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ICI Global feedback on the European Commission’s proposed regulation on sustainability disclosure

ICI Global¹ welcomes the European Commission’s effort (Commission) to foster a regulatory framework that encourages the financial system to focus appropriately on the longer-term impact of material environmental, social, and governance (ESG) factors. To that end, we applaud the Commission’s disclosure-based approach, which focuses on increasing transparency rather than prescribing how asset managers should consider ESG factors in their investment processes. We continue to be of the view that dictating the ESG components of fiduciary duty would not be in the best interest of investors nor will it promote the goal of sustainability. We believe that sustainability goals can be best achieved by encouraging transparency and market innovation in this area, which in turn will strengthen the burgeoning market for sustainable investing.

We have suggested below three recommendations on the Commission’s proposed regulation on sustainability disclosure (Disclosure Regulation).² We believe these recommendations would help achieve the Commission’s Capital Markets Union objectives without impeding continued growth and market innovation in ESG-related product offerings and investment strategies.

Summary of recommendations

- 1) Appropriately sequence the sustainability initiatives with the proposed taxonomy first and provide adequate time (*e.g.*, 24 months) for implementing the proposals so that each step is well-settled in market practice and meaningfully furthers the EU’s sustainability goals. Without a more considered approach to the multitude of initiatives, the Commission’s Action Plan may result in an inconsistent patchwork of legislative requirements.

¹ [ICI Global](#) carries out the international work of the [Investment Company Institute](#), the leading association representing regulated funds globally. ICI’s membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$29.6 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

² Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (24 May 2018), available at https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5524115_en#pe-2018-3336.

- 2) Provide an adequate framework for the Disclosure Regulation in level 1 so that financial market participants can better gauge the proposal's impact and address potential issues and concerns with the Commission and legislators. Also consider providing for a thorough level 2 process with a consultation period that provides sufficient time for feedback and allows the Commission to address any market concerns that surface in the detail of level 2 measures.
- 3) Retain the Disclosure Regulation's distinction between financial products at large and sustainability-themed financial products (*i.e.*, with a sustainability target). We welcome this distinction, as it properly recognizes that the regulatory framework cannot be one-size-fits-all. Requiring ESG-themed funds to provide specific sustainability-oriented disclosure will allow end users to compare these types of funds while appropriately recognizing that this disclosure is not relevant for funds that are not ESG-themed.

Before discussing our recommendations in more detail, it might be helpful to provide some context around how asset managers consider ESG factors today in their investing process.

Background: How asset managers consider ESG factors

ESG investing takes many different forms, but for regulatory purposes, we believe it is important for policymakers to understand and keep in mind how asset managers approach material vs. non-material ESG factors.

As a fiduciary charged with investing in the clients' best interest, an asset manager takes material ESG considerations into account in its investment process and in engagement with investee companies. Financially material ESG considerations represent objective drivers of long-term financial value along with other financially material risks or opportunities that an asset manager considers in both its investment process and stewardship of its investments. In determining whether ESG information is material to a particular investment,³ an asset manager analyzes its potential long-term impact on the financial health of the investment in the context of a fund's investment strategy. Therefore, incorporating material ESG factors into the investment process is a widespread practice for asset managers today—even for funds without an ESG-related investment objective and even for investors who have not expressed an ESG preference.

On the other hand, as an agent for the investor or asset owner, an asset manager may take certain additional ESG considerations into account as directed by a client or, in the context of a regulated fund, as disclosed in the fund's investment policy. These ESG considerations may or may not be financially material and may reflect particular values and preferences or a particular investment

³ For example, a joint World Bank/GPIF report noted that water stress is likely to be a material factor for certain sectors, such as extractives, food and beverage, and agricultural companies. See Inderst, G. and Stewart, F., Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment, World Bank Group publication, April 2018, at p. 11, available at <http://documents.worldbank.org/curated/en/913961524150628959/pdf/125442-REPL-PUBLIC-Incorporating-ESG-Factors-into-Fixed-Income-Investment-Final-April26-LowRes.pdf>.

focus. It is important to note that investors' values and preferences vary widely, and asset managers' product offerings reflect this spectrum of investor demand with a range of investment strategies that take different approaches to ESG investing. For example, asset managers may offer funds that screen out certain industries, focus on companies with certain types of governance structures, or invest in renewable energy.

In creating a regulatory framework for ESG investing, it is important that the Commission's work does not inadvertently conflate financially material ESG factors with other ESG considerations that represent certain investor values and preferences. A blurring of this distinction could harm asset managers' integration of material ESG factors by requiring asset managers to artificially incorporate values that do not reflect investor preferences. It could also impact the range of available ESG-themed investment strategies and funds, potentially narrowing the spectrum of ESG investing to a particular approach that reflects policymakers' preferences rather than the wide-ranging preferences of investors. We appreciate that the Commission has contemplated this difference in requiring separate disclosure for ESG-themed funds in Articles 5 through 7 of the Disclosure Regulation.

Building an ESG regulatory framework on the basis of this fundamental distinction will provide asset managers with tools to better assess material risks and allow managers to develop innovative strategies or products that meet investor demand for particular ESG investing styles and values.

Our recommendations below recognize that investors have wide-ranging ESG preferences and should be able to invest accordingly.

Recommendation 1: Sequence taxonomy initiative first and extend implementation timeline

Given the critical necessity of sequencing taxonomy before the other proposals, we encourage the legislators to balance carefully the timing of each of the initiatives. Providing adequate time for implementing the proposals will ensure that each step provides sufficient value to investors and meaningfully furthers sustainability goals. As Vice-President Dombrovskis has emphasized, '[t]hese four actions are interconnected, and they are all relevant for investors.'⁴ A coordinated approach will help ensure comparability and meaningful information for investors.

⁴ *The European Commission Action plan: Implications for Investors*, Vice-President Valdis Dombrovskis, Keynote speech at the Principles for Responsible Investment (PRI) Conference (26 June 2018), available at https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-commission-action-plan-implications-investors-vice-president-keynote-speech-principles_en.

Inappropriate sequencing of initiatives could hinder implementation of Disclosure Regulation

We support the Commission's proposal to develop a common taxonomy (Taxonomy Regulation)⁵ that may serve as the basis for standards and labels for sustainable financial products. We urge the Commission, however, to complete its taxonomy initiative before moving forward with other proposed actions that rely on the taxonomy as a foundation or conceptual basis for further legislation. Otherwise, moving forward with a disclosure framework without a taxonomy in place could result in an inconsistent patchwork of legislative requirements and undermine the Commission's goal of a common and consistent language. We also note that the European Parliament intends to progress its work on the Disclosure Regulation at an expedited rate, creating further concern that the Disclosure Regulation will proceed out of step with the Taxonomy Regulation.

As proposed, the Disclosure Regulation is sequenced before the taxonomy although it relies on the taxonomy to define 'sustainable investments.' The Commission's current timeline for the Disclosure Regulation contemplates specifying requirements through delegated acts to be adopted 18 months after the entry into force of the Disclosure Regulation, which could be before the taxonomy is completed.⁶ The Commission does not anticipate completing the taxonomy for environmentally sustainable activities until the end of 2022.⁷ Moreover, the Taxonomy Regulation focuses only on environmental sustainability—the 'E' in ESG. The timeline for incorporating social and governance factors into the taxonomy is undetermined.

Without a clear understanding of critical definitions, it is unclear how the Commission would be able to develop detailed level 2 requirements for the Disclosure Regulation. Article 2(o) of the Disclosure Regulation defines 'sustainable investments' broadly. For the 'E' in ESG, Article 2(o)(i) defines environmentally sustainable investments by reference to the Taxonomy Regulation. The Disclosure Regulation does not reference the Taxonomy Regulation, however, for the definitions of the 'S' and 'G.' Instead, the Disclosure Regulation refers to 'investments in an economic activity that contributes to a social objective' and 'investments in companies following good governance practices.'⁸ These definitions aim to be foundational, and the taxonomy work therefore should precede any disclosure requirements that are based on that taxonomy.

⁵ Proposal for a regulation on the establishment of a framework to facilitate sustainable investment (24 May 2018), available at https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5524115_en#pe-2018-3333.

⁶ See Fact sheet: Delivering on sustainable finance for a greener and cleaner economy: First actions, available at https://ec.europa.eu/info/sites/info/files/180524-sustainable-finance-factsheet_en.pdf.

⁷ See Taxonomy Regulation. The first piece of the taxonomy, concerning climate change mitigation, is scheduled for completion by mid-2020. The next piece of the taxonomy, regarding circular economy and pollution prevention, is scheduled for the end of 2021, with water protection and protection of the healthy ecosystem entering into force by the end of 2022.

⁸ See Article 2(o)(ii)-(iii).

Moreover, common definitions are needed to create comparable disclosure in both the issuer and asset manager context. Determining whether an issuer is ‘good’ in ESG terms can be a highly subjective exercise, particularly for the ‘S’ and ‘G.’ For example, a number of vendors provide ESG ratings of both companies and funds. It is not uncommon, however, for vendor ratings to differ significantly. These inconsistencies exist because of significant differences in the vendors’ proprietary approaches to data collection, analysis, and reporting.

In addition to ensuring common definitions are in place, improving the availability, reliability, and consistency of corporate disclosure also should be encouraged as a precursor to asset managers’ disclosure efforts. It is difficult for asset managers to disclose aggregated data on underlying portfolio securities where issuer data is inconsistent or unavailable. More broadly, corporate disclosure regimes have significantly different approaches to ESG-related reporting requirements.⁹ As the Commission considers the appropriate sequencing of various initiatives, we therefore would welcome an increased focus on corporate disclosure that would improve asset managers’ access to information about material ESG factors and subsequent ability to provide relevant disclosure.

Amendments to MiFID II suitability requirements demonstrate potential pitfalls of inappropriate sequencing of initiatives

This sequencing problem also is reflected in the Commission’s proposed amendments to suitability requirements contained in MiFID II. The delegated acts amending the suitability requirements under MiFID II rely on a taxonomy that is not scheduled to be completed until after the amendments take effect.¹⁰ The Commission anticipates completing the taxonomy for environmentally sustainable activities by the end of 2022¹¹ while the MiFID II suitability amendments are scheduled to enter into force by mid-2020.

The current sequencing creates potential for substantial challenges around operationalizing the new suitability requirements. A legal obligation to integrate sustainability into suitability assessments without an established EU taxonomy in place is likely to lead to inconsistency and divergent interpretations of which investments satisfy an investor’s ESG preferences or even what those preferences may be. Without common definitions in place, it is unclear how investment firms would gather information from investors about their ESG preferences. The amendments also do

⁹ See also OECD (2017), *Investment governance and the integration of environmental, social and governance factors*, at p.17, available at <http://www.oecd.org/cgfi/Investment-Governance-Integration-ESG-Factors.pdf> (OECD Report).

¹⁰ See Commission draft delegated regulation amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that directive (24 May 2018), available at https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5524115_en#isc-2018-03036, at Article 1, defining the ‘E’ in ESG preferences by reference to the Taxonomy Regulation. As in the Disclosure Regulation, the draft amendments’ definitions of ‘S’ and ‘G’ do not cross-reference the Taxonomy Regulation. Rather, the amendments vaguely define the ‘S’ as ‘social investments’ and the ‘G’ as ‘good governance investments.’

¹¹ See *supra* note 7.

not clarify how investment firms would translate those investor preferences into recommended products or services that would satisfy their suitability obligation.

In addition to providing sufficient time for adoption of the taxonomy, we also recommend extending the implementation timing for the proposed changes to the MiFID II suitability test to align with any changes that result from the planned 2019 review of MiFID II. MiFID II is still being ‘bedded down’ by industry, and investment firms and supervisors will need time to incorporate new guidance before additional requirements are added. The upcoming review of MiFID II presents an opportunity for the Commission to create efficiencies in combining the implementation of the suitability amendments with any additional changes resulting from the review. This approach would provide the Commission with sufficient time to complete the taxonomy and investment firms with adequate time to work out existing implementation issues before refocusing on the suitability amendments.

Recommendation 2: Provide a structured level 1 framework and a thorough level 2 process

We encourage the Commission and legislators to provide more structure for level 1 in the proposed Disclosure Regulation to create a detailed framework for level 2 requirements. We understand the Commission’s desire to treat this sustainable finance package as a priority and finalise it swiftly. We have concern, however, that the Disclosure Regulation does not provide sufficient guidance on what the delegated acts should encompass. The high-level nature of the proposal makes it difficult to understand what disclosure the Regulation ultimately will require, and therefore to assess the proposal’s impact properly. With most of the detail left to delegated acts, financial market participants are less able to form positions and address potential issues and concerns with the Commission and legislators. Equally importantly, with the lack of adequate framework in level 1, the co-legislators are adopting legislation at level 1 without an adequate understanding of the requirements and their full impact.

Setting forth adequate detail in level 1 will ensure that the legislators are able to take into account potential challenges that market participants may face with providing the required disclosure. For example, we fear that, with limited opportunity for market feedback, the delegated acts could inadvertently require asset managers to disclose information that is not available from corporate issuers. ESG data tends to be less available for fixed income investments, and from smaller companies or issuers in emerging markets. These issuers often do not have the resources to respond to vendors’ ESG-related information gathering exercises or other reporting. Without an adequate political exchange at level 1 of what type of disclosure is being envisioned, it will be more difficult for market participants to flag issues—such as data availability—with enough time for the Commission and legislators to address them.

Similarly, we encourage the Commission to contemplate adding language that would permit carveouts as needed—for example, adding a clause such as ‘subject to any exemptions granted by [ESMA].’ This type of provision would provide a means to address concerns that surface further along in the process. This mechanism would allow the Commission to avoid a scenario where a

needed carveout cannot be added at a later date because the provisions are already ‘baked in’ and do not allow for exemptions.¹²

Finally, without sufficient structure in level 1, it also is difficult for the regulated fund industry to determine the subsequent implementation cost of the Disclosure Regulation. Creating and updating asset manager disclosures, including possible retrospective changes to prospectuses, may present significant costs. In fact, there are estimates that implementing the Commission’s sustainable finance proposals could increase asset managers’ costs by 0.25%-2% depending on their current ESG capabilities.¹³ These estimates stand in contrast to the Commission’s impact assessment, which describes the Disclosure Regulation as ‘cost-neutral.’ It is the industry’s experience that implementation of significant, complex regulations often creates unexpected costs that impact both asset managers and investors.¹⁴

Remuneration disclosure provisions in level 1 fail to provide insight into ultimate disclosure requirements

Although some details should be left to level 2, we request more substantive structure in the level 1 proposal around what specific disclosure the Commission intends to require, particularly in proposed Articles 3 and 4. It is unclear what the remuneration policy disclosure provision would entail. Article 4 requires financial market participants, including asset managers, to disclose ‘how [their] remuneration policies take into account the integration of sustainability risks and sustainable investments.’ The lack of detail around what asset managers would need to disclose and how it would be disclosed makes it difficult to determine whether the Commission contemplates a remuneration policy that is process-driven or prescriptive. We would support a process-driven approach and that discussion should be had at level 1 among the co-legislators.

ICI Global strongly believes that remuneration requirements should not follow a one-size-fits-all approach. When establishing and applying remuneration requirements, firms should be permitted to comply with the requirements in a way and to the extent that is appropriate to their size, internal organisation, and the nature, scope and complexity of their activities. In the regulated fund context, fund manager remuneration should align with the objectives of the fund being managed. A disclosure-based approach to remuneration policies would permit appropriate flexibility for the

¹² For example, in MiFID II, the restrictions around research and soft dollars were applied to fixed income in the same way as equities, despite that soft dollars have never been paid on fixed income trades. A carveout for fixed income was not possible because the provisions were already ‘baked in’ and did not allow for exemptions.

¹³ ‘Moody’s says sustainable investment rules are “credit negative”’ (1 June 2018), available at <http://www.funds-europe.com/news/moody-s-says-sustainable-investment-rules-are-credit-negative>.

¹⁴ For example, the Commission estimated MiFID II would impose one-off compliance costs of between €512 and €732 million. Implementation costs have climbed much higher though with costs estimated at more than €2.5 billion. *€2.5bn cost of Mifid II rattles asset managers*, Financial Times (27 January 2018), available at <https://www.ft.com/content/ba243304-c224-11e6-9645-c9357a75844a>. To avoid this type of outcome, we ask the Commission to provide enough detail in the level 1 text to allow the market to better assess expected implementation costs.

broad spectrum of investment objectives among which fund investors can choose. For example, an ESG-themed fund with specific sustainability objectives or targets may explicitly incorporate the achievement of those objectives or targets into the manager's remuneration. Other funds that are not explicitly ESG-themed appropriately may focus remuneration on the fund manager's achievement of the fund's investment objective without considering sustainability as a separate remuneration target.

Importantly, we note that a comprehensive and strict framework for remuneration for fund managers—with requirements specifically adjusted to the distinct nature of the regulated fund sector—is already in place under UCITS V.¹⁵ These existing requirements already incentivise the integration of sustainability risk considerations, where relevant and material for investment performance, and aim to align asset managers' compensation with clients' interests. Rewarding a focus on long-term investment results functions as a proxy for taking sustainability into account because material sustainability considerations are drivers of long-term performance.

Consider more transparent and thorough approach to level 2

We encourage the Commission to take a considered and transparent approach to level 2 measures so that it can ensure it has the opportunity to address any market concerns that surface in the detail discussions around level 2 measures. The important policy goals underpinning the Disclosure Regulation merit a considered, thorough process. A transparent consultation process, that encourages open, public input would enable a thorough evaluation of policy options before a draft regulation is adopted, ensuring the quality and ultimate effectiveness of regulation.¹⁶ Without a comprehensive and transparent process in level 2, the resulting Regulation could contain elements that create unintended consequences that a thorough consultation process could have avoided with input from knowledgeable market participants. The cost of not engaging in such a process would be an ineffective Disclosure Regulation that does not provide consistency or comparability for end users and that instead creates additional fragmentation of disclosure.

Further, given the global nature of financial markets, a more deliberate process would allow for the consideration of the extraterritorial impact of regulation for market participants within, and outside, the European Union.¹⁷ We caution that imposing specific sustainability values or preferences onto UCITS and AIFs that are not explicitly ESG-themed, without sustainable

¹⁵ Before specifying further details around remuneration policy disclosure, it would therefore be prudent for the European Commission to conduct a comprehensive analysis focused on the future interaction of this and other existing remuneration-related EU rules.

¹⁶ We outlined our thoughts on a comprehensive level 2 process in our 29 January 2016 response to the Commission's Call for Evidence on the European Union's Regulatory Framework for Financial Services. Our response is available at <https://www.iciglobal.org/pdf/29677.pdf>.

¹⁷ For example, MiFID II has created significant challenges for global investment firms with its extraterritorial reach. We have expressed concern that the adoption of European rules that have substantial extraterritorial effects would cause significant operational complexity, compliance costs, and disruption across funds and clients at a global level.

investing as a target, is likely to have a negative impact on demand from non-EU investors. Our members expect that non-EU investors may react adversely if globally-offered UCITS and AIFs in which they invest added new sustainability requirements that did not reflect their preferences and could impact their investments' performance.

MiFID II suitability amendments demonstrate importance of addressing issues in level 1 or providing for a more thorough level 2 process

These issues came to the fore in the level 2 process for the recent ESG-related amendments to the MiFID II suitability test, which were incorporated into amendments to draft delegated acts.¹⁸ We are concerned that the provisions in these delegated acts have the potential to impact negatively investors and market participants. Moreover, market participants have struggled to address issues with the amendments within the short timeframe available in the level 2 process (less than one month to evaluate and provide written feedback).

As drafted, we fear the amendments could be construed to suggest that a client's ESG preferences would outweigh other important financial considerations, such as a client's investment objectives (including desire for financial returns), risk tolerance, and capacity for loss bearing. The text of the draft amendments would not appear to provide investment firms with sufficient flexibility and discretion in incorporating clients' ESG preferences as part of the mix of other information that the client provides during the suitability assessment, rather than a standalone consideration.

In addition, the amendments lack clarity around whether investment firms could consider a client's ESG preferences as part of the overall picture of a client's profile—not as a standalone checkbox that must be ticked for each individual investment. The amendments appear to contemplate that an investment firm should consider a client's ESG preferences for each security that it recommends to a client, rather than in the larger context of the client's overall portfolio.¹⁹ This approach could lead, however, to a portfolio with an allocation that is not suitably diversified or otherwise positioned to achieve the client's goals, possibly making financial advice noncompliant with the overall MiFID II package.²⁰ Investment firms instead should be able to take a holistic approach to integrating a client's ESG preferences, in recognition that the process of incorporating a client's ESG preferences is complex and may not lend itself to a simple screening approach.

¹⁸ See Commission draft delegated regulation amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that directive (24 May 2018), available at https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5524115_en#isc-2018-03036.

¹⁹ See *id.*, at Recital 12 ('Investment firms should also explain to the client how his or her ESG preferences for each financial instrument is taken into consideration in the selection process used by those firms to recommend financial products.').

²⁰ An ESG-themed fund is not necessarily less risky or higher-performing than a fund that is not explicitly ESG-themed.

These are serious issues worthy of consideration, but the nature of the level 2 process has constrained the legislators' and market participants' ability to deliberate and address them.²¹ To avoid a similar outcome for the Disclosure Regulation, we recommend that the Commission flesh out the proposal's details in level 1 to provide sufficient direction for the intended disclosure and to provide for a thorough level 2 process, so that the market has sufficient time and information to digest its potential impact and provide feedback.

Recommendation 3: Retain the Disclosure Regulation's Distinction between Financial Products and Sustainability-themed Financial Products

We appreciate the Commission's distinction between disclosure that applies to financial products at large and sustainability-themed financial products (*i.e.*, with a sustainability target). Importantly, this distinction recognizes that the regulatory framework cannot be one-size-fits all. Requiring ESG-themed funds to provide specific sustainability-oriented disclosure will allow end users to compare these types of funds while appropriately recognizing that this disclosure is not relevant or appropriate for funds that are not ESG-themed.

To maintain this distinction, we recommend clarifying where the Disclosure Regulation refers to *material* ESG risks and considerations.²² As we described above, asset managers in practice consider material ESG factors in their investing process, as part of their pursuit of long-term financial value on behalf of investors. Disclosure of material ESG risks and considerations therefore should apply to all asset managers. Non-material ESG risks and considerations, however, are only relevant in the context of an asset manager's ESG-themed fund or mandate. It is therefore important to distinguish between disclosure requirements for material vs. non-material ESG risks and considerations. For example, Article 3 of the Disclosure Regulation requires asset managers to disclose how they incorporate 'sustainability risks' into the investment process. The Disclosure Regulation should clarify that this disclosure concerns material sustainability risks.

²¹ We expect the Commission may face similar challenges in the upcoming potential amendments to delegated acts under the UCITS Directive, AIFMD, MiFID II, Solvency II, and IDD regarding integration of sustainability risks and factors. See Formal request to EIOPA and ESMA for technical advices on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC, Directive 2009/138/EC, Directive 2011/61/EU, Directive 2014/65/EU and Directive 2016/97/EU with regard to the integration of sustainability risks and sustainability factors (24 July 2018), available at <https://eiopa.europa.eu/Publications/Requests%20for%20advice/20180724-Letter%20to%20EIOPA-ESMA-St.Fin.pdf>.

²² We similarly note that the amendments to MiFID II suitability inconsistently use the terms 'ESG preferences' and 'ESG considerations,' without reference to the materiality of those ESG considerations. See Articles 47(3), 48(1), 52, and 54, *supra* note 18.