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Navigating the New ESG Landscape: How US and EU Policy Developments Affect Fund Managers

ICI Webinar

INVESTMENT COMPANY INSTITUTE®

Panelists

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- (Moderator) Linda French, Assistant Chief Counsel, ICI Global

What is ESG?

Environmental	Social	Governance
Air and water pollution	Community relations	Anti-competitive behavior
Biodiversity	Customer satisfaction	Audits
Carbon reduction/Climate change	Data protection and privacy	Board composition and committee structure
Climate change	Diversity and equal opportunity	Bribery and corruption
Deforestation	Employee attraction and retention	Business ethics
Energy efficiency	Employee engagement	Compliance
Fossil free fuels	Government and community relations	Disclosure practices
Hazardous materials	Human capital management	Executive remuneration
Land degradation	Human rights	Lobbying
Pollution	Indigenous rights	Political contributions
Regulatory change	Labor standards	Risk management
Resource depletion	Labor-management relations	Stakeholder dialogue
Waste management	Marketing communications	Succession planning
Water management	Philanthropy	Supply chain relationships
Water scarcity	Private prisons	Transparency
	Product mis-selling	Whistleblower schemes
	Product safety and liability	
	“Sin” industries (tobacco, alcohol, munitions, gambling)	
	Supply chain management	
	Workplace health and safety	

No single approach to ESG investing

- Exclusionary screens (i.e., avoiding “sin” stocks)
- Divestment movements (i.e., avoiding countries like Sudan)
- “Best in class” screens (i.e., apply a screen and find “best in class” companies)
- Corporate social responsibility; corporate sustainability (externally and internally evaluated)
- Impact investing (affirmatively seeking/influencing a result)

Wide spectrum of approaches to ESG investing

	Traditional	Screening	Integration	Thematic	Impact-First
		Responsible Investment		Impact Investing	
	Competitive Returns			Targeted ESG Impact	
FOCUS	Limited / not focused on ESG factors	Negative / exclusionary screening / positive / best-in-class screening	Using ESG information in investment process at the portfolio / sector / issuer level	Asset selection focused on addressed sustainability issues such as clean energy, education or water	Intention to generate specific environmental and social outcomes in addition to financial returns
EXAMPLES	• Traditional market-cap based strategies • Absolute return strategies	• Ethical funds • SRI funds	• Traditional funds with ESG integration in the investment process	• Clean energy fund • Emerging markets healthcare fund • Microfinance structured debt funds	• Capital provision fund to social enterprise / charities

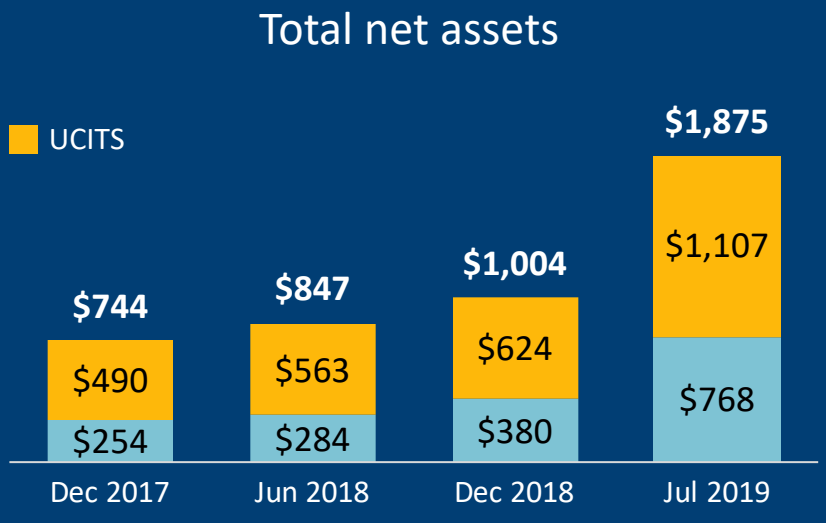
US SIF
The Forum for Sustainable and Responsible Investment

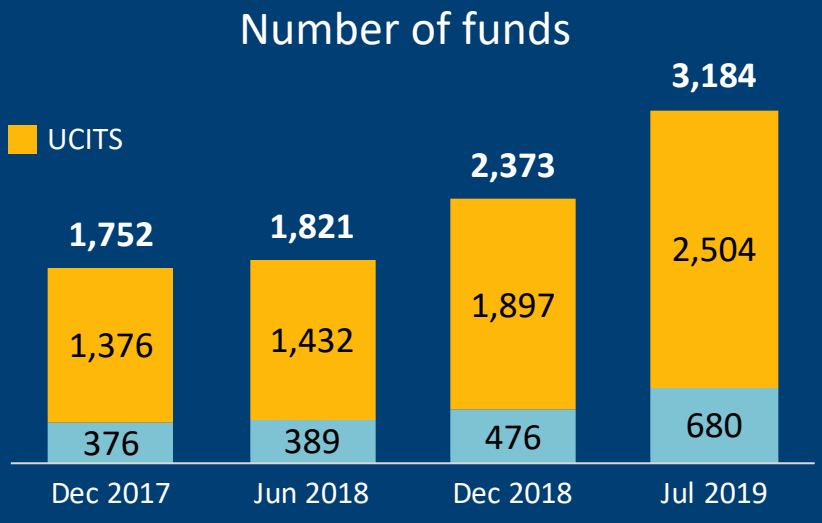
The ESG landscape: Who are the “influencers”?

- Investors
  - Institutional
  - Retail
- Non-governmental organizations and other standard setters
- Ratings and data analytics providers
- Governments

Total net assets and number of US funds and UCITS employing Morningstar-defined socially conscious* investment strategies is increasing

Total net assets in billions of US dollars





**Socially conscious* is defined as a fund that invests according to non-economic guidelines. This may include funds that invest based on environmental issues, but will also include funds with exclusionary clauses that prohibit the fund from investing in certain industries such as alcohol and tobacco.
Note: Data include exchange-traded funds but exclude money market funds, funds that invest primarily in other funds, and variable annuities.
Source: Investment Company Institute tabulations of Morningstar Direct data

Proliferation of standards

- Corporate reporting/disclosure frameworks
  - GRI, SASB, TCFD, CDP, CDSB
- Principles for institutional investors and asset managers
  - United Nations' Principles of Responsible Investing (UNPRI)
- Stewardship codes

Emergence of data analytics providers and ratings schemes

GLASS LEWIS

SUSTAINALYTICS

Summary Sustainalytics data now on Yahoo! Finance

ISS

MSCI

RepRisk
ESG data science and quantitative solutions

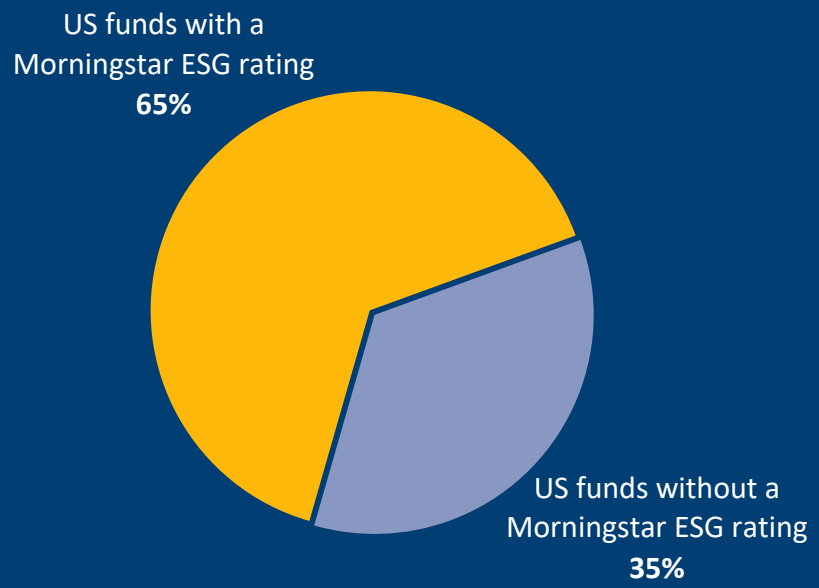
REFINITIV

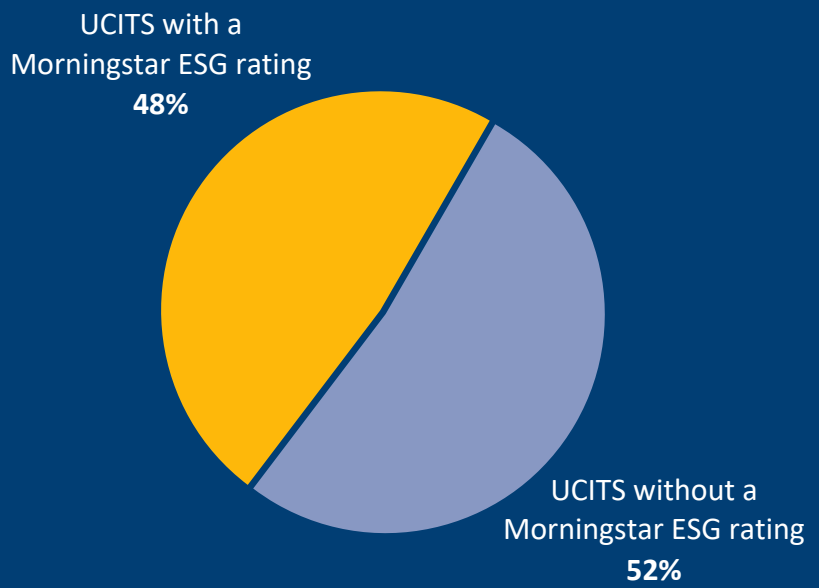
Bloomberg

- Self-identified experts
- Inconsistent
- Ambiguity = judgments
- Data collection varies
  - Surveys
  - Data verification requests
  - Technology vs. human evaluations
  - Dependence on precise language in public filings
  - Adequacy of staffing

About two-thirds of US funds and nearly half of UCITS have Morningstar ESG sustainability ratings

*Percentage of funds, as reported by Morningstar**

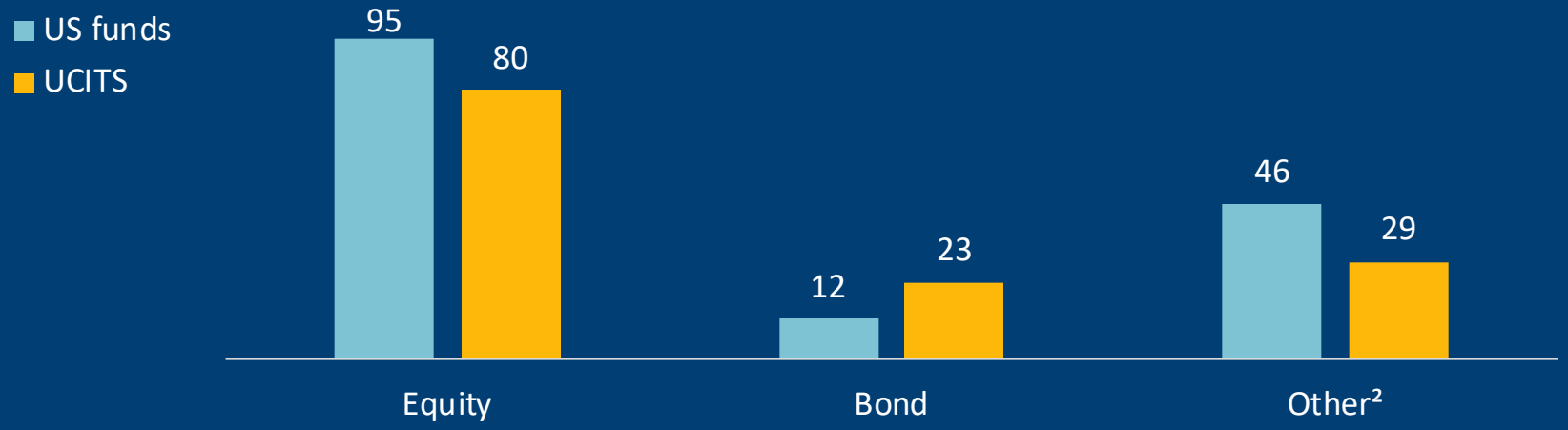




*Data are those available in Morningstar Direct as of April 9, 2019.
Note: Data include mutual funds and ETFs but exclude money market funds. Data also exclude funds that invest primarily in other funds.
Source: Investment Company Institute tabulations of Morningstar Direct data

Most US Funds and UCITS with Morningstar ESG sustainability ratings are equity funds

Percentage of US funds and UCITS, as reported by Morningstar[1]



Number of funds and UCITS:	Equity		Bond		Other[2]	
	4,882	8,031	260	1,344	601	2,477

[1]Data are those available in Morningstar Direct as of April 9, 2019.
[2]Other includes allocation funds, alternative funds, convertibles, and miscellaneous funds.
Note: Data include mutual funds and ETFs but exclude money market funds. Data also exclude funds that invest primarily in other funds.
Source: Investment Company Institute tabulations of Morningstar Direct data

Underlying political context

- US policymakers:
  - Lack of political agreement on policy goals
  - Piecemeal approach
- EU policymakers:
  - Massive political push to reorient capital flows toward Paris Agreement targets
  - Focus on reducing carbon emissions

US regulatory environment: ESG funds

- SEC IM staff review of ESG fund disclosure under “Names Rule”
  - Fund names including ESG/green/sustainable
  - Focus on disclosure of investment strategy
- SEC OCIE exam request letters on:
  - Proprietary or third-party ESG scoring systems
  - ESG-related investment decisions
  - Engagement with portfolio companies on ESG issues
  - ESG-related marketing materials

US regulatory environment: ESG funds

"…I am also aware of various efforts to encourage asset managers to integrate ESG factors into their investment strategies. It is important to note that, although we do regulate disclosure and oversee registered investment advisers, we do not regulate the merits of any particular investment strategy. The success of a particular investment strategy depends upon a multitude of factors, which may or may not include the extent to which the asset manager incorporates ESG factors. From my perspective, what is important is that investors have full and fair disclosure of the material facts about the investment strategy their fiduciary is following so that they are in a position to make informed investment choices."

— Jay Clayton, SEC Chairman (Dec. 2018)

US regulatory environment: Public company disclosure

"The flexibility of our principles-based disclosure requirements should result in disclosure that keeps pace with emerging issues, like Brexit or sustainability matters, without the need to for the Commission to continuously add to or update the underlying disclosure rules as new issues arise."

— Bill Hinman, Director of SEC's Division of Corporation Finance (Mar. 2019)

"The concepts of materiality, comparability, flexibility, efficiency and responsibility (i.e., liability) are the linchpins of our approach."

— Jay Clayton, SEC Chairman (Dec. 2018)

US regulatory environment: Retirement

- Department of Labor Guidance
  - ERISA restrictions on “economically targeted investments”; focus on attaining a secure retirement
- 2015 Guidance: ESG factors can be important in a plan fiduciary’s considerations
- 2018 Guidance: Affirms that plan fiduciaries may not sacrifice investment returns or assume greater risks to promote social policy goals

US political crosscurrents

- Current focus is on disclosures and investment companies as corporate stewards vs. investment companies as agents of change
- Partisan divide: Obama vs. Trump administrations
  - DOL 2015 vs. 2018 guidance
  - 2019 Executive Order on Promoting Energy Infrastructure and Economic Growth
    - DOL directive: Has focus on ESG decreased investment in US energy companies?
- Congressional bills
- Continued evolution seems inevitable, but outcomes will depend on how tensions are resolved

US legislative developments

- Focus on public company disclosure
  - Draft legislation on climate change risk, board diversity, political spending, broader ESG disclosure
- Political interest in hot button issues
  - Climate change, board diversity, political spending, conflict minerals, guns, fossil fuels, tobacco, opioids, palm oil harvesting

EU political context

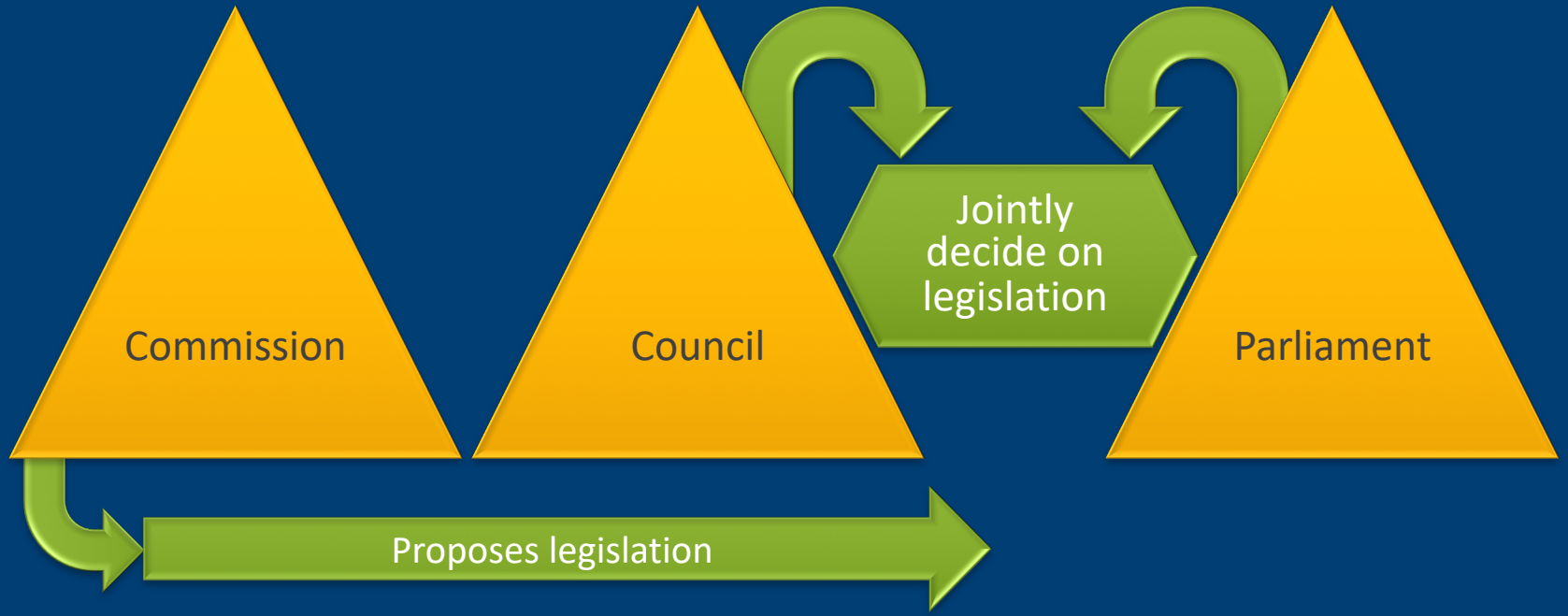
- Strong support for transition to low-carbon economy
- 2015: Adoption of UN 2030 Agenda and Sustainable Development Goals (SDGs) and Paris Climate Agreement
  - EU 2030 targets = 40% cut in greenhouse gas emissions
  - Scale of investment challenge beyond capacity of public sector alone
  - Investment gap of est. €180 billion per year to reach EU climate and energy targets by 2030
- EU aim = re-orient private capital toward sustainable projects

EU: What is sustainable finance?

- "Sustainable finance is the provision of finance to investments taking into account environmental, social and governance considerations."
- Aims to support economic growth while reducing pressures on the environment
- Also focuses on increasing awareness and transparency of:
  - ESG risks that may impact the financial system
  - Need for industry to mitigate those risks through governance

- *European Commission*

EU institutions and legislative process



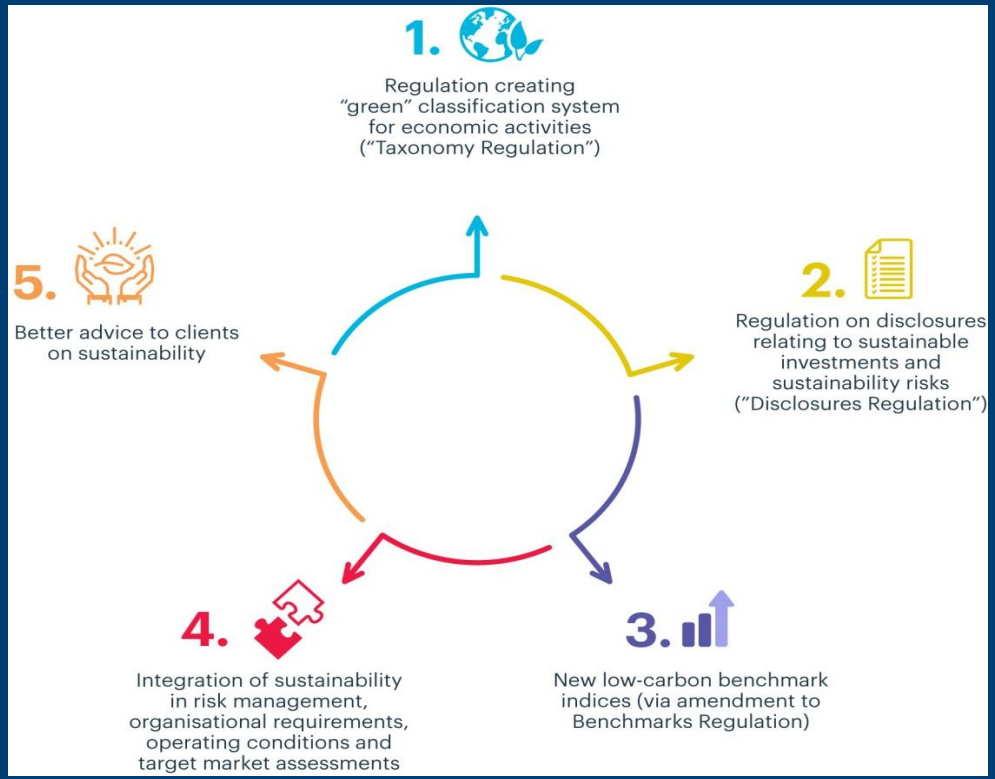
EU Action Plan on Sustainable Finance (1-5)

- Outlines 10 reforms in 3 areas:
  - Reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth
    - (1) Taxonomy to classify green economic activities
    - (2) Standards and labels for green financial products
    - (3) Fostering investment in sustainable projects
    - (4) Incorporating sustainability when providing investment advice
    - (5) Developing sustainability benchmarks

EU Action Plan on Sustainable Finance (5-10)

- Mainstreaming sustainability into risk management
  - (6) Better integrating sustainability in ratings and research
  - (7) Clarifying institutional investors' and asset managers' duties
  - (8) Incorporating sustainability in prudential requirements
- Foster transparency and long-termism in financial and economic activity
  - (9) Strengthening sustainability disclosure and accounting rule-making
  - (10) Fostering sustainable corporate governance and attenuating short-termism in capital markets

EU Action Plan on Sustainable Finance: Key legislation



EU legislation: Areas of impact on fund managers

- Taxonomy framework for defining green investments: impact on distribution and labeling of “green funds”
- ESG disclosure requirements for asset managers and institutional investors
- Integration of sustainability factors into investment process and accounting for ESG-related risk in management and governance
- Adding ESG preferences to suitability assessment
- New climate-related benchmarks
- Engagement with portfolio companies on ESG issues
- Widespread impact on financial sector

Taxonomy legislation: Framework for defining "green" investments

- Taxonomy legislation = foundation of EU's Action Plan on Sustainable Finance
- Defines how "green" particular economic activities are – and by extension how green an investment is
- To be defined as "environmentally sustainable," an economic activity must "contribute substantially" to and not "significantly harm" any of the following objectives:
  - (1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transitioning to a circular economy, (5) pollution prevention, (6) protection of biodiversity and ecosystems

How will the Taxonomy be used?

- Goals: Prevent “greenwashing” and market fragmentation? Influence direction of capital?
- Scope: “Financial market participants” and “financial advisers” including UCITS ManCos and AIFMs offering financial products (including UCITS and AIFs) in the EU – query whether these must be offered as “green”
- Status: EU Institutions (Council, Parliament, and Commission) currently negotiating – significant divergences in positioning
- Significant challenges anticipated around determining how “green” a large company’s economic activities are and by extension how green an equity investment in that company is

Taxonomy: Application to funds

- For “green” funds – likely requirement to disclose how “green” a fund is based on the degree of “environmental sustainability” of its holdings according to the taxonomy criteria
- Potential disclosure requirements for financial products with “negative sustainability impact”
- Asset managers may be prohibited from marketing a fund as environmentally sustainable if it does not meet the taxonomy criteria

Disclosure Regulation: ESG disclosure requirements for asset managers and institutional investors

- Goals: Transparency for investors, systematic integration of sustainability risks and consideration of adverse sustainability impacts
- Scope: Again, “financial market participants” and “financial advisers” including fund managers (UCITS ManCos and AIFMs) offering financial products (including UCITs and AIFs) in the EU

Disclosure Regulation: Entity-level disclosure

- All financial market participants – irrespective of product "greenness" required to provide:
  - Website and product (e.g., prospectus) disclosures on:
    - sustainability risk integration policies
    - consideration of environmental and social impact of investments
  - Website disclosure on how remuneration policies are consistent with integration of sustainability risk

Disclosure Regulation: “Green” fund disclosure

- Where product offered as “green,” higher disclosure burden applies with enhanced prospectus, website, and periodic report disclosures required for:
  - Funds that promote “environmental and social characteristics”
  - Funds that have an objective of “sustainable investments” or reducing carbon emissions
- Links to taxonomy and new suitability requirements?

Disclosure Regulation: Status

- Status: Final legislative text approved; waiting for official publication
  - ESMA (EU securities authority) working with banking and insurance authorities to develop regulatory technical standards (RTS) with details on disclosure presentation and content
- Implementation timeline issues:
  - Date for application of the legislation vs. publication of RTS
  - Request for delay denied by Commission
  - Links to taxonomy, which is not yet finalized

Other EU measures

- Proposed amendments to existing UCITS, AIFMD, and MiFID regimes to integrate sustainability risks and factors into investment process and account for ESG-related risk in management and governance
- Proposals to ensure ESG preferences of investors taken into account in product selection process/suitability assessments – further amendments to MiFID regime
- New category of climate-related benchmarks and mandatory ESG benchmark statement disclosure for all benchmarks

Shareholder Rights Directive II: Engagement on ESG

- UCITS and AIFs (funds) / UCITS Management Companies and AIFMs (fund managers) invested in companies listed on EU regulated markets (as defined under MiFID II) in scope as shareholders
- Requirement to adopt (comply or explain basis) policy describing funds' and fund managers' engagement with the listed companies in which they hold shares
- Engagement policy should describe how a firm monitors an investee company's environmental and social impact
- Must publicly disclose on website (or other like means) on annual basis how engagement policy has been implemented

Widespread impact on EU financial sector

- Sustainable Finance Action Plan targets entire financial sector
- Legislation also targeting banks, insurance, investment firms, credit ratings agencies, pension plans, and other institutional investors
- Huge focus on climate change risk (financial) and also environmental impact (non-financial)
- Sustainable Finance Action Plan part 2 is coming…

Litigation and enforcement

- Theories of liability?
- Pension plan liability and impact on asset managers?
- Government enforcement?

Discussion: Practical implications for asset managers

- Implications of diverging views on ESG and fiduciary duty among jurisdictions?
- US market impact of EU requirements?
- What types of disclosures should fund managers be focused on?
- Compliance considerations?
- Implications for engagement with portfolio companies?