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Public consultation on long-term and sustainable investment

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Introduction

Fostering growth and investment is one of **European Commission's top priorities.**

To maintain and extend its competitiveness, Europe needs significant new long-term and sustainable investment.

These can also help achieve the EU's policy objectives linked to the transition to low carbon and climate resilient economy and promote environmentally and socially sustainable wealth creation, including respect for fundamental rights.

The Communication on Long-Term Financing of the European Economy [COM/2014/168 final] emphasized that one of the key features of long-term financing is that investors take longer-term aspects such as environmental, social, governance issues into account in their investment strategies. It further underlined the importance of ESG issues for the longer-term sustainable performance of companies and investors and announced further reflection on incentives for more sustainable investment. The Action Plan on building a Capital Markets Union [COM/2015/468 final] also reiterates the importance of ESG investments.

This consultation seeks to gather information on how **institutional investors, asset managers and other service providers in the investment chain factor in sustainability (ESG) information and performance of companies or assets into investment decisions.** The consultation will also gather information about possible obstacles to long-term, sustainable investment.

The results of this consultation will be used by the Commission to assess the state of play in this field. A feedback document outlining the overall results of the consultation will be made public.

Definitions

For the purpose of this consultation, the following definitions are used:

Sustainable or responsible investment is a comprehensive approach to investment that explicitly takes account of environmental, social and governance (ESG or sustainability) issues and the long-term health and stability of the market as a whole. The evaluation of ESG issues is a fundamental part of assessing the value and performance of an investment over the medium and longer term. It also implies that an investor should be an *active asset owner* engaging with companies (for example through dialogue on strategy, risk, corporate governance) to improve their performance. [See Principles for responsible investment, What is responsible investment?]

Material *environmental* factors include, among others, carbon emissions, climate change risks, energy usage, raw material sourcing and supply risks, waste and water management. *Social* factors include, in particular, customer and employee relations, health and safety, human capital management, fundamental rights. *Governance* matters include, in particular, board accountability, structure and size, management ability to deliver a strategy, executive compensation schemes, bribery and corruption.

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About the respondent

* 1. Please provide your full name (authority, association, organisation, enterprise, ..., as applicable)

Frank Bold, public interest law firm

* 2. Please provide contact details (e-mail, phone number, postal address)

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* 3. Are you replying as:

- a. Public authority
- b. Institutional investor
- c. Asset manager
- d. Other service provider or advisor
- e. Company
- f. Association
- g. Retail investor
- h. Private person

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Contact

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- ○ i. Other

* d. Other service provider or advisor

- ○ Investment bank or broker
- ○ Investment consultant
- ○ Financial analyst
- ○ Proxy advisor
- ○ Accountant or auditor
- ○ Credit rating agency
- ◉ Other

* Please specify:

Law firm

* 4. Is your organisation registered in the EU Transparency Register? (If not, you may register here, although you do not have to be registered to reply to this consultation.)

- ◉ Yes
- ○ No

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- ○ No, I do not consent to the publication of my contribution. I understand that my anonymised responses may be included in published statistical data, for example, to show general trends in the response to this consultation.

Please note that before completing the survey you will have the opportunity to upload documents to further support or illustrate your views.

Questions

1. Rationale for ESG inclusion into investment decisions

1.a. Do ESG factors pay a role in the investment decisions of investors? If not, why?
If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

Yes and no. Environmental, social and governance (ESG) risks are increasingly seen as financially material, both in positive terms (high ESG performance is correlated with improved long-term financial performance) and in negative or defensive terms (ignoring them can result in lower returns or losses, directly through stranded assets, and indirectly through the vulnerability of investee companies to regulatory investigations, litigation, regulatory changes and reputational/brand damage). In theory, pension funds have the correct incentives to engage with investee companies to steer them towards the long-term. Yet evidence suggests this is not happening despite escalating soft law interventions.

Although trustees across the EU are legally permitted to take account of environment, social and governance risks in making investment decisions, the law in this area is vague and ill-defined. Furthermore, it appears that many investors are reluctant to factor these risks into their analysis, preferring instead to take a short-term, purely quantitative approach to management of risks across their portfolio.

This consultation response focuses on addressing the legal barriers to the integration of ESG considerations and is accompanied by the attached position paper with the relevant citations.

1.b. What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues (multiple choice)

- [x] a) risk management:
- [x] b) alignment of investment policies with the long-term interests of beneficiaries of the institutional investor,
- [ ] c) pressure from clients on whose behalf the institutional investor invests funds,
- [ ] d) seeking a positive social or environmental impact of investments,
- [ ] e) ethical considerations,
- [x] f) legal or regulatory constraints, please specify,
- [ ] g) other, please specify.

a) risk management:

- [ ] i) managing asset value risk in the short-term, including preservation of investment value, better investment performance,
- [x] ii) managing asset value risk in the medium-to long-term, mitigation of exposure to long-term and systemic risks,
- [ ] iii) management of liability risks,

* f) legal or regulatory constraints, please specify:

The current state of the law on fiduciary duties is uncertain and it is unlikely that the courts will have adequate opportunities in the near future to clarify matters. It would therefore be extremely helpful to have clarification at the EU (and national) level about the scope of discretion available to pension fund trustees. Many investors are willing to consider taking account of ESG risks in their policies and decision-making but are currently held back by legal uncertainties and (ill-founded) fear of liability. Guidance from the Commission would embolden pension funds to play the role that is expected of them by their beneficiaries and society.

Please provide an explanation :

2. Information on ESG risks and opportunities

2.a. Which ESG risks do you perceive as material to investors?

There is increasing evidence that considering ESG is no longer simply an ethical consideration but rather a material financial risk (and opportunity) that must be identified, managed and disclosed. Financial risk from environmental factors may arise where individual investments are jeopardized by the effects of pollution, extreme weather events (e.g. heat waves, droughts, flooding), or more generally climate change. Many institutional investors have publicly acknowledged that current economic models of the impact of climate change have inadequately considered the significant tail risks associated with extreme climate change and thus underestimate the associated economic risks. Other institutions have also made public statements about materiality of climate change, including Mark Carney, Governor of the Bank of England.

Specific financially material environmental risks can impact on the interests of beneficiaries in two main ways. First, they can impact on the value of specific investments. Examples include fossil fuel energy companies whose assets may become stranded; concession and construction companies in charge of maintaining core infrastructure with very long-term contracts; and tourism infrastructure such as ski resorts. Those risks may come from the environment, from litigation, or from regulatory responses to changes in the environment. In their stewardship role, large pension fund trustees holding shares in these entities could press the directors to insure against these risks, which would quantify the risk and impact on the value of shares, potentially creating pressure for a change of business model where the risk is elevated.

Second, they can contribute to the ongoing destruction of the environment as an essential system on which the beneficiaries depend for their quality of life, and even their survival. Thus the G20/OECD High-Level Principles on Long-term Investment Financing highlight the need for the governing bodies of institutional investors to measure, monitor and manage the long-term environmental risks in their portfolios. Yet this second category is harder to reconcile with fiduciary duty, and particularly the requirement that the connection between investment decisions and beneficiary returns not be 'too speculative and remote'. As the Cowan case noted, even the largest pension fund cannot hope to save a national economy by its actions alone. This logic applies with even more force to the environmental system. As 'universal owners', pension funds have an interest in the survival of the planetary ecosystem, both because it affects the returns on their investments and because it affects what their beneficiaries will be able to do with those returns in the future. This implies that pension funds should act collectively, by putting pressure on policy makers to address these problems, and to coordinate investment strategies in relation to particular sectors. However, as things stand, this is a minority pursuit, confined to pension funds which have committed themselves to be socially responsible investors.

At the same time, ESG integration can have a positive impact on portfolios as companies with better ESG ratings tend to have better long-term financial performance (measured over 15-20 years), improved credit ratings, and a lower cost of debt. Indeed, a study of 1,500 firms from 26 developed countries over a 77 month period concluded that (1) there were no indications that the integration of aggregated or disaggregated corporate environmental responsibility ratings into pension fund investment processes had any detrimental financial effect; and (2) considering ESG resulted in substantially lower downside volatility. Thus, ESG integration may be considered financially material both in terms of risk and opportunity.

2.b. What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

There is currently a shortage of high quality, publicly available information on long-term risks and opportunities, especially with respect to ESG matters. It is hoped that the requirements for disclosure of ESG information under the Non-Financial Reporting Directive (2014/95/EU) will go some way to addressing this issue. It is therefore important that the guidelines currently being developed by the European Commission on non-financial reporting provide clear instructions to companies and Member States on their obligations, especially on the question of defining 'materiality' for non-financial information and the due diligence processes necessary to uncover ESG issues, especially in supply chains and overseas business operations.

2.c. Is it difficult for investors to access such information? If so, please specify:

An increasing number of companies are reporting on ESG matters but quality and comparability remain ongoing issues. Furthermore, many corporate governance codes encourage disclosure of certain non-financial information but reliance on the comply or explain principle of reporting means that many companies will either fail to explain at all or inadequately explain their deviations from the general rule.

2.d. Is access to such data expensive? If so, please specify:

N/A

2e. What factors may prevent or discourage companies from disclosing such data?

The pressure to focus on short-term financial performance means that there is little incentive to disclose non-financial/ESG information.

2.f. What is the main rationale for companies to publish such information? Please indicate all the relevant issues. (multiple choice)

- [x] a) relevance of ESG issues to company performance
- [x] b) attracting financing for specific projects, for example green bonds
- [x] c) legal or regulatory constraints
- [x] d) demand from investors
- [ ] e) pressure from stakeholders
- [x] f) other

* f) other - please specify:

Discounted cost of capital

2.g. Is there sufficient accountability for the disclosure by companies of such information?

No. Some companies are beginning to ask auditors to provide an assurance report on their non-financial information. However the lack of robust controls for non-financial information, as exist for financial information, continues to pose a challenge to assurance providers.

2.h. What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

As noted in the CSES Report on Disclosure of non-financial information by companies (Dec 2011), oversight of corporate responsibility and sustainability issues may be delegated to a board committee tasked with reviewing and approving non-financial reports. Support is often provided by a specialised department or manager responsible for corporate responsibility, sustainability, health and safety, or the environment. This is an emerging practice that continues to be confined to larger companies.

2.i. What is the role of specific ESG investment instruments, like green bonds?

Green bonds continue to represent a small percentage of finance and risk diverting attention from the mainstreaming of ESG issues within finance as a whole.

3. Integrating ESG information into risk assessment models of institutional investors and asset managers

3.a. What should an appropriate long-term risk assessment methodology look like? Please indicate some examples of good practice.

N/A

3.b. Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

The current focus on maximising shareholder value, as measured in quarterly returns and short-term share price, creates pressure for publicly traded companies to ignore ESG matters and other longer-term concerns in their business strategies. This is mirrored by a similar pressure on institutional investors to maximise short-term returns for their beneficiaries, even though this is not strictly required by existing law on fiduciary duties. \

4. Integration of ESG aspects in financial incentives

4.a. When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies? What are the best practices in this area?

Even if pension fund trustees hold strong views that ESG risks should be taken into account, there are significant barriers to asset managers and investment consultants doing this. As both the Myners Report of 2001 and the Kay Review of 2012 identified, the performance of asset managers tends to be assessed on a very short-term basis and in comparison with their peers. It is also clear that most pension fund trustees do not include specific ESG instructions in their mandates to asset managers.

The result is a lack of alignment between the incentives and decision-making of asset managers and the financial interests of end beneficiaries. Whilst pension fund trustees who fail to give mandates to asset managers which require them to adequately protect the best interests of beneficiaries may be in breach of the fiduciary duties of prudence and loyalty. However, there is a lack of clarity surrounding duties and required standards in this area of the law because litigation by beneficiaries against trustees or by trustees against asset managers is practically non-existent. As a result, the law does not provide clear signals to these important intermediaries.

4.b. Is ESG performance and active asset ownership taken into account in the remuneration of the executives and/or board members of institutional investors? What are the best practices in this area?

No, or to a very limited extent. Ideally remuneration should be tied to a combination of financial and non-financial performance. In the longer-term, it will also be necessary to look at readjusting asset managers' mandates/benchmarks to integrate ESG criteria and thereby refine incentives to encompass extra-financial matters. Although it is unlikely that asset managers' performance assessment will significantly exceed one year, claw-back clauses could be used to cover the possibility of materialised environmental or social harm. Claw-back clauses are already used for bankers' bonuses to deter excessive risk-taking and improper conduct. Another option would be to change benchmarks so that asset managers would be compared only to SRI funds or other relevant peer groups, rather than to traditional funds investing in the same asset classes.

5. Capacity of institutional investors

5.a. Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG

factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

N/A

5.b. Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

N/A

6. Internal governance and accountability of the institutional investor

6.a. To what extent can good internal governance of institutional investors, such as mechanisms aiming to align interests between beneficiaries, board and key executives, influence their ability and willingness to integrate ESG factors in investment decision-making and engage on these issues? Please provide evidence or good practices if possible.

Creating the right incentive structure is critical. The interests of the board, executives, asset managers and beneficiaries should be aligned. Additionally, ShareAction's report Realigning Interests, Reducing Regulation (2015) found that Australian non-profit pension funds where trustees were appointed by employers, beneficiaries or their unions outperformed for-profit pension schemes by an average of 2.4% over the past decade. This may be an interesting model to explore in Europe.

6.b. Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

There continues to be a lack of transparency and beneficiary engagement/consultation. The draft revision of the Shareholder Rights Directive (2007/36/CE) foresees that institutional investors and asset managers will be required to develop and disclose to the general public a policy on shareholder engagement and, on a comply or explain basis, disclose how it has been implemented and the results achieved. They should also disclose how their investment strategy as to equity investments aligns with the long-term value of the assets in which they are invested, and consider ESG matters. This is a step in the right direction. However, more than transparency is needed. Ideally pensions should develop online or other tools to interact with their beneficiaries to develop investment policies that align with their long-term interests, e.g. in line with climate change scenarios.

6.c. Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

N/A

7. The role of other service providers

7.a. Is there sufficient long-term oriented, reliable and relevant external investment research? Are there barriers to good quality external investment research on ESG risks and opportunities? If so, please explain. What role, if any, do financial incentives or conflicts of interests of some service providers play?

N/A

7.b. To what extent do investment banks, investments analysts and brokers provide information on medium-to long-term company performance, including corporate governance and corporate sustainability factors, when they make buy, sell and hold recommendations to investors?

N/A

7.c. To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

N/A

7.d. To what extent do proxy advisors consider medium-to long term performance of companies, including ESG performance, in their voting recommendations?

N/A

7.e. To what extent do credit rating agencies take medium-to long term performance of companies, including ESG performance, into account in their ratings?

N/A

7.f. What are the best practices as regards independent external assurance (for example auditor review) for the disclosure by companies of material medium- to long-term risks and opportunities, particularly ESG issues?

N/A

8. The role of non-professional investors

8.a. Do you know of initiatives that led to more sustainable and responsible investment from non-professional investors? Please provide details about them.

N/A

9. Legal or regulatory constraints

9.a. Are there legal or regulatory constraints likely to significantly and unduly prevent or discourage investors from taking a long-term view in their investment strategies and decisions and from investing in a sustainable way? If so, please provide details.

Yes. As explained above, the current emphasis on maximising short-term returns may prevent investors from taking a long-term view in their investment strategies. The existing practice of quarterly financial results could be contributing to short-termism. Furthermore reporting tends to be primarily backward-looking, which prevents companies from taking adequate account of long-term risks (information which should be independently audited). An interesting exception is found in the proposed revision to the Dutch Corporate Governance Code, which will require the management board to identify and analyse risks, establish the company's risk appetite, and publish a control statement stating that the risks will be adequately dealt with for the next year (principle 1.2 on risk management and principle 1.4 on risk management accountability).

Furthermore, we consider there is a need for greater legal guidance from regulators on whether consideration of ESG matters is part of fiduciary duty. Whilst there have been leading reports on this issue published by the Commission (DG Environment), UNEP Finance Initiative and Fair Pensions, there has been no definitive legal guidance from regulators to provide clarity to trustees and directors.

9.b. Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

Yes. Fiduciary duties are typically interpreted in a narrow way to exclude or limit the scope of ESG considerations. To remedy this, national financial authorities with support from the European Commission should provide official guidance and interpretation of fiduciary duties and the extent to which institutional investors may or must include ESG issues into their investment strategies and decisions both in terms of risk and opportunity. The Commission has issued similar guidance through influential albeit not legally binding

guidance would clarify minimum expectations across the EU and settle the question of ESG issues and fiduciary duties.

The Commission might also point out that the duties of asset owners require that they ensure that mandates given to asset managers:
- reflect the asset owners' views on the relevance of ESG risks to beneficiaries' returns; and
- are sufficiently long-term, and include performance measures and incentives which are aligned with the interests of beneficiaries.

The Commission could issue guidance in the form of model mandates or in other ways, and give thought to how hard or soft law might be used to extend the time horizons in which asset manager performance is assessed to bring it into line with beneficiaries' financial interests.

10. Others

10.a. Are you aware of any other incentives or obstacle(s) with a significant impact? If so, which ones?

N/A

10.b. Would you consider further increase in sustainable investments if market or regulatory conditions for sustainable investment would be more favourable? If so, please provide estimations, if possible.

N/A

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