efama

European Fund and Asset Management Association

EFAMA's comments on the European Commission's Proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

Contents

EXECUTIVE SUMMARY 2

1. PROPORTIONATE AND BALANCED DISCLOSURE IS NECESSARY 3
2. THE NEED TO LOOK BEYOND IMPACT INVESTING 3
3. THE LINK WITH THE TAXONOMY PROPOSAL SHOULD BE CLARIFIED 4
4. ESG/SUSTAINABILITY IS NOT A FACTOR IN ALL INVESTMENT DECISIONS 4
5. REMUNERATION IS ALREADY ALIGNED WITH ASSET OWNERS' LONG-TERM INTERESTS AND LONG-TERM SUCCESS 5
6. DISCLOSURE BY PUBLIC COMPANIES IS THE STARTING POINT 5
7. A LONGER TRANSITION PERIOD IS NECESSARY 6
8. CONSIDERING THE BIGGER PICTURE: FRAGMENTATION OF REGULATION 7

DETAILED COMMENTS REGARDING DISCLOSURES PROPOSAL 8

rue Montoyer 47, B-1000 Bruxelles

☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

EXECUTIVE SUMMARY

EFAMA welcomes enhanced transparency which will support informed and qualified investment decisions regarding the integration of sustainability risks. We also welcome the focus on disclosure/transparency, and the shift away from previously discussed policy options such as codifying investor duty with regards to sustainability risks in a rigid way. We hope that any amendments to Level 2 of the UCITS- and AIFM-Directives will codify investors' duty only with regard to material sustainability risks, in a principles-based and not overly descriptive and rigid way. Given that different actors are at different starting points, transparency provides the right incentives to further integrate ESG and improve on existing market practices. For example, it can help to raise internal awareness but above all provide more information to end-investors, while retaining flexibility and fostering market innovation and client-driven developments. This also has the potential for positive branding of products and the aim should be to provide end-investors with sufficient and relevant information to help them choose products, whilst ensuring that a particular approach is not imposed on them.

To ensure the Disclosures proposal is a success, we have a number of recommendations, which are based on many years of experience of pan-European asset managers:

1. The level of disclosure needs to be **balanced with the materiality/relevance** of the information provided to investors.

2. We strongly recommend continued diversity, and would advocate against a position where sustainable investments are **restricted to impact and thematic investing**.

3. **Definitions need to be aligned** between the Taxonomy and Disclosures proposals, but also within the Disclosures proposal.

4. Financial market participants should only publish written policies on the integration of ESG/sustainability risks, **where relevant for a particular investment approach**.

5. Remuneration: Integration of ESG/sustainability risk considerations, where these are relevant and material for investment performance, are already incentivised by existing requirements to align with **asset owners' long-term interests** and the **long-term success of the investment management company.**

6. **Meaningful disclosure from public companies** is the necessary starting point for asset managers to integrate ESG factors in their operations and comply with the proposed disclosure requirements.

7. We would encourage a **longer transition period** in order to accommodate new disclosure requirements.

8. Policymakers need to bear in mind the **bigger picture in relation to the fragmentation of regulation** given that market participants have to deal with an increasing number of regulations which leads to duplication and inconsistency of disclosure requirements.

1. PROPORTIONATE AND BALANCED DISCLOSURE IS NECESSARY

The level of disclosure needs to be balanced with the materiality/relevance of the information provided to investors. The focus should therefore be on ensuring that disclosure requirements are targeted towards the most important information pieces not already included in existing product documentation. Some of the suggested information to be provided is relatively complicated, especially for individual investors. If sustainable investing is to be widely adopted, a key challenge is to keep its presentation as comprehensible and comparable as possible for the widest range of investors. It will therefore be important that information requirements, and the suggested ways of presenting this information, are subject to open and transparent consultations with relevant stakeholders. We would also like to see the format and content being tested on relevant target groups, to ensure overly-complicated and costly solutions are avoided and that the disclosures are effective.

Article 4(1)(b) requires financial market participants to include a description in pre-contractual disclosure to what extent ESG risks are expected to have a relevant impact on the returns of a financial product. While the wording is generic, we fear that (i) such generic description would not lead to a more meaningful disclosure for market participants, (ii) NCAs might require more than a generic description or may require different general descriptions which could then lead to forward-looking statements. Forward-looking statements, however, are subject to a variety of risks, uncertainties and speculation. Actual events or results will very likely differ from such statements and their value for investors will be limited, but may lead to negative client experiences with ESG products, making them in effect counterproductive. In particular, the requirement to include information about the extent of the impact on the return seems to be inappropriate, and will in any case most likely be speculative.

2. THE NEED TO LOOK BEYOND IMPACT INVESTING

The proposal appears to focus on impact and thematic investing, given that firstly ‘sustainable investments’ are defined as economic activities that contribute to an environmental (‘E’) or (‘S’) social objective, secondly, the transparency requirement comprises monitoring the impact of a sustainable investment (Art. 6(1)(b)) and thirdly, the financial market participants are required to describe the overall sustainability-related impact in period reports (Art. 7 (1)(a)).

Whilst we do not know whether this was the Commission’s intention, this could be interpreted in a way that only funds pursuing the achievement of specified pre-determined environmental and social objectives, i.e., so called “impact investing strategies”, can qualify as “sustainable”. Unless this drafting is changed, this would mean that the majority of investment approaches and products that today are adopted as “sustainable” on objective and legitimate grounds may no longer be considered so. This would contravene the EU’s objective of spurring on

sustainable investments, without any analysis or reasoning behind such a move. We would recommend the legislation taking into account the wide range of approaches used by asset managers to achieve the diverse investment and sustainability objectives of individuals and institutional asset owners (screened investments, best-in-class responsible investment, impact investing, stewardship, thematic investing and ESG integration). This diversity is a key element of different firms' responsiveness to client demand and expectations and it would be regrettable if the EU legislator, possibly unintentionally, limited opportunities or created a bias towards specific ways of pursuing sustainable investment with unintended consequences on risk management, diversification and ultimately financial stability.

3. THE LINK WITH THE TAXONOMY PROPOSAL SHOULD BE CLARIFIED

We believe there should be more clarity on the relationship between the Taxonomy and Disclosures proposals, as it may create confusion for market participants. According to the Taxonomy proposal, an economic activity should contribute substantially to one of the environmental targets. However, in the Disclosures proposal, sustainable investments are defined as economic activities that contribute to 'E' or 'S' objectives or investing in companies with good governance, which we interpret as contributing to 'G'. In this part of the legislation, there is no requirement that the contribution be 'substantial'. It is important that we strive to clarify and align these definitions and concepts between the various pieces of legislation.

We also note that the Disclosures proposal uses both the terms 'ESG' and 'sustainability' without making it clear if or to what extent they are interchangeable. We need to make sure that we have consistent understanding, particularly in the context of the Taxonomy proposals possibly coming to define "sustainability" in a more prescriptive way than the market has done hitherto.

Furthermore, both the Taxonomy and Disclosures proposals provide for disclosure requirements for 'environmentally sustainable investments or investments having similar characteristics' and 'sustainable investments' respectively. The taxonomy appears to focus on products that will be able to measure investments in economic activities, whilst the Disclosures proposals focuses on products targeting sustainable investments. We understand that the taxonomy aims to help the EU meet its climate (and more broadly environmental) targets, whereas the Disclosures regulation aims to improve transparency and data availability more broadly. However, as currently drafted, the regulations create confusion for market participants. We would recommend deleting the disclosure requirement in Article 4 of the draft Taxonomy proposal and having the disclosure requirements only in the Disclosure proposal in a consistent way.

4. ESG/SUSTAINABILITY IS NOT A FACTOR IN ALL INVESTMENT DECISIONS

As the text currently stands, it could be misunderstood that ESG/sustainability risk considerations should be a critical factor in all investment decisions. In practice, the materiality and weight of ESG factors for investment decisions depend to a large extent on the investment strategy, investment objective, and time horizon of the investment (all of which is determined

by the asset owner client. We would therefore recommend that the text be clarified to state clearly that financial market participants need to publish written policies on the integration of ESG/sustainability risks, where relevant for a particular investment approach (e.g. some investment strategies are inherently short-term; others rely on very broad diversification across sectors and markets with very limited exposures to individual sectors and issuers, which make ESG/sustainability risks less relevant). In addition, asset managers' business models entail that investments are made in capital markets and projects based on their clients' investment guidelines, investment profile and best long-term interest. This requires that asset managers consider ESG factors within the parameters set out by asset owners.

5. REMUNERATION IS ALREADY ALIGNED WITH ASSET OWNERS' LONG-TERM INTERESTS AND LONG-TERM SUCCESS

Article 4(1)(c) requires financial market participants to include a description in pre-contractual disclosure regarding how their remuneration policy is consistent with the integration of ESG/ sustainability risks. We struggle to understand how the integration of ESG/sustainability risk and targets can be objectively reflected in remuneration of investment professionals. A typical approach to remuneration of investment professionals and other senior executives by investment managers already seeks to: (i) align a manager's incentives with asset owners' long-term interests and the long-term success of the investment management company; and (ii) to promote a sound and effective risk management culture to protect the value of the investment portfolio. Integration of ESG/sustainability risk considerations, where these are relevant and material for investment performance, should be incentivised by these existing requirements as it should be seen and used as an instrument to enhance investment performance, which would equally benefit the clients, the asset management firm and its employees.

Commission Recommendation 2009/384/EC and other post financial crisis remuneration rules already set out obligations on financial market participants across all sectors to take into account non-financial criteria and promote sound and effective risk management in line with the values of the entity.

We note that this part of the legislative proposal would benefit from an overview and a more thorough analysis of how the proposed link with ESG would interact with other existing remuneration related EU rules.

6. DISCLOSURE BY PUBLIC COMPANIES IS THE STARTING POINT

We would reiterate the importance of encouraging disclosure of material ESG risks by public companies and recognising a set of standards that can apply broadly. The extent to which ESG risks and opportunities can be considered by asset managers both in their investment decision-making as well as in the exercise of their stewardship activities is directly linked to the quality and availability of data and metrics from the entities in which they invest. ESG / sustainability risk policies, integration of sustainability risks and subsequent transparency of these processes will hinge on portfolio managers being able to acquire the necessary information and data from investee companies.

Better harmonised and standardised reporting remain a priority. In this respect, we would welcome consistency of EU guidelines on non-financial information with the Financial Stability Board's Task Force on Climate related Financial Disclosure (TCFD), as mentioned in action 9 of the Commission's Action Plan: Financing Sustainable Growth. However, this framework is only relevant for climate-related disclosures of certain sectors, whereas investors need to ensure that all ESG risks that a company considers to be material are reported. Where climate is not a material risk for the company in question, TCFD reporting would likely be quite onerous and not proportionate. Further alignment to International Integrated Reporting Framework, the independent Sustainability Accounting Standards Board (SASB) standards or other recognised reporting frameworks would therefore also be crucial.

More disclosure does not necessarily mean good disclosure. What investors need is meaningful disclosure, demonstrating the business resilience of companies due to their inherent E and S risks, as well as how they are managing such risks.

There is still a long way to go with regards to having access to this data, and possibly even corporates having such data at hand. For example, the Swedish government recently concluded that there are flaws regarding data on $C0_2$ emissions[1]. Many portfolio managers share the view that calculations available are not yet of sufficiently good quality to be used by investors for the purpose of allocating capital to sustainable investments. The risks of misallocation of funds is thus significant, if rules were to end up being too prescriptive and inflexible.

7. A LONGER TRANSITION PERIOD IS NECESSARY

We would encourage a longer transition period, related where relevant, to the falling into place of other pieces of the sustainable finance framework, in order to accommodate new disclosure requirements. Learning from experiences in the recent past, 12 months would be too short to implement such a complex regulation in a meaningful and effective manner. Many firms would have to coordinate internally regarding the scope, type of businesses, putting in place new reporting processes/systems, reviewing documentation for the new mandatory disclosures, etc. It is important to keep in mind that we are not dealing with an urgent financial crisis, but an area where market participants are already making significant progress.

[1] An independent inquiry in Sweden came to the conclusion that there are substantial flaws in $C0_2$ measurement. Following this inquiry, the Swedish government came to the same conclusion in a 2017 government bill (https://www.regeringen.se/rattsliga-dokument/proposition/2017/09/prop.-2017185/). For example, from a $C0_2$ measurement perspective for an investment fund, it would be better to invest in the equities of a car manufacturer than in equities of a manufacturer of solar cell panels as the end use of the product is not measured. It would therefore not be appropriate for investors (especially not retail) to base their investment decisions on funds' $C0_2$ disclosures if the overall aim is a move towards more sustainable growth.

8. CONSIDERING THE BIGGER PICTURE: FRAGMENTATION OF REGULATION

From a regulator's point of view, it is generally easier to stipulate a new topic in a separate Regulation. It makes the discussion at hand less complex and the result is directly applicable to market participants. However, market participants have to deal with an increasing pieces of regulation which leads to duplication and inconsistency of disclosure requirements, thereby making the picture even more complex for their clients. For instance, asset managers comply with the UCITS and AIFM Directives, in addition to disclosure requirements included in the MiFID II framework for some services, in the Shareholder Rights Directive II, the Securities Financing Transaction Regulation, the Benchmark Regulation, the Money Market Funds Regulation, the European Long Term Investment Fund Regulation, EMIR reporting, and in future possibly under the currently proposed Regulation on facilitating cross-border distribution of collective investment funds. In the past few years, the industry has experienced significant inconsistencies of legal texts and we would therefore ask policymakers to keep this in mind during this legislative process to ensure the text is not drafted in ways causing inconsistent outcomes.

DETAILED COMMENTS REGARDING DISCLOSURES PROPOSAL

- **Article 1**:

  The term 'sustainability objective' or 'sustainable investment policy' would be preferable to the term 'target' which appears to have a quantifiable connotation. Objectives are typically of qualitative nature (although an asset manager may choose to specify quantifiable objectives for some products) while quantitative targets tend to suggest impact investments. There has to be a clear definition of what is meant by 'ESG/sustainability' risks and 'sustainability objective'. ESG/sustainability risks are typically understood as referring to "sustainability of the business/performance", i.e. risks to the company itself and its financial performance arising from negative externalities of the business or its ESG practices. This is different from a 'sustainability objective', which would typically be aimed at supporting businesses with sound ESG practices and positive impacts on the environment or society. The differentiation is critical as sub-standard ESG practices and negative externalities may not amount to a material risk for the business (e.g. a coal-powered utility in China may be a low ESG risk investment for many years to come, but would not qualify for a fund with a stated sustainability objective). In practice, there will be many more strategies fully integrating material ESG risk considerations into investment decisions, without pursuing any specific sustainability objective.

- **Article 1 and Article 2(o):**

  - We recommend clarifying the term 'sustainable investments'. Paragraphs (i) and (ii) of Article 2(o) correspond to what is usually referred to as impact investments, which represent a small portion of ESG strategies and will remain niche products by nature. The emphasis on "an economic activity that contributes to an environmental/social objective" suggests all funds conducting a systematic ESG screening and/or applying a shareholder engagement policy would fail to be included. Exclusionary/ negative screening strategies and positive screening/best-in-class strategies are the most commonly used ESG strategies. For example, asset owners who want to avoid funding companies violating human rights exclude such companies from their investments. In practice, this would mean that most strategies that are sustainable today would not meet the terms of the new proposal, without any analysis or explanation provided. In line with the diverse sustainability goals of asset owner clients, a wide range of approaches is used by asset managers to satisfy their clients' needs. Ultimately, only this diversity will ensure the desired sustainability effect across all asset classes and economic sectors. Hence, the definition of "sustainable investment" should encompass screened investments, best-in-class responsible investment, impact investing, stewardship, thematic investing and ESG integration.
  - The scope of Article 2 (o)(ii) appears to describe a EuSEF. If this is the legislation's intention, it should be clarified.
  - 'Sustainable investments' are also defined as an economic activity that contributes to an environmental or social objective or invests in companies following good

governance practices. There is a risk that the lack of clarity on what are sustainable economic activities in the EU would persist under this current wording. For an investment to qualify as sustainable from a governance perspective (Article 2 (o)(iii)), it is required that the company in which the investment is made already has good governance. This differs substantially from current views on governance where focus is on how the asset manager can contribute, through a dialogue with companies and voting at AGMs, to improving governance of the company.

- **Article 3:**

  The primary obligation in this proposal is to write a policy on the integration of sustainability risks in the investment decision-making process. While we support the obligation to publish a written policy on the integration of ESG related issues in the investment decision process, it is unclear what 'sustainability risk' (Article 3) means, given that there is only a definition of 'sustainable investments'. This concept is at the core of the proposal but is not defined. The terminology used in article 10 ('factors' and 'risk management') is clearer than the terminology used in articles 3 and 4. Consistent terminology should be used throughout the three proposals.

- **Article 4:**

  - Article 4(1)(a) – We do not understand the term 'conditions', which we recommend deleting ('procedures' would be more appropriate).
  - Article 4(1)(a) – We note that article 3(1) refers to 'integration of sustainability risks in the investment decision-making process' and article 4(1)(a) to 'integrating sustainability risks in investment decisions'. We recommend using the same terminology in both articles.
  - Article 4(1)(b) –
    - The notion of 'relevant impact on the returns' is ambiguous and might lead to the reference to targets or quantifiable objectives.
    - Will there be any guidance on a methodology for how that should be measured/anticipated?
    - Further analysis and guidance is required on how this will overlap with the Revised Shareholder Rights Directive.

- **Article 5:**

  - The benchmark provisions should only apply where a fund or service has sustainable investing as a specific objective and a decision has been made to adopt a benchmark which specifically purports to be a sustainable benchmark in relation to that fund or service. The benchmark obligations should not apply more broadly.
  - Article 5(1) – It should be clarified that there is no obligation to use an index, and it is simply an option. The emphasis on sustainability focused benchmarks to gauge performance implies that ESG considerations necessarily require a different way of considering performance.

- Article 5(1) – The term 'investments with similar characteristics' is unclear and uncertain from a legal perspective. What is the difference between a 'sustainable investment' and an investment which has 'similar characteristics'?
- Article 5(1) – We recommend clarifying that paragraphs (a) and (b) should only apply to indices which have been replicated (i.e. index-tracking strategies). The sole use of a benchmark as a reference for tracking past performance or for fee calculation should not require compliance with (a) and (b). The difference must be made between a product that replicates an index and an index that is used to measure/compare the performance of the product.
- It would also be helpful to have further clarity on how this would work with regard to a comparison against a customised basket of broad market indices.
- It should be possible for benchmarks to be applied for comparison purposes without a need to justify the difference to the investment and the impact on sustainability it may have. Such performance comparison has nothing to do with the amplitude of the sustainability of the real investments. It will also not be possible for a portfolio manager to analyse single components of an index used as comparison benchmark as the required data may not be available and, even if it is, this will make a product a lot more expensive. Costs for such analysis clearly will be charged to the fund which ultimately reduces return for investors. It will also make the information provided not least to retail clients overly complex, without adding much of benefit to such clients.
- Throughout this article, we understand the use of 'target' to mean 'objective' rather than quantifiable target.
- Article 5(3) – There should be a definition of 'carbon emissions'. For example, would Scope 3 be captured by this definition? What happens in a situation where there is no data or it is inaccurate?

- **Article 6:**

  - How would transparency of sustainable investments on websites work for tailored portfolio management services or for single investor funds? While we are generally positive regarding providing information on websites, as this is a flexible and low cost way of providing and updating information, it is important to consider and determine more precisely what information should be provided and by whom.
  - The transparency requirement in article 6 should only apply if a share class is open to the public. Transparency in relation to sustainability cannot overrule the usual restriction on marketing. It is here, as elsewhere, important that a thorough overview and analysis is made of already existing rules.

- **Article 7:**

  - Article 7 (1)(a) -
    - How can the overall sustainability-related impact by a financial product by means of relevant indicators be described? Would this refer to the yield or an overall description of the sustainability impact?
    - Threshold amounts should be established.

- The amount of work cannot be justified in case of holding periods of less than 1 year – they should be exempted from reporting.
- An extensive guidance should be made available that includes examples, such guidance should be subject to an open consultation with concerned stakeholders.

* * *

Brussels, 23 August 2018
[18-4040]