporating adverse impact in targeted sustainable finance legislation to achieve the EU's objectives. SFDR Article 4, for example, requires financial market participants, including UCITS managers when they consider principal adverse impacts of investment decisions on sustainability factors, to disclose a statement on due diligence policies on those impacts, taking due account of their size, the nature and scale of their activities, and the types of financial products they make available. This proportionate approach accounts for investor mandates and investment objectives and would apply the obligation when appropriate to the investment strategy of the portfolio.