Principles for Responsible Investment

# CONSULTATION RESPONSE

## PUBLIC CONSULTATION ON THE REVIEW OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

January 2021

PRI Association

Registered office: 5th floor, 25 Camperdown Street
London, UK, E1 8DZ  Company no. 7207947
T: +44 (0) 20 3714 3220  W: www.unpri.org  E:info@unpri.org

# THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 3,000 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $100 trillion in assets under management.[1]

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

This consultation response represents the view of the PRI Association and not necessarily the views of its individual members.

More information: www.unpri.org

**For more information, contact:**


Elise Attal
Head of EU & UK Policy
Elise.Attal@unpri.org

Hazell Ransome
Policy Analyst
Hazell.Ransome@unpri.org


[1]See https://www.unpri.org/signatory-directory/

## SUMMARY OF PRI RESPONSE

Alternative Investment Funds (AIFs) have an important role to play in supporting the EU's Green Deal and climate aspirations. In our recent report, *Delivering Net Zero Emissions In The European Union*, the PRI highlighted 5 priority policy areas for the EU to focus on when striving to achieve net zero by 2050, including energy efficient buildings and zero-carbon power. Holding assets in real estate or private equity, Alternative Investment Fund Managers (AIFMs) can contribute to these priorities and bridge investment gaps by taking advantage of the EU funds available such as InvestEU, the European Fund for Strategic Investment (EFSI), the European Structural and Investment Funds and the Smart Finance for Smart Buildings Initiative.

For this reason, the PRI has decided to respond to this consultation, focussing on questions relating to sustainability. We found recurring themes within these questions: firstly, whether AIFMs should be required to make further sustainability-related disclosures under the AIFMD; and secondly, whether AIFMs should be required to incorporate information that is not considered to be financially material into their investment decision-making process.

In response, the PRI makes two overarching recommendations, using the following terms with distinct definitions throughout:

- The **sustainability impact** of an investment decision is the effect it has on the environment, people or society as a whole. Negative sustainability impacts are labelled as '*Principal Adverse Impacts*' (PAI) or '*Adverse Impacts*' by the Commission. In the Sustainable Finance Disclosure Regulation (SFDR) PAIs are described as '*those impacts of investment decisions and advice that result in negative effects on sustainability factors'*. Sustainability impacts may or may not be financially material, and this can change with time.

- A **sustainability risk** (as defined by the Commission in the SFDR) is '*an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment'*. Therefore, sustainability risks are bounded by having clear financial materiality.

PRI's two overarching recommendations are:

- In terms of sustainability-related disclosures, **the European Commission should focus their attention on clarifying and harmonizing the SFDR and Taxonomy disclosure regulations**. It is advisable to avoid additional disclosure requirements for individual directives for different fund types – this piecemeal approach could lead to unnecessary complexity. **Any changes to the AIFMD must be aligned with, and avoid contradicting, the requirements AIFMs must meet under the SFDR and Taxonomy**.

- The PRI strongly advocates for the incorporation of sustainability issues in investment decision making. We encourage investors to also consider sustainability impacts as part of this process and argue that the direction of regulatory reforms should be aligned to this goal. We recommend the Commission undertake **legal and impact analysis to determine whether to introduce a specific mandatory requirement related to sustainability impact for AIFMs. In addition, the Commission should ensure consistency of approach across investor types, not only AIFMs,** as they develop impact-related regulations, to ensure a coherent regulatory framework which is fair and aligned with the SFDR and Taxonomy regulation.

## CONSULTATION RESPONSE

**Section II**

**Question 36. Are the mandatory disclosures under the AIFMD sufficient for investors to make informed investment decisions?**

- **Yes**
- **No**
- **<u>Don't know/ No opinion/ Not relevant</u>**

**Question 36.1 If not, what elements of the mandatory disclosures under the AIFMD could be amended? Please explain your position presenting benefits and disadvantages of the potential changes as well as costs:**

The PRI is strongly in favour of environmental, social and governance (ESG) disclosure requirements for fund managers and companies. It is necessary for investors to have a complete picture of the risks not only to the intrinsic value of the product but also the risks or benefits they could bring to the wider environment and society. However, new additional mandatory sustainability-related disclosures should not be added to the AIFMD delegated regulation.

Currently under the Commission delegated regulation 231/2013/EU (AIFMD delegated regulation), AIFMs are required to disclose information which includes but is not limited to: conflicts of interest, investment risk profile and management systems. However, there is no requirement to disclose information relating to ESG factors. That said, AIFMs already fall under the scope of the regulation on sustainability-related disclosures in the financial services sector (regulation (EU) 2019/2088 – the SFDR) and the Taxonomy regulation ((EU) 2020/852). Under these regulations (articles 6(3) an 11(2) of the SFDR and articles 5-7 of the Taxonomy regulation) AIFM's must disclose their Taxonomy alignment and their consideration of principal adverse impacts and sustainability risks in their annual reports, alongside information about their risk management policies (see articles 40, 22 and 23 of the AIFMD delegated regulation).

Therefore, it seems unnecessary to add any further sustainability-related disclosure requirements specifically for AIFMs. In response to the European Commission's consultation on the regulatory technical standards (RTS) for the SFDR, the PRI highlighted that there is risk of confusion and investor burden with both the SFDR and Taxonomy regulation providing two distinct sets of indicators for measuring related concepts. Another set of requirements for ESG disclosure, for only one investor type, would likely lead to more confusion.

Instead, the PRI recommends that the Commission focusses on aligning the SFDR and Taxonomy regulations and improving those as required, rather than making piecemeal changes to different fund-type directives. If any changes are made to the AIFMD, they must be aligned with, and avoid contradicting, the requirements AIFMs must meet under these two regulations.

**Section VI**

**Question 90. The disclosure regulation 2019/2088 defines sustainability risks and allows their disclosures either in quantitative or qualitative terms. Should AIFMs only quantify such risks?**

- **Yes**
- **<u>No</u>**
- **Don't know/ No opinion/ Not relevant**

**Question 90.1 Please substantiate your answer to question 90, also in terms of benefits, disadvantages and costs as well as in terms of available data.**

ESG disclosure must be accurate and useful to create the change in the financial market needed to advance progress towards a sustainable financial system.

Investors should be encouraged to disclose quantitative data first, when possible, "and/or" qualitative information (rather than on an 'either/or' basis) so that they have the opportunity to ensure the information is as accurate and as useful as possible for clients to make sustainable choices. This will create incentives, while recognising that, at this stage quantification of some sustainability risks isn't feasible.

In PRI's response to the RTS consultation for SFDR, we argue that the current structure of the SFDR disclosure requirements must be improved to include a process which allows an investor to not only provide quantitative information about adverse impacts but also comment on how it embeds responsible business conduct into policies and management systems; identifies and assesses adverse impacts in the firms in which it invests; ceases, prevents or mitigates adverse impacts; communicates how impacts are addressed; and provides for, or cooperates in, remediation where appropriate.

The Commission should carefully select and define which information is the most useful to investors. Any changes made to investor disclosure requirements should be done through the SFDR rather than any individual investor regulation (such as the AIFMD) to ensure consistency across regulations for all investors.

**Question 91. Should investment decision processes of any AIFM integrate the assessment of non-financial materiality, i.e. potential principal adverse sustainability impacts?**

- **Yes**
- **<u>No</u>**
- **Don't know/ No opinion/ Not relevant**

**Question 91.1 Please substantiate your answer to question 91, also in terms of benefits, disadvantages and costs. Please make a distinction between adverse impacts and principal adverse impacts and consider those types of adverse impacts for which data and methodologies are available as well as those where the competence is nascent or evolving.**

The implication of this question that sustainability impacts can't be financially material is misleading. The PRI understands the sustainability impact of an investment decision to be the effect it has on the environment, people or society. Impacts on the environment and society may also have impact on financial value and the dynamic between sustainability impacts and financial materiality can change with time.

We recommend the Commission make its definition of 'sustainability impact' clear and explicit. In the SFDR, the Commission does not define precisely principal adverse impacts but states they can be '*understood as those impacts of investment decisions and advice that result in negative effects on sustainability factors'.* There is also no precise definition of (principal) adverse impacts in the draft RTS. Such definition should not imply the distinction between risk and impact with reference to financial and non-financial materiality for the above reasons.

The PRI is becoming increasingly focussed on how investors can consider the sustainability impacts of their investments and work towards positive 'real word outcomes'. It is the central aim of our upcoming 3-year strategy for 2021-2024, and has been the central pillar of many of our projects including Investing with SDG outcomes: a five-part framework; Driving Meaningful Data Financial materiality, sustainability performance and sustainability outcomes; and A Legal framework for Impact – an ongoing programme by the PRI, UNEP FI and The Generation Foundation to examine how investors can consider impact in relation to investor duties.

The PRI encourages investors to consider sustainability issues both for risk-adjusted investment returns, and to assess their environmental and social impacts. We support regulatory reforms aligned to this goal and recommend the Commission undertakes legal and impact analysis to determine whether to introduce any mandatory requirements for AIFMs.

We also recommend the Commission consider all investors, not only AIFMs, as they develop impact-related regulations, to ensure a coherent regulatory framework which is fair and aligned with the SFDR and Taxonomy regulation. In addition, we also recognise that many investors (particularly private equity investors and others who fall under AIFMD) are working through meeting the impact disclosure requirements of the SFDR and caution against adding further requirements at this stage.

**Question 92. Should the adverse impacts on sustainability factors be integrated in the quantification of sustainability risks?**

- **Fully agree**
- **Somewhat agree**
- **Neutral**
- **Somewhat disagree**
- **Strongly disagree**

- **<u>Don't know/ no opinion/ not relevant</u>**

**Question 92.2 Please explain your answer to question 92:**

'Sustainability risks' and 'adverse impacts' represent two very different, yet equally important frameworks within EU sustainable finance legislation. The PRI understands the two terms to have the following meanings:

- The **sustainability impact** of an investment decision is the effect it has on the environment, people and/or society. Negative sustainability impacts are labelled as '*Principal Adverse Impacts*' or '*Adverse Impacts*' by the Commission (in the SFDR PAIs are defined as '*those impacts of investment decisions and advice that result in negative effects on sustainability factors'*). Sustainability impacts may or may not be financially material, and this can change with time.

- A **sustainability risk** (as defined by the Commission in the SFDR) is '*an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment'*. Therefore, sustainability risks have financial materiality.

Evidently, it is important for an investor to consider both 'sustainability risks' and 'adverse impacts'. However, it would be confusing to combine both of these terms into one definition; the distinction and requirements for disclosures around sustainability risks and adverse impacts (both of which must be considered in investment decision-making) are already set out in the level 1 text of the SFDR. The Commission should not make any changes to the AIFMD delegated regulation which confuses these two terms and thus impedes an AIFM's ability to comply with the SFDR regulation.

In terms of the distinction between adverse and principal adverse impacts, as set out in our response to the European Commission's consultation on the RTS for the SFDR, the PRI recommends that investors should be able to identify the most significant issues in their overall portfolio but that climate change and respect for human rights should be always be considered (i.e. these are the central topics for *principal* adverse impacts) considering their systemic nature and significance for all investors.

**Question 93. Should AIFMs, when considering investment decisions, be required to take account of sustainability-related impacts beyond what is currently required by the EU law (such as environmental pollution and degradation, climate change, social impacts, human rights violations) alongside the interests and preferences of investors?**

- **Yes**
- **No**
- **No, ESMA's current competences and powers are sufficient**
- **<u>Don't know / no opinion / not relevant</u>**

**Question 93.1 If so, how should AIFMs be required to take account of the long-term sustainability and social impacts of their investment decisions? Please explain.**

See previous response to Q91.

The PRI strongly advocates for the incorporation of sustainability issues in investment decision making. We encourage investors to also consider sustainability impacts as part of this process and support that the direction of regulatory reforms should be aligned to this goal.

We recommend the Commission undertake **legal and impact analysis to determine whether to introduce a specific mandatory requirement related to sustainability impact for AIFMs beyond what is currently required by EU law.** In line with our upcoming 3-year strategy, we intend to explore this topic further in the future.

**Question 94. The EU Taxonomy Regulation 2020/852 provides a framework for identifying economic activities that are in fact sustainable in order to establish a common understanding for market participants and prevent green washing. To qualify as sustainable, an activity needs to make a substantial contribution to one of six environmental objectives, do no significant harm to any of the other five, and meet certain social minimum standards. In your view, should the EU Taxonomy play a role when AIFMs are making investment decisions, in particular regarding sustainability factors?**

- **Yes**
- **No**
- **Don't know / no opinion / not relevant**

**Question 94.1 Please explain your answer to question 94:**

As stated in our answer to question 91, the PRI encourages investors to integrate the sustainability risk and impacts into their investment decision-making. This will ensure a faster transition to a sustainable economy.

Currently the Taxonomy regulation and the SFDR are purely disclosure-based regulations. There is no requirement for investors to invest in Taxonomy eligible activities or meet certain alignment targets for example.

As investors grow confidence into the Taxonomy classification system, it is likely to play a more important role in most investors investment decision processes. Through the Taxonomy Practitioner's Group (a group of almost 40 signatories who submitted case studies on Taxonomy implementation in summer 2020), the PRI found that although the Taxonomy is operational and investors could make good progress in reporting, they faced challenges and requested further practical and interpretive guidance. Therefore, in order to build up investors' confidence in the operationality and effectiveness of these frameworks, the Commission should focus on harmonization, not creating new Taxonomy-related requirements only for certain fund types.

**Question 95. Should other sustainability-related requirements or international principles beyond those laid down in Regulation (EU) 2020/852 be considered by AIFMs when making investment decisions?**

- **Yes**
- **<u>No</u>**
- **Don't know / no opinion / not relevant**

**Question 95.1 Please explain your answer to question 95, describing sustainability-related requirements or international principles that you would propose to consider. Please indicate, where possible, costs, advantages and disadvantages associated therewith.**

Provided its integrity is maintained in the finalised delegated regulation this year, the EU Taxonomy is the most suitable tool to measure and report against environmental sustainability. The Taxonomy regulation 2020/852 sets necessarily high ambitions and, being evidence based and advised by non-political experts in a transparent process, it has importantly gained investor support. The Taxonomy covers social issues as well as environmental issues; the minimum social safeguards of the Taxonomy are based on the ILO core labour conventions, OECD guidelines for MNEs, and UN Guiding Principles on Business and Human Rights. Furthermore, as the 'Social Taxonomy' and 'Significant Harm Taxonomy' are developed, the Taxonomy will become an even more comprehensive toolkit to measure sustainability impact.

Therefore, the PRI argues that including any other sustainability-related requirements/principles in a new AIFM investment decision-making law would likely lead to unnecessary burden and confusion.