

MEMO# 31078

February 8, 2018

EU High-Level Expert Group on Sustainable Finance Publishes Final ESG-Themed Report

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February 8, 2018 TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: Disclosure
Fund Governance
International/Global
Investment Advisers RE: EU High-Level Expert Group on Sustainable Finance Publishes Final ESG-Themed Report

The European Commission's High-Level Expert Group (HLEG) recently released its final report (Final Report) with recommendations for policy action on "sustainable finance."^[1] The Final Report includes eight recommendations for key priority actions, as well as additional broader and sector-specific suggestions, including for asset managers. The Final Report will form the basis of the Commission's comprehensive Action Plan on sustainable finance, which the Commission expects to publish in March. We summarize the relevant recommendations below.

I. Background

As previously reported, the Commission tasked the HLEG with recommending an EU strategy on sustainable finance as part of the Commission's Capital Markets Union Action Plan. The Commission also views its strategy on sustainable finance as a key step toward implementing the Paris Agreement on climate change and the EU's objective of aligning its financial system with its sustainability objectives.

This Final Report follows an interim report that the HLEG previously published in July 2017.^[2] That interim report included an early recommendation that the Commission clarify in legislation or regulatory reviews that the fiduciary duties of institutional investors and asset managers explicitly integrate material sustainability (i.e., environmental, social, and governance (ESG)) factors with a view toward long-term performance.^[3] The Commission published a consultation in late 2017 to gather feedback on this interim recommendation.^[4] ICI Global submitted a response to the consultation, urging the Commission to avoid prescribing a uniform ESG investing mandate.^[5]

II. Eight Key Recommendations

The Final Report recommends that the Commission pursue the following eight priority actions.

Recommendation 1: Establish a common sustainability taxonomy at the EU level.

The HLEG recommends that the Commission develop a technically robust classification system that establishes market clarity on what is “green” or “sustainable.”^[6] As a first step, the HLEG invites the European Investment Bank to coordinate the development of an EU classification of climate change finance, starting with definitions of activities that deliver climate change mitigation results consistent with EU goals. The HLEG proposes a roadmap to develop a fully-fledged sustainability taxonomy by 2020.

Recommendation 2: Clarify investor duties to encourage a greater focus on sustainability issues over the long-term.

The Commission should require asset owners to consider ESG factors over the investment horizon of their beneficiaries (e.g., pension fund beneficiaries) and incorporate those factors into their investment strategies and the mandates that they give to asset managers. Asset managers should be required to communicate with their clients about the sustainability priorities and timeframe of the investment mandate or fund. The asset manager also should ensure that the asset owner understands the potential risks and benefits of incorporating sustainability issues into the investment strategy, including the strategy’s effect on prospective return. The Commission should require “collective investment management companies” to receive informed consent from clients on sustainability issues. Under Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Managers Directive (AIFMD), this obligation would include consideration of the interests of all investors who are clients of the scheme.

The HLEG recommends implementing its suggested course of action through an EU omnibus proposal that would amend a number of directives, including the Markets in Financial Instruments Directive (MiFID II), UCITS, and AIFMD.

Recommendation 3: Require increased disclosure of sustainability risks, starting with climate-related risk. The Commission should endorse and implement the disclosure recommendations of the Task Force on Climate-related Financial Disclosures,^[7] drawing on the experience of the implementation of France’s Article 173.^[8] The Commission also should consider “comply or explain” disclosure principles on a set of metrics for companies, such as financial exposure to the activities/products listed in the EU green taxonomy.

Recommendation 4: Require retail fund disclosure on sustainability and develop an EU-wide label for green investment funds. The Commission should ask all retail funds to disclose clear and understandable information on their sustainability impact, as well as information on the exercise of voting rights. These funds should disclose, as a first step, their strategy and portfolio exposure in relation to climate-related risks and opportunities. Funds also should disclose whether and how they are implementing “sustainability strategies,” so that retail investors can assess whether an investment is consistent with their preferences. To help the industry in overcoming methodological obstacles, the Commission should support and encourage the development of a common set of sustainability impact metrics and proxies, including the development of indicators assessing funds’ contribution to implementing the Sustainable Development Goals outlined in the UN’s 2030 Agenda for Sustainable Development.

The Commission should protect retail investors by establishing minimum standards for

funds using the terms “ESG” or “sustainable.” The Commission should identify and analyze the numerous sustainability labels being used in the market and clarify them for the benefit of retail investors, while allowing for the specificities of each of the member states’ markets to be respected.

The Commission should develop a voluntary EU green label for green-themed funds. These should include specifications based on the use of the EU sustainable taxonomy and include a high proportion of green activities in the portfolio of invested companies, exclusion of incompatible business (such as the fossil fuel sector), an ESG risks screening (human rights, governance, etc.), as well as strong and understandable impact indicators on environmental issues.

The Commission and the European Securities and Markets Authority (ESMA) should require financial advisors to ask about, and then respond to, retail investors’ preferences about the sustainable impact of their investments, as a routine component of financial advice. As a first step, ESMA should update the guidelines on suitability requirements to include explicit provisions on the obligation to ask clients about their sustainability preferences.

Recommendation 5: Develop and implement official European sustainable finance standards and labels, starting with green bonds. As a first step, the Commission should introduce an official EU Green Bond Standard (EU GBS) and consider an EU Green Bond label or certificate to help the market to develop fully and to maximize its capacity to finance green projects that contribute to wider sustainability objectives. The Commission should work toward publishing additional European sustainable product standards for other asset classes.

Recommendation 6: Establish a “Sustainable Infrastructure Europe” facility to ensure adequate investment in sustainable and resilient infrastructure. This facility would be an entity built on existing institutions and designed to accelerate the development of high-quality infrastructure projects that meet investor demands and deliver the EU’s sustainable objectives, including its obligations under the Paris Agreement. Sustainable Infrastructure Europe would focus on providing project development expertise on the ground across different parts of Europe.

Recommendation 7: Strengthening director duties and stewardship principles. The Commission should require adoption of minimum stewardship standards for investment mandates covering all asset classes and applicable to all institutions in the investment chain that act on behalf of others. The Commission should extend the Stewardship Principles for institutional investors, for example, by amending the Shareholder Rights Directive or a similar instrument. The Commission also should strengthen director duties related to sustainability.

Recommendation 8: Include sustainability in the supervisory mandate of the European Supervisory Agencies (ESAs) and extend the horizon of risk monitoring to include long-term sustainability risks. This recommendation responds to the Commission’s recent proposals to improve the mandates, governance, and funding of the ESAs for banking, securities and financial markets, and insurance and pensions.^[9] The proposals would require the ESAs to consider sustainability factors in supervisory practices at the European level. In adopting these proposals, the HLEG recommends that the Commission further clarify how the ESAs should interpret the inclusion of sustainability in their mandate; update EU financial regulatory rules accordingly; and extend the horizon of risk monitoring to include climate-related risks and other long-term risks.

III. Recommendation on Benchmarks

The Final Report also includes broader “cross-cutting” recommendations that advise the European Union, among other things, to improve financial market benchmark transparency and guidance. Specifically, the HLEG recommends that the Commission urge the International Organization of Securities Commissions (IOSCO) to update its Benchmark Principles so that they refer explicitly to sustainability and governance aspects, and specifically to climate considerations. The HLEG also recommends that ESMA include references to ESG and sustainability considerations in its guidance on the “Benchmark statement,” notably in Article 1.2, where a fourth point could be added: “(4) to what extent are sustainability (environmental, social and governance) considerations, including the transition to a low-carbon economy, reflected within the methodology of the benchmark?”

The HLEG believes that index providers should be asked to provide details of the exposure of widely used and referenced benchmarks to climate and sustainability parameters based on the securities included within the index and their weights. It notes that this type of consistent disclosure should help to assess how an index/fund is aligned with the climate targets from the Paris Agreement and with sustainable development targets.

The HLEG also recommends enabling investors to understand the sustainability characteristics and exposures of different fund options, both active and passive.

IV .Recommendations for Asset Managers

In its Final Report, the HLEG includes specific recommendations for different types of financial institutions. Its recommendations for asset managers are as follows:

- Embed sustainability in internal training and professional development of relevant personnel, including management leadership and the board;
- Reflect sustainability in incentive structures, with pay composition for fund managers and analysts based on performance over time periods longer than one year;
- Adopt minimum sustainability standards for investment mandates vis-à-vis their institutional clients;
- Review valuation and risk models to ensure consideration of long-term ESG factors in the investment process;
- Ensure institutional clients’ investment mandates incorporate the clients’ sustainability, governance, or broader ethical preferences, and seek clients’ informed consent; and
- Inform retail investors about ESG risks, integrate sustainability within management processes, and provide client reporting on engagement with portfolio companies.

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endnotes

[\[1\]](#) EU High-Level Expert Group on Sustainable Finance, *Final Report: Financing a*

Sustainable European Economy, (January 2018), available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

[2] EU High-Level Expert Group on Sustainable Finance, *Interim Report: Financing a Sustainable European Economy*, at p. 57, (July 2017), available at https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf.

[3] *Id.* at p. 57.

[4] See ICI Memorandum No. 30987, available at https://www.ici.org/my_ici/memorandum/memo30987.

[5] See ICI Memorandum No. 31045, available at https://www.ici.org/my_ici/memorandum/memo31045.

[6] See Final Report, *supra* note 1, at p. 17, Table 1: Key features of the taxonomy.

[7] See ICI Memorandum No. 30764, available at https://www.ici.org/my_ici/memorandum/memo30764.

[8] Article 173 of France's Energy Transition Law requires all major institutions to evaluate, report, and address their exposure to long-term climate-related financial risk on a "comply or explain" basis.

[9] Press release: *Creating a stronger and more integrated European financial supervision for the Capital Markets Union*, European Commission, Brussels (20 September 2017), available at http://europa.eu/rapid/press-release_IP-17-3308_en.htm.