Principles for Responsible Investment

CONSULTATION RESPONSE

EUROPEAN COMMISSION

Integration of sustainability risks and factors and integration of sustainability into investment advice across the financial sector.

INTRODUCTION

ABOUT THIS CONSULTATION RESPONSE

This response reflects the PRI and UNEP FI 2015 report *Fiduciary Duty in the 21st Century*. In addition, it draws from preliminary analysis as part of the PRI, UNEP FI and The Generation Foundation project *A Legal Framework for Impact,* an ongoing programme to understand and analyse how investors can manage fiduciary duties and sustainability impact, and how to resolve situations where they may be in conflict. At this stage, we have identified some potential challenges within the framework. Formal recommendations from this programme will be shared in late 2020.

Below, we set out recommendations and further considerations in relation to Solvency II, MiFID II, UCITS and the Insurance Distribution Directive.[1]

BACKGROUND

Investors have a fiduciary duty to integrate financially material factors, including sustainability risks. The PRI strongly supports action by EU institutions to clarify the relationship between investor duties and sustainability. Since 2005[2] a growing body of analysis and opinion has demonstrated that failure to consider these issues in investment practice is a failure of investor's duties. The 2015 report, *Fiduciary Duty in the 21st Century*, recognised that outdated perceptions of fiduciary duty and sustainability and lack of regulatory clarity contributed to the lack of systematic integration of sustainability factors by investors. This was echoed in the 2016 consultation on long-term sustainable investment[3] and the 2017 consultation on the Capital Markets Union mid-term review[4], as well as the recommendations of the High-Level Expert Group on Sustainable Finance (HLEG)[5]. Clarification of these duties will encourage consistent and systematic integration of sustainability issues.

In recent years, PRI has recognised greater attention to real economy outcomes amongst investors (we understand *impacts* to refer to a *change in these outcomes*). In June 2020, the PRI released Investing with SDG outcomes[6] which sets out guidance to investors seeking to contribute to real-world outcomes aligned with the Sustainable Development Goals. Assessing and accounting for the sustainability impact of investment decision-making is increasingly part of investment activity, and indeed is integrated into European law through the "principal adverse impacts" disclosure requirements of the Regulation on Sustainability-Related Disclosures in the Financial Sector (Regulation (EU) 2019/2088 (hereinafter Sustainable Finance Disclosure Regulation "SFDR") and the EU Taxonomy. The proposed delegated acts introduce clauses designed to reinforce or support the "Principal Adverse Impacts" requirements embedded the Sustainable Finance Disclosure Regulation ("SFDR"). We note that the Commission's open consultation on a revised Sustainable Finance Action

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[1] Individual responses were submitted for each Directive/Regulation, and as such this document repeats the same analysis where relevant.
[2] A Legal Framework for the Integration of Environmental, Social and Governance issues into Institutional Investment (Freshfields, 2005).
[3] https://ec.europa.eu/information_society/newsroom/image/document/2016-44/feedback_final_pc_30068_en_19173.pdf
[4] https://ec.europa.eu/info/publications/mid-term-review-capital-markets-union-action-plan_en
[5] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf
[6] https://www.unpri.org/sdgs/investing-with-sdg-outcomes-a-five-part-framework/5895.article

Plan includes question 91 regarding further adapting fiduciary duties to require investors to consider and integrate adverse impacts of investment decisions on sustainability.

Responding to the sustainability preferences of clients or beneficiaries is an important driver of sustainability impact management, and the concept of preferences may be connected to the discharge of fiduciary (equivalent) duties. The PRI strongly supports the Commission's aim to increase dialogue between financial institutions and their institutional and retail clients around the sustainability preferences clients may hold. The majority of retail clients would prefer their investment products to give greater attention to sustainability.

SOLVENCY II

Under clarifications to the Solvency II delegated acts, the prudent person principle requires insurance and reinsurance undertakings to consider sustainability risks, the potential long-term impact of their investment strategy and decisions on sustainability factors, as well as respond to the sustainability preferences of customers subject to product approval processes. This applies irrespective of whether the insurer or reinsurer is complying with the adverse impact requirements of SFDR.

These clarifications will provide greater comfort to insurers and reinsurers seeking to integrate impact considerations, although practical challenges may remain in the absence of clear guidance on resolving potential conflicts between sustainability impact and financial return. In the Commission's open consultation on a revised Sustainable Finance Action Plan, question 91 asks whether there are merits in further adapting the prudent person principle to require (re)insurers to consider and integrate adverse impacts of investment decisions on sustainability. The proposed amendments described here, while positive, would permit rather than require any such consideration.

We have substantial concerns about the proposed harmonised definition of "sustainability preferences" which would restrict sustainability preferences to an augmented version of the definitions in SFRD. This is problematic for several reasons:

1. It defines a consumer's preference in relation to a regulated fund category. It is very unlikely that an end-investor will formulate their preference in this way, or that this categorisation will be helpful in creating meaningful dialogue between advisors and clients. In addition, the categories themselves – while they cannot be changed without amending Level 1 Regulation – do not accurately reflect the sustainability outcomes an investor may expect from different products.
2. The gold-plating of Article 8 funds is misguided. We understand Article 8 funds to be a "catch-all" category which would include a large number of existing sustainable, ESG and SRI strategies on the market. Article 9 funds, by contrast, focus on allocating capital to sustainable activities and avoid exposure to activities which are substantially harmful. As we understand it, the proposed delegated acts would require Article 8 funds to also pursue some sustainable investments and to avoid significant harm across all underlying investments. This is a concern for several reasons:

   a) this reflects an inaccurate understanding of how individual investors can influence outcomes in the real economy. In many cases, exposure to harmful activities is essential to influencing environmental performance of underlying investee (for example, through voting in support of adoption of meaningful climate transition plans). Stating that a client can only have a preference for a fund that avoids all exposure to harmful activities would remove fund options that may be better aligned with their preferences.
   b) The requirement also adds further confusion to the definition of Article 8 and 9 funds. The framework implies that Article 8 funds may target and include some "sustainable investments" in line with the regulatory definition. However, it is not clear at what point this would become an Article 9 fund, given that no minimum expectation is set for Article 9 funds' exposure to "sustainable investments".
3. For insurance and reinsurance undertakings, the clarifications to the prudent person principle state "*(the investment..) strategy and those decisions shall reflect the sustainability preferences of its customers taken into account in the product approval process*". This could be interpreted as mandating insurance and reinsurance firms to develop specific products in line with the categories embedded in the definition.
4. Finally, while we expect a high, and increasing, number of clients (retail and institutional) to express a preference for funds with positive sustainable characteristics, it is still legitimate that some clients will prefer to rely on the regulatory minimum expectations which have been strengthened through the other provisions in the delegated acts, as well as through the Disclosure Regulation and revised Shareholder Rights Directive. Logically, the definition should allow for a client to express no preference for sustainability outcomes.

The Disclosure Regulation and the Taxonomy Regulation both set fund-level disclosure requirements for Article 8 and 9 funds. Rather than define a client's sustainability preferences in relation to fund categories, we recommend that the Commission establish a broader definition of sustainability preferences, while in parallel ensuring that the fund-level sustainability disclosures provide a clear, coherent and accessible framework for understanding the sustainability profile of the products.

The PRI recommends the following alternative definition:

Sustainability preferences means a client's or potential client's choice as whether, to what extent and how sustainability-related investment objectives should be reflected into his or her investment strategy.

UCITS

The proposed amendments to the delegated acts underpinning UCITS state that sustainability risks should be considered in risk management, conflict of interest and governance. However, they do not directly address the need to integrate sustainability risks when determining how to act in the best interests of end investors. Without explicit clarification of the relationship between sustainability and fiduciary duties, we are concerned that investors will continue to lack the necessary certainty, undermining systematic integration of sustainability risks.

To address the sustainability risk angle, the PRI recommends that clarification be introduced to the following clauses:

a) Article 22 of Commission Directive 2010/43/EU (UCITS delegated directive); and
b) Article 17 of Commission Delegated Regulation 231/2013/EU (AIFMD delegated regulation);

This clarification should reflect the recommendations of the EU High Level Expert Group on Sustainable Finance which include:

- Clarification that sustainability risks and opportunities should be taken into account, consistent with the investment timeframe of the client;
- Financial market participants should proactively seek to understand the sustainability preferences of their clients and incorporate those preferences into decision-making and stewardship where possible.

Regarding impact, UCITS management companies are required to incorporate principal adverse impacts into their due diligence processes, where they consider them under their SFDR obligations, but no clarification is made regarding fiduciary duties. In the absence of an investment policy which makes specific reference to sustainability objectives, the best interests will likely be understood as the financial best interest. In many cases, we expect that sustainability impact and financial materiality can be pursued in tandem. However, there are cases where an investment decision may require resolution of a conflict between financial return and sustainability impact. In addition, stewardship – a critical tool for investors to influence the performance of investees, and therefore real economy outcomes – may incur additional costs, which may be considered not to consistent with the "best interests" of the UCITS unless a clear financial benefit can be expected.

In the Commission's open consultation on a revised Sustainable Finance Action Plan, question 91 asks whether there are merits in further adapting fiduciary duties to require investment firms to consider and integrate adverse impacts of investment decisions on sustainability. The proposed amendments do not offer clarity around whether these issues can be taken into account as part of pursuing best interests. They therefore offers little comfort to investors seeking to introduce impact into their investment decision-making and stewardship activities, including where they are doing so to comply with the SFDR disclosure obligations. In addition, by focussing only on negative impacts, the framework is increasingly at odds with market practice, as investors typically seek to maximise positive outcomes as well as minimise negative outcomes.

MIFID II

The proposed amendments to the delegated acts underpinning MiFID state that sustainability risks should be considered in risk management, conflict of interest and governance, but do not directly address the need to integrate sustainability risks when determining how to act in the best interests of clients (as defined in Article 24(1)). In the context of MiFID, investment decisions are also substantially guided by the concept of "suitability" of the investment in relation to the individual client. The proposed amendments to Delegated Directive (EU) 2017/593 and Delegated Regulation (EU) 2017/565 do require investment firms to consider the sustainability preferences of clients in

determining the suitability of products, in addition to risk. The proposed amendment to Article 54 would clarify that the client's sustainability preferences should be considered in the suitability assessment alongside their risk tolerance. However, although this framework does not prohibit consideration of sustainability risk, it does not explicitly clarify that sustainability risks should be considered either.

To address sustainability risk, the PRI recommends that Commission delegated regulation 2017/565/EU (MiFID II delegated regulation) be amended as follows:

- Article 65 of be amended to clarify that sustainability risks and opportunities should be considered;
- Article 54 be amended to clarify that sustainability risks should be considered (as a sub-set of the client's overall risk tolerance) as well as sustainability preferences.

The concept of impact is addressed through the lens of suitability. Investment firms are required to consult clients on their sustainability preferences, but the draft delegated acts do not explicitly require providers to systematically offer sustainable investment products, when the provider has them available and otherwise meeting all requirements regarding cost and suitability. In the Commission's open consultation on a revised Sustainable Finance Action Plan, question 91 asks whether there are merits in further adapting fiduciary duties to require investment firms to consider and integrate adverse impacts of investment decisions on sustainability. The proposed amendments provide a route by which impact may be considered but would not require systematic consideration. In addition, we have substantial concerns with the proposed definition of "sustainability preferences" in the delegated acts[7]:

"(7) 'sustainability preferences' means a client's or potential client's choice as to whether either of the following financial instruments should be integrated into his or her investment strategy:
(a) a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;*
(b) a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 and that either:

> *(i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or*
> *(ii) as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in Article 7(1), point (a), of that Regulation; or*

The definition would restrict sustainability preferences to an augmented version of the definitions on the regulation on Sustainability-Related Disclosures in the Financial Services Sector. This is problematic for several reasons:

1. It defines a consumer's preference in relation to a regulated fund category. It is very unlikely that an end-investor will formulate their preference in this way, or that this categorisation will

[7] The text from MiFID II delegated acts is given as an example, but the concept is harmonised across all delegated acts in scope.

be helpful in creating meaningful dialogue between advisors and clients. In addition, the categories themselves – while they cannot be changed without amending Level 1 Regulation – do not accurately reflect the sustainability outcomes an investor may expect from different products.

2. The gold-plating of Article 8 funds is misguided. We understand Article 8 funds to be a "catch-all" category which would include a large number of existing sustainable, ESG and SRI strategies on the market. Article 9 funds, by contrast, focus on allocating capital to sustainable activities and avoid exposure to activities which are substantially harmful. As we understand it, the proposed delegated acts would require Article 8 funds to also pursue some sustainable investments and to avoid significant harm across all underlying investments. This is a concern for several reasons:
    c) this reflects an inaccurate understanding of how individual investors can influence outcomes in the real economy. In many cases, exposure to harmful activities is essential to influencing environmental performance of underlying investee (for example, through voting in support of adoption of meaningful climate transition plans). Stating that a client can only have a preference for a fund that avoids all exposure to harmful activities would remove fund options that may be better aligned with their preferences.
    d) The requirement also adds further confusion to the definition of Article 8 and 9 funds. The framework implies that Article 8 funds may target and include some "sustainable investments" in line with the regulatory definition. However, it is not clear at what point this would become an Article 9 fund, given that no minimum expectation is set for Article 9 funds' exposure to "sustainable investments".
3. Finally, while we expect a high, and increasing, number of clients (retail and institutional) to express a preference for funds with positive sustainable characteristics, it is still legitimate that some clients will prefer to rely on the regulatory minimum expectations which have been strengthened through the other provisions in the delegated acts, as well as through the Disclosure Regulation and revised Shareholder Rights Directive. Logically, the definition should allow for a client to express no preference for sustainability outcomes.

The Disclosure Regulation and the Taxonomy Regulation both set fund-level disclosure requirements for Article 8 and 9 funds. Rather than define a client's sustainability preferences in relation to fund categories, we recommend that the Commission establish a broader definition of sustainability preferences, while in parallel ensuring that the fund-level sustainability disclosures provide a clear, coherent and accessible framework for understanding the sustainability profile of the products.

The PRI recommends the following alternative definition:

Sustainability preferences means a client's or potential client's choice as whether, to what extent and how sustainability-related investment objectives should be reflected into his or her investment strategy.

INSURANCE DISTRIBUTION DIRECTIVE

We have substantial concerns with the proposed definition of "sustainability preferences" in the delegated acts[8]:

"(7) 'sustainability preferences' means a client's or potential client's choice as to whether either of the following financial instruments should be integrated into his or her investment strategy:
(a) a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;*
(b) a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 and that either:

> *(i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or*
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    e) this reflects an inaccurate understanding of how individual investors can influence outcomes in the real economy. In many cases, exposure to harmful activities is essential to influencing environmental performance of underlying investee (for example, through voting in support of adoption of meaningful climate transition plans). Stating that a client can only have a preference for a fund that avoids all exposure to harmful activities would remove fund options that may be better aligned with their preferences.
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