Principles for Responsible Investment

PRI RESPONSE

FCA DISCUSSION PAPER DP23/1 – FINANCE FOR POSITIVE, SUSTAINABLE CHANGE

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PRI Association

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

UN environment programme finance initiative | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (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 as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range 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.

ABOUT THIS CONSULTATION

The Financial Conduct Authority (FCA) are consulting on how firms' governance, incentives and competencies align with their integration of sustainability-related considerations and their commitments to contribute to positive change. They are interested in how firms embed a clear purpose, how this relates to sustainability objectives, and the strength of the 'tone from the top' on sustainability-related matters. The FCA recognise that the transition to net zero requires a huge transformation and have commissioned 10 articles from international thought leaders on different aspects of governance, remuneration, incentives, training and stewardship.

For more information, contact:

Eliette Riera

Head of UK Policy, PRI

eliette.riera@unpri.org

Sebastien Akbik

Corporate Governance Analyst

sebastien.akbik@unpri.org

Louisa Guy

UK Policy analyst

louisa.guy@unpri.org

Clara Melot

Specialist, Stewardship

clara.melot@unpri.org

KEY RECOMMENDATIONS

The PRI welcomes the continued work of the FCA to support the financial sector in enabling an economy-wide transition to net zero and to a sustainable future. Additional clarity is required to ensure that firms, through their governance arrangements, incentive structure and organisational skills and capabilities, can reach their sustainability-related claims and commitments. To support progress toward global sustainability goals and thresholds, the PRI supports regulatory progress to remove barriers to investors contributing to positive sustainability outcomes.

The PRI's key recommendations are summarised below.

- **The FCA should clarify expectations on how firms' culture and behaviours can achieve their business purpose, whilst managing positive sustainability outcomes.** Further work should be done to identify signals or incentives to encourage financial services firms to pursue clear and well-articulated long-term plans, with concrete actions designed to deliver change.
- **The FCA should consider updating their general guidance to ensure that firms have the right skills and knowledge on material climate- and sustainability- related risks**, opportunities and impacts on their boards, as well as ensuring that the board has access to external counsel on complex climate- and sustainability- related matters.
- **Decision-useful reporting is required on sustainability-related targets, performance against those targets and the actual impact on pay.** To promote sustainable value creation, and avoid creating incentives contrary to this objective, transparent reporting of remuneration should highlight how pay packages are structured appropriately and what role sustainability factors play in compensation.
- **The FCA should continue to signal the importance of adequate resourcing of stewardship functions**. The FCA should also more widely explore barriers to adequate resourcing and resourcing disclosures.
- **The FCA should play a role in clarifying the legal responsibility to address market-wide and systemic risks** and consider ways for all investors to outline their approach to these challenges in their governance and objectives.
- **Further clarity is required** to ensure that investors understand the full extent of their legal duties, especially where they require or permit them to consider pursuing sustainability goals. In the absence of more explicit guidance and direction, asset owners and asset managers may remain hesitant to use investment decisions, stewardship and policy engagement to pursue positive sustainability impacts.

DETAILED RESPONSE

CHAPTER 3 – ESG GOVERNANCE, REMUNERATION AND INCENTIVES IN REGULATED FIRMS

Question 1: Should all financial services firms be expected to embed sustainability-related considerations in their business objectives and strategies? If so, what should be the scope of such expectations? Please explain your views

Sustainability-related considerations have material effects on financial risk and return in the short and long term, and therefore on investors ability to achieve their investment objectives and fulfil their legal duties. Using relevant information to integrate ESG factors in investment decision making **and contribute to achieving sustainability goals can help improve investment returns** and protect portfolios in the interests of clients and beneficiaries, especially over the long term. All investors should integrate relevant sustainability considerations into their investment decisions, as failing to do so not only results in unmitigated risks and missed opportunities, but also risks breaching fiduciary duties. Investors are also likely to have a legal obligation to consider pursuing sustainability impact goals where doing so could help achieve their investment purpose and objectives.

PRI signatories recognise that they "have a duty to act in the best long-term interests" of their beneficiaries, and that "environmental, social and corporate governance issues can affect the performance of investment portfolios". Many investors, including non-PRI signatories, are now looking beyond the impacts of ESG risks on their portfolios to understand the sustainability impacts of their portfolios have. As highlighted in the report A Legal Framework for Impact (2021), authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, the United Nations Environment Programme Finance Initiative and the Generation Foundation, investors also recognise that **financial returns depend on the stability of social and environmental systems**. Institutional investors – especially those that are focused on long-term financial returns – have **a responsibility to consider** whether such system-level risks are relevant to their ability to meet their legal obligations and objectives and, if so, how they can mitigate these risks.

Insights from PRI reporting data on signatory practices shows that clients and beneficiaries, policy makers and other stakeholders are increasingly **requiring investors to align their investments with the global sustainability objectives** of society, including those set out in the SDG targets and indicators, the Paris Agreement, and the International Bill of Human Rights.

To meet these expectations and responsibilities, investors need to understand and manage the real-world, sustainability outcomes connected to their activities.

Sustainability outcomes include those that:

- must be addressed for economies to operate within planetary boundaries, such as climate change, deforestation, and biodiversity loss;
- must be in place to drive inclusive societies, such as human rights (including decent work), diversity, equity, and inclusion; and

- are needed in corporate cultures to ensure sustainability performance, such as tax fairness, responsible political engagement, and anti-corruption measures.

These outcomes are understood in the context of – and assessed against – global sustainability goals and thresholds mentioned above.

To support progress toward these global sustainability goals and thresholds, investors should seek to decrease negative outcomes and increase positive outcomes arising from their actions, including by aligning their business objectives and strategies with achieving these goals.

The extent to which legal frameworks permit or require investors to pursue sustainability impact goals is examined in the A Legal Framework for Impact report.

Our response to **Question 12** includes more detailed information on findings from this work programme, including UK-specific recommendations.

Question 2: Beyond the FCA's ongoing work on diversity and inclusion, and introduction of the Consumer Duty, should we consider setting regulatory expectations or guidance on how firms' culture and behaviours can support positive sustainable change? Please explain your views.

Yes, the FCA should consider further steps to clarify expectations on this topic, either through regulation or clearer guidance.

As indicated in the PRI's Policy Engagement Handbook, well-designed policies build the foundations that support the development of society towards shared goals, enhance the resilience and stability of financial systems, as well as improving market efficiency.

In the PRI's work on diversity, equity and inclusion (DEI), we find the following benefits related to culture which can help to drive better financial and sustainability outcomes.

- **Decision-making**: specifically, within investment organisations, DEI can strengthen decision-making. A diverse and inclusive culture within the investment team is crucial to ensure it is working to represent and understand the end beneficiaries. According to Willis Towers Watson, investment teams with diversity, in particular ethnic diversity, tend to generate better excess returns. There is also a growing body of research to suggest that diverse teams can strengthen performance on other ESG issues. One study finds that diversity of skills, gender and age could accelerate the integration of climate-related issues by investors and boards of directors. Gender diversity is also said to lead to better identification of key ESG issues as critical to corporate strategy by the board. Diversity within investment organisations can also reduce conduct risk; prevent risky overinvestment decisions; result in fewer instances of fraud and fewer financial reporting mistakes and controversial business practices.
- **Employee engagement:** beyond the benefits of cognitive diversity, there is significant evidence that DEI can strengthen a company's ability to recruit and retain employees, although these are only fully realised when inclusion (as well as diversity) is part of the organisation's culture. A sense of inclusion can also lead to greater attendance at work,

improved performance, productivity, creativity and a better assessment of consumer interest and demand.

- **Brand value and market opportunities:** a diverse and inclusive workforce can help companies to understand and recognise the needs of different stakeholder groups. Consumers are increasingly looking for products that are accessible to everyone and can be used by a diverse range of people with different identities. In addition, consumers want to see commitments and evidence of action on DEI – companies that are slow to progress on DEI risk losing business. DEI within an organisation can strengthen its reputation and increase its client or customer base.

The PRI welcomed the FCA's study on understanding approaches to Diversity and Inclusion (D&I) in financial services. The insights provide a meaningful account of the gaps between D&I mandates, policy, strategy and D&I execution and implementation. The findings indicate that **most firms tackle D&I from a compliance basis**, which has notably different implications to a genuine commitment coming from the top. As the FCA noted, the firms' D&I strategies **lacked clear articulation of purpose and actions oriented to achieve their goals**. Therefore, **the current trajectory of the FCA's work on D&I is not producing adequate industry signals** that the market requires to spur behavioural change.

In this study, the FCA concluded by encouraging "all regulated firms to consider these findings and use them to assess their current diversity and inclusion strategies and practices.", however it is unclear whether a **follow-up outreach strategy** is in place. Regulatory expectations or robust guidance would encourage the market to coalesce around an ecosystem for positive sustainable change.

More broadly, a crucial element of culture and behaviour change on positive sustainable change lies in financial services firms pursuing long-term plans to deliver change**,** and the FCA should consider which signals or incentives encourage this, and contribute to level the playing field for financial services firms to support positive, sustainable change.

Question 3: What steps can firms take to ensure that they have the right skills and knowledge relating to material climate- and sustainability- related risks, opportunities and impacts on their boards? Should we consider setting any regulatory expectations or guidance in this area? If so, what should be the scope of such expectations?

Studies such as those done by the Boston Consulting Group and INSEAD and NYU Stern have found that companies **often lack the expertise on ESG issues at the board level**. Enhanced expertise, particularly on material sustainability matters, is of paramount importance if boards are to provide the necessary oversight on a firm's sustainability strategy. To ensure that firms have the right mix of skills and competence on sustainability issues, the PRI recommends that companies should:

- **assess board expertise on a regular basis** to identify any skills gap. Board skills matrices may assist in assessing spread of knowledge and experience on the board and identify any gaps that must be addressed through board renewals;

- **actively seek out expertise on sustainability issues** (as relevant to business operations, perspectives of stakeholders and financial considerations) in nominating and selecting directors;
- **ensure access to external counsel for the board on complex matters** such as scenario planning and conduct regular training in line with an assessment of members' skills and needs. This proactive training may also be supplemented with reactive training triggered by events such as, for example, mergers and acquisitions, or in response to systemic issues such as the urgent need to tackle climate change or stakeholder concerns; and
- **establish regular reporting channels between the board and executive team and other experts** so there is appropriate accountability and monitoring of material impacts. Board members should receive detailed briefings on performance against sustainability goals and strategy from the leadership team.

Over time, these measures should enable a majority of board members to be knowledgeable on key sustainability issues. This can be further tested from time to time through board questionnaires. These considerations can be **included in general guidance from the FCA**.

Question 4: What are likely to be the most effective strategies in embedding climate- and sustainability-related considerations across a firm's operations? What is the potential benefit of initiatives such as the appointment of functional 'champions', or the creation of dedicated working groups or forums? And how can the value of such initiatives be enhanced?

Demonstrating good climate risk management at Board level often crosses into other oversight areas such as public policy (ensuring Paris aligned policy and lobbying activities), and audit and accounting (ensuring this is in line with TCFD recommendations). This suggests climate oversight should ideally be integrated horizontally at Board level, to achieve a comprehensive and holistic oversight of climate change.

There has been an emergence of standalone board-level sustainability committees, many of which focus exclusively on climate in various jurisdictions, including in the UK[1]. The FCA could **look further into the effectiveness of such governance arrangements**. Standalone committees should not insulate the rest of the Board from sustainability or climate related considerations and accountability e.g. a standalone sustainability or climate committee shouldn't preclude other committees from integrating such matters. In keeping with sound corporate governance practices, the role, responsibilities and make-up of each board-level committee should be clearly defined and disclosed.

The Climate Action 100+ (CA100+) enhanced Benchmark 2.0 published this year assesses target companies on whether their board has clear oversight of climate change. Companies have various options to meet the assessment criteria on oversight of climate change with stand-alone board-level committees being just one of these options.

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[1] https://www.thecorporategovernanceinstitute.com/insights/news-analysis/over-half-of-ftse-100-firms-have-esg-board-committees/#:~:text=FTSE%20100%20companies%20are%20required,addressing%20their%20responsibilities%20on%20ESG

Question 8: What matters should firms take into consideration when designing remuneration and incentive plans linked to their sustainability-related objectives? In particular, we welcome views on the following:

a. the case for linking pay to sustainability-related objectives;

Executive pay should be **aligned with corporate strategy and performance to drive value creation**, and the PRI considers that linking ESG performance to pay can help hold executive management to account for the delivery of sustainable business goals.

In 2021, the PRI published recommendations for investors which highlighted that, if structured appropriately and implemented effectively, ESG-linked pay can:

- increase firm value;
- rebalance the excessive emphasis on short-term performance targets in typical remuneration packages, which may run contrary to long-term financial and sustainability objectives; and,
- create better accountability on sustainability-related performance.

However, existing remuneration packages do not always promote sustainable value creation and can risk creating incentives contrary to this objective. Often, even where ESG factors are incorporated into pay by companies, they do not reflect the ESG priorities for the business nor do they form a meaningful component of the overall remuneration framework.

To mitigate these risks, the PRI has called for **decision-useful reporting by companies on ESG targets, performance against those targets and actual impact on pay**. When integrating sustainability into executive pay, we recommend that:

- companies should adopt a clear process for identifying appropriate ESG metrics that relate to company strategy;
- companies should disclose how sustainability related targets included in executive remuneration are balanced with other metrics of financial performance that influence executive pay;
- companies should link appropriate ESG metrics to reward systems in a way that they form a meaningful component of the overall remuneration framework; and
- companies should endeavour to disclose the rationale, method and challenges presented by the incorporation of ESG metrics into executive pay clearly and concisely.

In our 2021 work looking at the research on ESG-linked pay, the PRI has not identified evidence for mandating a specific proportion of ESG-linked pay within remuneration packages. In fact, it could be sub-optimal and result in unintended consequences, for example, resulting in companies over-weighting ESG factors that may be easier to quantify, or adopting operational targets that would be easily met through the normal course of the business (e.g. in relation to compliance).

b. whether firms should break down their sustainability-related commitments into different factors, allocating specific weightings to each;

Boards should have the discretion to **select relevant ESG factors** and the appropriate balance of these factors in the remuneration package. This process should take into account material impacts on business operations, e.g. climate change for fossil fuel intensive industries, and that such factors are incorporated in executive remuneration packages. Sustainability factors should stimulate systematic progress towards sustainability ambitions, and should not reward executives for business as usual (e.g. maintaining compliance with laws and regulations) or for improving perceptions regarding sustainability performance (e.g. by tying pay to inclusion in sustainability indices, which are rarely specific to companies' ESG performance).

Further, companies should **explain how ESG issues could affect financial performance**, and how this is reflected in long-term incentive plans. Companies that choose not to incorporate ESG metrics into executive pay plans, or only link them to short-term incentive schemes, should adequately explain how ESG issues are reflected in financial performance and the delivery of long-term strategy.

Where companies face challenges in identifying the right metrics or targets for certain ESG issues, they should endeavour to **disclose these issues**, in addition to describing the process undertaken, so investors and stakeholders can understand the rationale and meaningfully input into the process.

The PRI has been calling for **decision-useful reporting** by companies on sustainability targets, performance against those targets and actual impact on pay. Transparent reporting of these matters should highlight how pay policies are structured appropriately and what role sustainability factors play in compensation actually paid.

Firms should endeavour to **specify the sustainability related factors and the specific weighting** of each significant factor that influence compensation. Firms should also seek to **identify specific targets that are quantifiable and specific** such as "reduce greenhouse gas on Scope 1+2 by 25% by 2030", as opposed to overarching qualitative criteria such as "delivery of sustainability strategy".

Further, firms should balance the need for executive pay plans that are closely tied to company performance including on sustainability and climate matters, and the need for simplicity, and understandability. Consideration should be given by firms not to further complicate remuneration reports, which are often already lengthy and complex.

c. whether short-term or long-term measures are more appropriate, or a combination of both;

The incorporation of ESG metrics into both long-term and short-term remuneration packages can be an important tool. However, in practice, companies tend to favour ESG metrics in short-term incentive plans,[2] potentially because of concerns that the performance period can affect the impetus to act on sustainability goals. Where this is a concern, firms should explain how annual targets contribute towards meeting longer-term sustainability objectives rather than setting one-off targets. **ESG metrics in long-term incentive plans** can enable longer-term decision-making.

[2] According to this study, 85% of UK companies tied their short-term incentive plans to at least one ESG measure, up from 79% the previous year, while the number of companies that used at least one ESG measure in their long-term incentive plan rose from 24% to 37% in the last year.

d. whether sustainability-related incentives should be considered for senior management only, or a wider cohort of employees;

This depends on many factors related to an entity's business model, structure, industry etc. Incentives for the wider workforce **should reflect the level of responsibility, duties and agency** that they have in achieving the company's sustainability targets.

e. how firms could consider remuneration and incentive plans in the design and delivery of their transition plans; and

Firms **should align their annual bonuses and long-term incentive plans with ambitious climate targets** to ensure that they are incentivised to deliver on their transition plans. It is critical that the targets and underlying measures are **objective and measurable**. They should have sufficient weight to be meaningful in the overall remuneration package. It is also essential that there is **clarity on how the targets have been set**, **measurement of performance** against those targets and actual impact on pay, so concerns around pay padding do not surface.

As the UK Transition Plan Taskforce (TPT) has highlighted, to ensure accountability for the delivery and monitoring of transition plans, entities should describe "whether and how the entity has put in place arrangements to align remuneration and incentive structures with the stated objectives and priorities in its transition plan". As the TPT has outlined, relevant decision-useful governance, business and operational metrics and targets, which includes remuneration and incentive plans, should be **clearly linked to the entity's climate objectives and priorities**, its implementation strategy of its climate targets, and its engagement strategy.

The PRI recommends that the FCA **aligns governance, business, and operational considerations within transition plans with forthcoming guidance** from the UK Transition Plans Taskforce. Further PRI views on the TPT's work can be found in our responses to the TPT's 2023 consultation and our response to their 2022 call for evidence.

Additional design approaches for incorporating climate measures are detailed below.

f. remuneration adjustments where sustainability-related targets (at either the firm level or individual level) have not been met.

The PRI supports **remuneration arrangements plans that include bonus/malus and clawbacks to adjust remuneration** when sustainability-related targets are not met. Malus pay structures (that allow downward adjustment of awards before they become payable) can incentivise executives to take precautions to mitigate risks to the company. Similarly, clawbacks provisions (whereby part of the awarded incentives is recouped) can discourage negligent management; and increase focus on sustainability issues by aligning pay with performance and long-term strategy to protect and create value.

Firms should set out clear circumstances under these adjustments will be applied. These should be broad enough as to act as effective adjustment mechanisms for sustainability-related performance (e.g., a clawback provision that only applies if the company is fined for sustainability related reasons might not penalise executives for sustainability-related failures that lead to financial or reputational loss but not to a penalty). Firms should have **robust and transparent processes for assessing performance** against malus and clawbacks provisions and should be prepared to justify these decisions to apply, or not apply, such provisions. In addition, the period of application of clawbacks should be given careful consideration given that the effects of poor performance or oversight of sustainability issues may become evident in the longer term.

The role of the remuneration committee in using these structures effectively is critical. They must exercise **independent judgement and appropriate discretion** in relation to remuneration outcomes. For instance, sustainability-linked pay should be adjusted where targets have been met as a result of external factors outside the control of executives such as changes in regulations or market conditions e.g., greenhouse gas reductions targets met as a result of an economic downturn.

Sustainability or climate related incentives can also be used as pre-condition metrics. For instance, pay structures for executives can include getaways whereby climate or sustainability related targets have to be met before executives become eligible to receive compensation for other incentives. Such structures can lead to greater alignment and coherency between incentives on sustainability related targets and incentives related to financial performance.

Question 9: Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.

There is growing concern regarding the disconnect between the level of achievement of ESG-linked targets that result in pay-outs to executives, and actual progress from corporations on climate change and sustainability issues. Recent research by the UK service provider PIRC found that among global listed companies using climate metrics in their executive bonus schemes, on average 80% of the climate related bonus is paid out.

The latest results from the CA100+ benchmark show that most companies are still failing to meet the assessment criteria on ambitious remuneration policies tied to companies' greenhouse gas targets. The FCA could look further into the impact of integrating climate and sustainability targets on company's sustainability performance.

Question 10: Should we consider additional regulatory measures to encourage effective stewardship, particularly in relation to firms' governance and resourcing of stewardship, and associated incentive mechanisms and conflict of interest policies? Are there regulatory barriers that we should consider? Please explain your views.

As the FCA continues to emphasise that investors have an obligation to exercise stewardship as part of investor duties owed to their clients or beneficiaries, stewardship resourcing represents an increasingly relevant issue.

While the PRI has only recently launched a new project on stewardship resourcing and has not formally consulted with signatories, early feedback points to a broad acknowledgement that **the quantum of resources dedicated to stewardship functions is often insufficient**.

In future regulatory efforts, as well as through upcoming guidance and interactions with regulated entities, the FCA and other relevant regulators could:

- keep signalling the importance of adequate resourcing of stewardship functions (with explicit reference to issuer-, fund-, portfolio- and system level-stewardship) in the discharge of fiduciary duty;
- considering current stewardship resourcing challenges, investors would benefit from standardised information with regards to the quantum of resourcing allocated to stewardship within the industry. In that respect, the proposed Sustainability Disclosure Requirements (SDR) and its requirement for disclosure of stewardship actions, strategies and outcomes for financial products with sustainability labels may contribute to greater visibility over stewardship resources. However, the FCA may be required to explore needs for resourcing related information at organisational level. The PRI's recently launched stewardship resourcing project exploring and assessing the appropriate level of resources that institutional investors should be prepared to dedicate to stewardship within their organisations;
- more widely explore and consider barriers to both increased resourcing and resourcing disclosures (including but not limited to cost limitations, mandates, minimum requirements); and
- the FCA should align and leverage the creation of any additional guidance or regulatory expectations with existing work being done by other regulatory bodies such as the Financial Regulation Conduct's review of the UK Stewardship Code and the forthcoming guidance from the UK Transition Plan Taskforce.

The PRI has undertaken extensive work on stewardship, including publishing a recent toolkit on "How policy makers can implement reforms for a sustainable financial system: stewardship". This report focuses on the development and implementation of stewardship (engagement, voting and active ownership) policies. We highlight that **the key to driving long-term improvements in investor stewardship will be gradually raising the threshold for stewardship practices established by regulation**, while ensuring the stewardship code recognises best-in-class practices. The UK stewardship code, implemented on a voluntary basis, has played a crucial role in guiding the improvement of stewardship practices and increasing public awareness and recognition of the value of stewardship.

Financial regulators should acknowledge and clarify that investor duties should include all fiduciary or asset management activities, including stewardship. Financial policy makers and regulators should ensure that stewardship is not treated, as it often is, as an investment activity suitable only for some purposes or for specific asset classes. Rather, policies should consistently promote the appropriate use of stewardship by investors as part of discharging their duties. This will create a foundational drive for institutional investors (both asset owners and asset managers) to improve governance and resourcing of stewardship and to monitor and assess the effectiveness of stewardship in delivering outcomes aligned with the best interests of clients or beneficiaries.

While setting out stewardship responsibilities through mandatory regulations, it is important to emphasise that institutional investors should retain the flexibility and the discretion to decide on a case-by-case basis whether and when to exercise stewardship considering the best interest of their clients or beneficiaries. In cases where they decide it is in their clients' or beneficiaries' best interests not to exercise stewardship, they should clearly communicate and explain the reasons to clients and beneficiaries. We have been engaging with the FCA and the Financial Reporting Council (FRC) on these topics and look forward to contributing to the ongoing review of the Stewardship Code and wider UK stewardship guidance.

Question 11: What additional measures would encourage firms to identify and respond to market-wide and systemic risks to promote a well-functioning financial system? How can the collective stewardship efforts of asset owners and asset managers best be directed towards the most pressing systemic issues? And how can remaining barriers best be reduced? Please explain your views.

Systemic risk and fiduciary duty

A Legal Framework for Impact encourages policymakers to clarify investors' legal duties. In particular, how duties are understood to facilitate investing for sustainable impact, such as allowing the pursuit of sustainability goals as long as financial return goals are prioritised, and a presumption in favour of investor collaboration to tackle sustainability challenges.

The FCA can **play a role in clarifying the legal responsibility to address these risks** and thereby create a strong drive for all investors to then detail their approach to addressing systemic sustainability challenges in their governance and objectives.

Systemic risks and stewardship

In the Legal Framework for Impact report, we identified stewardship as one of the key levers available for institutional investors seeking investment impacts to address systemic risks. Clarifying investors' legal responsibilities to address systemic risks would also involve the **clarification of investors' stewardship responsibilities.** This would reinforce that investors can take actions to shape investment impacts that are instrumental to addressing systemic risks and ultimately preserving and creating value for clients or beneficiaries and the responsibility to make disclosure to enable public scrutiny.

The FCA's proposed Sustainability Disclosure Requirements (SDR) set a strong example by recognising stewardship as one of the key channels for investors to obtain sustainability impacts or characteristics, and requiring investor disclosure of stewardship strategies, actions and outcomes for financial products with sustainability labels. However, further consideration of whether such responsibility of exercising stewardship and disclosure should be extended to all financial products or on an entity level would be useful.

Systemic risk and collaboration

Further, the Legal Framework for Impact report found that in the UK, "(...) there is no specific exemption to competition law for arrangements designed to address sustainability risks. (…) In most competition law regimes, exempt arrangements must be necessary and proportionate in order to provide an improvement to the production or distribution process, or a promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefits, and still allowing for sufficient residual competition in the market. (…) However, while there is some guidance and case law, there are not enough past examples to give certainty around what evidence of sustainability benefits will be enough in practice. Collaborative arrangements entered into with a view to improve sustainability outcomes may not necessarily provide direct improvements and/or consumer benefits that outweigh their anti-competitive harm, or to the extent that they do, the benefits may be difficult to measure and prove in monetary terms."

As competition and collaboration related concerns are raised in other jurisdictions, the FCA and other regulators should continue to be proactive and vocal on these questions[3] to ensure that investors are not receiving overly conservative legal advice that is inconsistent with the letter and application of UK law and its oversight.

The PRI encourages additional guidance from relevant authorities to explain in more detail their attitude towards:

- the legal case for adequate issuer-, portfolio- and system level-stewardship (and adequate stewardship resourcing) whether it be from an individual or collective standpoint; and
- investor collaboration to address sustainability risks and how sustainability outcomes can be quantified and assessed both within the existing horizontal collaboration regime and through vertical interactions.

Future regulatory guidance or activity from the FCA and/or other relevant regulator should provide clarity on:

- which engagement-related activities (whether taken in isolation or jointly) can be conducted collaboratively without raising "acting in concert" concerns; and
- how such activities (and assorted escalation measures) can be differentiated from takeovers and control-seeking bids.

Further approaches could be considered by the FCA (or other relevant competent authorities) are included below.

- **A review of antitrust/competition law-related impediments faced by service providers** (who may participate in collective efforts to pursue sustainability outcomes through the development of products and services or whose product offerings may support and enable collaboratively and individually led stewardship activities).
- **Considering establishing or exploring the establishment of prima facie legal presumption in favour of cooperation** in relation to specific sustainability/public policy goals unless there are solid reasons against.
- **Providing safe harbours in market abuse and competition regulations**: antitrust and competition law concerns might arise where companies need to consider changing pricing, hiring or purchasing strategies in order to address ESG risk. Current interpretations of antitrust and competition law may limit an investor or a company's perceived ability to take actions addressing ESG risks, for example where activities might involve what may be viewed as horizontal or vertical agreements or hub and spoke configurations. Upcoming and updated antitrust and competition regulation could more clearly accommodate the changes to

[3] https://www.environmental-finance.com/content/news/climate-transition-planning-not-anticompetitive-says-fcas-esg-head.html

business practice which are needed to urgently address climate, environmental and social issues which threaten overall long-term value. Particularly, safe harbour clauses could be introduced to specify that certain activities would be deemed allowable provided their objectives are related to advancement of or alignment with sustainability objectives and with public policy goals.

CHAPTER 4 – TRAINING AND COMPETENCE IN REGULATED FIRMS

Question 12: What do you consider to be the main sustainability-related knowledge gaps across the financial sector and how can these best be addressed? What do you consider to be the potential harms to market integrity, consumer protection or competition arising from these knowledge gaps?

The Legal Framework for Impact report finds that in the 11 jurisdictions analysed, including the UK, investors are broadly permitted to consider pursing sustainability impact goals where this would contribute to their financial return objectives. Specifically, the extensive legal analysis concludes that:

- financial return is generally regarded as the primary purpose for investors;
- investors generally have a legal obligation to consider pursuing sustainability impact goals where that can help achieve their financial objectives;
- in some circumstances, investors can pursue sustainability impact goals for reasons other than achieving financial return goals (i.e., as an ultimate end); and
- investors are legally required to pursue improved sustainability impacts if the objective of the financial product commits them to doing so.

Within this report, the main sustainability-related knowledge gaps identified in the UK were:

- the uncertainty around and misinterpretation of legal duties that may require or enable investors to consider pursuing sustainability goals; and
- decision-makers may have insufficient information on clients' or beneficiaries' expectations and/or preferences.

Our subsequent UK-specific report, A Legal Framework for Impact UK: Integrating sustainability goals across the investment industry, also finds that **the way UK investors understand and discharge their duties may discourage them from pursuing positive sustainability impacts,** or even considering doing so. Similarly, our analysis shows that many UK investors remain hesitant to change their established practices and pursue sustainability impact goals, even when this is required to achieve financial objectives.

The UK's existing requirements on responsible investment are focused on disclosures of sustainability risks: investors must report how they manage ESG *risks to* investments, rather than if and how they tackle the sustainability *impacts of* their investments. In contrast, leading responsible investors are expanding their toolkit to achieve positive sustainability impacts through their investments, with asset allocation, increasingly ambitious stewardship, and engagement with policy makers all at play.

In the UK, there is a (mis)perception that pursuing sustainability impact goals represents a departure from prioritising an investor's financial purpose. Not only is this a false assumption, but it also overlooks the fact that in some cases investors *need* to address sustainability impacts to achieve financial returns. The absence of more explicit guidance and direction leaves asset owners and asset managers hesitant to use investment decisions, stewardship, and policy engagement to pursue positive sustainability impacts.

Regulatory guidance is therefore required to overcome inertia and embed the confidence to pursue sustainability impact goals more clearly in the concept of using an investment power for its proper purpose. This guidance should clarify that purpose-related requirements already oblige investors to consider pursuing positive sustainability impacts through their powers of investment and stewardship. Guidance should also remind investors to consider the relevance of their sustainability impacts to the success of the scheme or portfolio, rather than only to each individual investment.

Research considered by the authors of the Legal Framework for Impact report found that the levels of assets committed to sustainable investing approaches are lower than what might be expected based on preferences expressed by individual investors. Decision-makers throughout the investment chain may not have sufficient information about individual investors' sustainability preferences to act upon them. Further, investment professionals may not be sufficiently incentivised to consider individual investors' sustainability preferences in their investment strategies and decision-making.

In the FCA's proposed SDR regime, the FCA had not yet set out any guidance on how advisers understand client's sustainability preferences but has signalled intent to do so. The FCA should now explore measures to encourage investment professionals to assess retail investors' views on the extent to which they want their money to be managed in line with achieving positive sustainability impacts and take those into account in product design and distribution. This could include the development of new rules that would require financial advisors to ask for a client's sustainability preferences. The FCA should then offer guidance on implementing these preferences, to ensure that investment options appropriately respond to investor preferences. Asset owners and asset managers could also collaborate on research to establish individual investors' likely attitudes towards sustainability goals generally, with a view to investing in the way most likely to satisfy most individual investors' objectives and preferences.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the Financial Conduct Authority further to enable finance for positive, sustainable change in the UK.

Please send any questions or comments to policy@unpri.org.

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