EFAMA's comments on the European Commission's Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment

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General comments on the overall sustainable finance package

From resource efficiency to social inequality and environmental risks to health, Europe and the world face many challenges. Achieving sustainability and climate objectives require direct action from industries directly involved in these issues. At the same time, finance is also increasingly looked to as an important part of helping to solve some of these pressing issues. EFAMA very much supports the Commission's ambition to encourage and facilitate sustainable investments and be a global leader in sustainable finance policymaking. A common language and disclosure building on such common language have the potential to help with the transition to a more sustainable economy. We would caution, however, against a prescriptive and narrow approach which would create unintended consequences on the development of the sustainable investment market in Europe.

Many investors already today recognise the importance of sustainability and feel a responsibility to be more selective in their investments in this respect[*]. Environmental, Social and Governance ('ESG') analysis in the investment decision-making process is also seen as an important driver of economic long-term value, as it can be a measure of how well a company is planning for and managing its short and long-term ESG risks and opportunities. In this respect, policy can enable capital markets to understand risk better by providing a clear framework for how the various participants in the economy are going to transition to a lower-carbon economy.

European asset managers have been integrating ESG in their investment processes in different forms for some time. This is part of their pursuit of helping individuals and institutional asset owners achieve long-term financial returns and a key element of their operational excellence and competitive advantage. Screened investments, best-in-class sustainable investment, impact investing, stewardship, thematic investing and ESG integration are examples of a wide range of approaches – cumulative or exclusive – used by asset managers today to achieve the diverse sustainability goals of individuals and institutional asset owners. Different approaches avoid unintended consequences on risk management, diversification and, ultimately, financial stability.

One important overarching comment on the package concerns the perceived focus on impact and thematic investing in the Commission's proposals. We note this in the definition of "sustainable investments" used in the Disclosures proposal which are described as "economic activities that contribute to an environmental or social objective", and also the use of terms such as "target" which has a quantifiable connotation. In practice, there are and will be many more strategies integrating material ESG considerations into investment decisions, without pursuing any specific sustainability objective. It would be regrettable, and even counterproductive, if the Commission limited opportunities or created a bias towards a limited way of pursuing sustainable investments. Objectives are typically of qualitative nature and suggest impact investments, although an asset manager may choose to specify quantifiable objectives. The proposals need to take into account – or at least allow the continued use of – the wide range of ways in which asset managers tackle ESG depending on the

[*] The European responsible investing fund market continued to grow, almost doubling since 2010 to EUR 476 billion of Assets under Management at the end of 2016, according to an ALFI-KPMG report

expectations and demands of those that are and will provide capital to boost sustainable investments: the individuals and institutional asset owners. It is all the more important to retain flexibility, in this part of the package as well as in other parts, to ensure we futureproof the rulebook and do not unnecessarily lock ourselves to present-day strategies and thinking, but leave room for strategies yet to be brought to market.

We understand the logic behind the focus on climate change, however, it is important that the EU agenda on sustainable finance seeks to strike a balance of the three Environmental (‘E’), Social (‘S’) and Governance (‘G’) pillars. We would strongly emphasize the importance of such a holistic ‘E’, ‘S’ and ‘G’ approach, as we believe that the ‘G’ is often a key driver to achieve ‘E’ and ‘S’ objectives. How a company approaches and executes its governance will determine how it manages their environmental and social material risks and opportunities. In other words, a well-run company is more likely to grasp the social and environmental challenges and opportunities for its long-term success. Investors apprehend investee companies from this footing and do not take the E, S and G factors in isolation as it seems suggested by the definitions mentioned above.

Whilst we understand the perceived political imperative of agreeing the level 1 text before the end of this Commission’s mandate, meaning that subsequent detail will be left to level 2, sufficient time for discussion and negotiation, and most importantly for a rigorous legislative process, needs to be given to ensure we get this right. Against the background of recent experiences, and given the level of detail which will have to be agreed at level 2, it is essential that the division of work between co-legislators at level 1 and the Commission and European Supervisory Authorities (‘ESAs’), is carefully calibrated. It is also important that the rulemaking process at level 2 and 3 is carried out in a transparent, open manner, with proper consultation of relevant stakeholders, including the asset management sector. Once the division of work between level 1 and 2/3 is decided, we would recommend articulating high-level objectives in the legislation to be issued by the Commission, and delegating more detailed implementation rules to the relevant agencies.

Finally, policy makers and regulators ought to consider the extent to which the asset management sector, alone, can contribute to achieving their political objectives in relation to sustainability. Arguably, policy objectives as broad and ambitious as these can only be holistically addressed in conjunction with other macro-economic tools and direct action from industries most impacted by these issues. Furthermore, it must be kept in mind that asset managers act as agents of their clients – individuals and institutional asset owners – who often have different affinities for sustainable investment. While the intention is that asset managers will do their part of the job by executing their clients’ sustainable investment wishes and discussing their position on ESG, it must be kept in mind that the initial and final decisions rest with asset owners, which will in future be even better informed and in a good position to take an informed view on ESG, as they have the ultimate responsibility and duty of care towards their end-investors or beneficiaries.

Taxonomy proposal

Executive summary

EFAMA is supportive of the Commission's proposal for an EU taxonomy and is keen to make it a success. We welcome the move towards a commonly agreed language as markets need clarity and the number of investor questions regarding terminology is high in practice. The lack of a common language for sustainable assets and the lack of consistent and comparable corporate disclosure on sustainability have long been challenges (and continue to be) in the integration of sustainability in the investment decision-making process. We support defining common standards and principles, and very much welcome the proposed framework for ensuring transparency and accountability regarding its implementation.

To ensure the taxonomy is a success, we have a number of recommendations, which are based on many years of experience of ESG professionals attempting a taxonomy and of its broader experience of marketing so-called 'ESG' or 'sustainable' products:

1. We strongly recommend continued **diversity,** and would advocate against a position where the taxonomy would result in **a restrictive focus on impact and thematic investing or any other specific strategies**.

2. It is imperative that these measures **allow for continued product and strategy innovation**. We would recommend a principles-based, risk-based approach rather than an overly prescriptive list of designating factors which would limit the ability of firms to offer investors appropriate ESG products.

3. The proposal (or level 2 measures) need to allow for sufficient flexibility for "transition" investments, which consider the investable assets **transiting to the low-carbon economy**, rather than the focus on investments that are already fully sustainable.

4. The criteria put in place by this **taxonomy must be linked to the value of the investment given** that sustainability is linked to economic activities and associated innovation and behaviours.

5. The **sequencing of legislative actions** should be looked at closely, given that other proposals, such as the amendments to the MiFID II suitability test, which is linked back to the taxonomy, is likely to come into force even before the initial parts of the taxonomy are established.

6. A principles-based approach to an EU taxonomy is essential given the inherent **cross-border nature of investments.**

7. A **longer implementation phase is necessary** to allow market participants sufficient time to incorporate the taxonomy in their operations.

1. A TAXONOMY LOOKING BEYOND IMPACT INVESTMENT

As set out in our "general comments" section, we are concerned with the perceived focus on impact and thematic investing in the Commission's legislative proposals, but particularly so in the taxonomy proposal as it will be the backbone of the EU's sustainable finance architecture. Impact strategies represent a small portion of ESG strategies adopted by asset owners and will remain niche products by nature. An effective taxonomy needs to acknowledge the wide range of ways in which financial market participants, including asset managers, tackle ESG. In our view, a preferable approach would be to define clearly each of these activities, such as:

- Exclusion/screened approaches: Excluding companies or industries from portfolios where they are not aligned with an investor's values.
- Integration: Integrating environmental, social and governance factors into traditional investment processes to improve portfolio risk/return.
- Thematic: Offering a variety of themes, which allows investors to choose specific areas of sustainable investment.
- Stewardship: Monitoring of, voting in, and engagement with investee companies.
- Impact Investing: Investing with the intention to generate measureable environmental and social impact alongside a financial return.

2. A TAXONOMY SHOULD BE AN EVOLVING TOOL, ALLOWING CONTINUED PRODUCT INNOVATION

We fully agree with the High Level Expert Group's recommendation that a taxonomy framework should be an evolving tool. What might be considered sustainable today may not be so tomorrow, and vice-versa, and a flexible framework must therefore be put in place to ensure its continuous evolution in line with market innovation and with technological and scientific developments. An overly-prescriptive taxonomy would, in our view, run the risk of setting impractical standards in a fast-evolving environment for obsolete products, thereby limiting the impact of the taxonomy on markets. The taxonomy should be constantly evolving and inclusive rather than directive – otherwise this runs the risk of curtailing legitimate sustainable and other investments.

Given the taxonomy might be linked to the new MiFID II requirements on assessing client suitability for MiFID II advisory purposes (and that this may have an impact both on the existing client base and acquisition of clients), it is integral that the taxonomy is sufficiently flexible to allow for current and future product ranges to be designated as compliant where appropriate.

This is even more important, given that we would not want to see the rather long timeframe on setting criteria (scheduled for completion in 2022) hampering product development in this area, which unintentionally may be put on hold until there is full certainty on the taxonomy's final criteria. While parts of the regulatory framework proposed by the Commission under the Sustainable Finance Action Plan are said to be non-binding, it is not unlikely that such rules become de facto market standards.

3. A TAXONOMY SHOULD CONSIDER "TRANSITION" INVESTMENTS

As it currently stands, the proposal tips the balance towards creating a narrower green niche, thereby shrinking sustainable finance to what's considered on paper as the purest type of green finance. This would narrow the investment universe (and as such only marginally increase sustainable investments), and would have consequences on risk management and diversification. For example, when an active manager considers including an oil and gas company in a client's investment portfolio, this company may not be considered "sustainable" on paper, but may score well on ESG metrics because they are transparent about how they manage their ESG risks and opportunities and have a plan in place for their ESG management in the future.

The taxonomy should therefore not classify an economy activity based on how sustainable a certain economic activity is at a certain moment in time, but should rather look at the direction of travel. In other words, it should not help in indicating the current state of an activity, but rather should shed light on a company's efforts on sustainability and should incorporate both results and efforts. In this regard, we consider the proposal in Article 4 (3) (a) and (b) regarding investors being able to identify the percentage of holdings pertaining to companies carrying out environmentally sustainable economic activities and the share of the investment funding environmentally sustainable economic activities overly detailed and inadequate for capturing the reality of the transition to a low-carbon economy. The empowerment for the Commission to draft delegated acts in this respect should be deleted. Experience with delegated acts over the past few years shows that they have a tendency to be very detailed and descriptive. While in some cases this might be justified, it often leads to burdensome tick-the-box compliance exercises, behaviours the EU wants to avoid, as this may hamper development in a market that is already moving in the right direction.

Linked to the issue of transition investments, purely "green" issues are a relatively small part of the overall sustainability picture. This taxonomy should be about effecting change in the overall system and helping capital markets to more generally understand and manage long-term ESG risks. The focus should be on growing "sustainable investment" in a broad sense, rather than crowding out "sustainable investment" approaches of individual client needs which do not perfectly match the proposal's taxonomy. The taxonomy needs to acknowledge the various "shades of green" to ensure it does not excessively reduce the realms of sustainable (and possibly "investible") assets.

4. SUSTAINABILITY NEEDS TO BE DELIVERED ALONGSIDE (NOT INSTEAD OF) FINANCIAL RETURN

What does sustainability mean in the context of an investment product? The premise behind the taxonomy proposal appears to be based on a certain set of sustainability values, rather than the economic value of an activity on an investment. The primary purpose of an asset manager is to safeguard their client's assets and generate investment returns (for the client) with a certain level of risk tolerance. If the criteria put in place by this taxonomy is not linked to the value of the investment or undermines investment returns, there is a risk of capital flows being directed to a possibly limited range of "green" assets which then become overvalued. In such circumstances, "smart money" may move to alternative assets, while ordinary retail investors may suffer. Sustainability needs to be delivered alongside (not instead of) financial return.

5. THE SEQUENCE OF LEGISLATIVE ACTIONS NEEDS TO BE CONSIDERED

Whilst we understand the reasoning behind the Commission's step-by-step approach and therefore its initial focus on climate change, EFAMA believes this sequencing may be problematic, particularly in the context of the other legislative proposals of this package which are linked back to the taxonomy and are likely to come into force before even the initial parts of the taxonomy are established.

A common language is generally necessary in order to have a comprehensive approach and avoid confusion. For example, we already see this problem manifest itself in the proposed changes to the MiFID II suitability process. The Commission's draft proposal correctly references "environmentally sustainable investment" of the published taxonomy proposal, but only defines "social investment" and "good governance" in a general manner, with no apparent linkages to further EU taxonomy discussions. This approach may not only result in advice on sustainability being provided in a piecemeal fashion, but also allow for the parallel development of "social investment" and "good governance" standards at best at Member State level, which could have serious implications for the cross-border distribution of financial instruments and further complicate implementation of a taxonomy for S and G for many years to come. It will likely confuse individual investors too if it is left to each distributor to decide what the understanding of social investments or good governance is. The same is true for environmental sustainable investments as long as the main parts of the taxonomy are not yet put in place. As the taxonomy will probably be the most disputed part of the package, the timeframe to apply delegated acts on 1 July 2020 is very ambitious. Even if everything goes to plan, the taxonomy relating to other objectives than climate change mitigation/adaption will only come into force on 31 December 2021 or 2022, respectively – i.e. one and a half years later than the MiFID amendments might enter into force.

6. THE CROSS-BORDER NATURE OF INVESTMENTS NEEDS TO BE CONSIDERED

Given the inherent cross-border nature of investments, as well as the fact that sustainability is a global issue, EU investors need to be able to facilitate sustainable investments on a global basis. This makes a principled-based approach to an EU taxonomy all the more important to safeguard cross-border flows with regards to sustainable investments, both within and in and out of the EU.

In this respect, it is important to clarify how a European taxonomy will co-exist with national practices, as well as with other taxonomies which individuals and institutional asset owners have become used to. To the extent possible, the EU should seek alignment of incentives at global level towards common goals such as the Sustainable Development Goals and the principles of UN Global Compact. These should be properly articulated with existing international frameworks as a minimum basis, with the objective of creating a global level playing field.

It would also be useful to understand how this proposal relates to investments or economic activities in third countries. For example, the definition of "significant harm" in article 12 refers to marine waters of the EU while the definition of "minimum safeguards" in article 13 refers to rights established in an international convention. This may create confusion as to whether funds labelled as sustainable can only invest in assets in the EU.

7. LINK WITH DISCLOSURES PROPOSAL

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 proposal 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. However, as currently drafted and cross-referenced, both Regulations create confusion for market participants. We would recommend deleting the disclosure requirement in Article 4 of the draft Taxonomy proposal and include disclosure requirements only in the Disclosure proposal in a consistent way.

8. A LONGER IMPLEMENTATION PHASE IS NECESSARY

We would recommend allowing market participants sufficient time to incorporate the taxonomy in their operations, and granting a minimum of 12 months for the operational part (articles 3 to 12 of the Regulation) to enter into application after the delegated act entry into force, instead of the 6 months currently indicated in article 18 of the Regulation.

Detailed comments regarding taxonomy proposal

- **TITLE:**
  - The Title of the Regulation should capture the fact that the focus of this Regulation is on the environment / climate change, rather than social and governance issues. The term 'sustainable investment' is too general and may cause confusion.

- **ARTICLE 1:**
  - Article 1(2)(a) –
    - Who or what is a 'market actor'? What is the difference with 'financial market participant' as defined in Article 2(1)(b)?
    - The scope of the Regulation seems to be very limited. In particular corporate bonds are specifically mentioned and included but for example shares are not. This may lead to arbitrary outcomes, for example if a corporate bond qualifies as environmentally sustainable, the share capital of the issuing company usually would also be considered environmentally sustainable – at least to some extent. However, a bond can have a green purpose while the company is not ESG compliant and vice versa. On the other hand, if shares are not included in the taxonomy, then listed companies could establish SPVs to issue green bonds and the main company does not need to make efforts to become itself a "sustainable investment" as the SPV can make a green investment, pledge the assets to obtain a credit and grant a loan to the mother company for investing in non-sustainable products. However, there is no logic behind such an approach if the Commission's and the EU's sustainable finance goals are to be reached in a short period of time. Even though a step by step approach is required, not everything can be "taxonomised" in one go – but shares of listed companies represent a major part of investments made by AIFs and UCITS.
  - Article 1(2)(b) - It is not clear what is meant by 'financial products having similar characteristics'.
  - The definition of 'financial products', which the taxonomy proposal cross-references to the disclosures proposal, includes portfolio management. However, portfolio management is a service, not a financial product, and should be described as such, e.g. with a reference to Annex I Section A (4) of MiFID II.
  - It is unclear how the criteria used to determine the degree of sustainability relates to sustainable collective investment products and we would welcome clarification in this regard.
  - As a general comment, more disclosure does not necessarily mean good disclosure. What we 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 from a cash flow and balance sheet perspective.

- **ARTICLE 4:**
  - The disclosure requirement for financial market participants in the Taxonomy proposal should be deleted as the proposed Regulation on Disclosures already provides for disclosure

requirements for financial market participants. At the very least, there should not be any overlaps in disclosure requirements in the two proposals.
  - If this disclosure requirement is not deleted, it should at least be clarified that a financial market participant is only responsible and liable for the correct disclosure of how it uses the criteria to determine the environmental sustainability of its investments. The financial market participant cannot be responsible or liable for its assessment of whether an activity complies with the technical screening criteria set out in the framework regulation.
  - Regarding the concept of determining the degree of sustainability, the process of establishing the sustainability of an activity performed by a company is very extensive. A UCITS portfolio often consists of hundreds or more financial instruments which lead to a multiple of “activities”. It would be very burdensome and costly to determine the degree of environmental sustainability by assessing and tracking all activities of the respective companies as indicated in Article 4(3).
  - We would suggest deleting paragraphs 2-4 of Article 4.

- **<u>ARTICLE 6 – 11:</u>**
  - Articles 6-11 can only be applied by asset managers under the condition that the requirements for technical screening criteria in article 14 are substantiated to an extent that makes the criteria easily measurable and that sufficiently granular data is available to enable asset managers to look at the underlying economic activity to assess whether it meets the technical screening criteria. Additionally, it should be possible for asset managers to rely on external assessments.

- **<u>ARTICLE 13:</u>**
  - Whilst article 1 clearly outlines that this regulation will establish criteria for determining whether an economic activity is environmentally sustainable for establishing the degree of environmental sustainability of an investment, Article 13 introduces social factor considerations.
  - Notwithstanding the definitional issues, it should be clarified that an asset manager can only check to the best of their knowledge whether the eight fundamental conventions identified in the ILO declaration on Fundamental Rights and Principles at Work are respected by each and every target investment. Additionally, it should be possible for asset managers to rely on external assessments.
  - ‘Equal remuneration for men and women workers for work of equal value’ is also difficult to measure.

- **<u>ARTICLE 18:</u>**
  - Delegated acts to Article 6-11 need at least a 12 month period from the putting into place of relevant level 2 measures before application of the said articles is possible. Once the delegated acts enter into force, there may be substantial IT infrastructure or manual diligence procedures required to process the necessary tests before an investment may be made. Experience with MIFID and EMIR has proven that a 6 month timeframe is too short to

implement such complex new frameworks. It must also be kept in mind that we are in this case not dealing with regulations stemming from a financial crisis, but rather a framework surrounding business activities that are already today moving in the right direction.

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