IMPLEMENTATION TASKFORCE RESPONSE TO THE ESMA CONSULTATION ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN THE UCITS DIRECTIVE AND AIFMD

In 2016 the UK government set up an advisory group (the "**Advisory Group**") to assess how providers of savings, pensions and investments engage with individuals to support the values and social causes they care about. Composed of senior representatives from the savings, investment and social sectors, the group has focused on developing a set of practical recommendations that aims to help:

- increase the choice of savings, investment and pension products that offer social impact; and
- broaden sources of funding for enterprises targeting social impact as well as financial return.

The Advisory Group published its report 'Growing a Culture of Social Impact Investing in the UK' (the "**Report**") in November 2017. The report identified a comprehensive range of recommendations for stakeholders and policy makers, grouped under the following five key action areas:

- improve deal flow and the ability to invest at scale;
- strengthen competence and confidence within the financial services industry;
- develop better reporting of non-financial outcomes;
- make it easier for people to invest; and
- maintain momentum and build cohesion across initiatives.

The Implementation Taskforce on Growing a Culture of Social Impact Investing in the UK (the "**Taskforce**") was formed in January 2018 to progress the recommendations identified by the Advisory Group. Through the membership of its working group, steering group and advisory committee, along with ad hoc industry engagement initiatives, the Taskforce is able to draw on the expertise of over 80 firms and industry associations across a number of different sectors and jurisdictions. We are responding to this consultation in our capacity as the Taskforce.

DISCUSSION

We applaud the Commission's goal of supporting the Paris agreement on climate change and the United Nations 2010 Agenda for Sustainable Development through its Action Plan: Financing Sustainable Growth. We support the reorientation of capital flows towards all forms of sustainable investment in order to achieve the ultimate goal of sustainable and inclusive growth.

In particular, we support the Commission's recognition that investors can invest sustainably by either:

- integrating environmental, social and governance ("**ESG**") factors/risks into investment decision-making; or
- ***by investing directly into economic activities that positively contribute to sustainability.***

We note that the first limb of the Commission's notion of sustainable investment above provides value by improving investor awareness and understanding of ESG factors and risks. Over time, this has the potential to boost market confidence in the strategic relevance of such ESG factors and risks. Incorporation of ESG factors into the process of investment thereby lays the groundwork for progression towards investing directly in economic activities that positively contribute to sustainability.

Spectrum of Capital

There are a range of investment approaches available to achieve the end goal of investment in sustainable activities, ranging from screening mechanisms to ESG integration to more intensive impact investment (the area of the Taskforce's concern). The potential for progression from traditional to impact-driven investment is well-illustrated by the "**spectrum of capital"** found at **appendix 1**.

It is essential that the notion of sustainable investment includes the full range of "green" and social impact investments in order to promote and develop the entire sustainable finance landscape. This includes impact-driven investments with market returns – and separately those appropriate for investors who are willing and able to tolerate below market returns. This latter category is closer on the spectrum to philanthropy, and generally not appropriate for the retail market. Thus, in this response our use of the term impact investing (more specifically defined under the heading "**Impact Investing**" below) refers to investments that positively contribute to sustainability and also deliver market returns.

Achieving Scale

We welcome this consultation on integrating sustainability risks and factors in the UCITS directive and AIFMD. We acknowledge the importance of integrating sustainability into the investment fund industry in order to achieve progress towards the United Nations' Sustainable Development Goals and to better reflect the risks embedded in the externalities presented by ESG issues. The UCITS directive plays a pivotal role in providing a harmonized EU fund regime suitable for retail investors and UCITS account for around 75% of all investments by small investors in Europe. UCITS and, to a lesser extent, AIFs provide the building blocks of pension plans, life-assurance and other savings products. Integration of sustainability factors (including risks) into investment funds' decision-making processes - and investment by UCITS and AIFs directly into economic activities that positively contribute to sustainability, provide an important opportunity to encourage broad awareness of, and demand for, sustainable investment and generate scale. All investments have some form of impact on society and environment - whether positive, negative, intentional or incidental. Consideration of ESG factors in retail-facing products is an important part of a "journey" towards impact investing and is a step towards aligning with existing demand, with a representative survey of 1,000 individuals finding that nearly two thirds of UK citizens would like their money to support companies that are both profitable and make positive contributions to society and the environment.[1]

[1] Centapse, SII Attitudinal and Behavioural Research, 2017. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/659060/Social_Impact_Investment_Attitudinal_and_Behavioural_Research__Centapse.pdf

Research indicates that it makes financial sense to consider ESG factors and risks when making investments. These studies have found a link between company-level ESG performance and their financial and operational performance; in particular, there is evidence that taking ESG into account can help protect against volatility and downside risk.[2]

We agree that international cooperation and globally consistent standards are necessary to avoid fragmentation in ESG investment. We encourage ESMA and the Commission to consider and contribute to ongoing International Organization of Securities Commission[3] and Financial Stability Board[4] work on sustainable finance in developed and developing markets.

Impact Investing

Our primary goal as a Taskforce is to encourage social impact investment – a specific type of sustainable finance. We use the term "impact investing" giving it the Advisory Group's definition as set out in the Report:

"Investment *in the shares or loan capital of companies and enterprises that not only measure and report their wider impact on society — but also hold themselves accountable for delivering and increasing positive impact. The enterprises themselves may either directly focus on social impact or take social impact into account as part of the way they do business."*

We believe that finding the means for pension schemes and other savings vehicles such as UCITS and AIFs to invest in appropriate social impact investments will help "jump start" this developing area - providing a positive environment and encouraging the industry to generate product to meet consumer demand. With increased investment and scale will come innovation, professionalism and lower costs.

Despite evidence demonstrating that sustainable investment makes financial sense, we acknowledge that there are perceived barriers. Impact investments may require a longer term investment horizon - but "patient capital" invested in this way within large retail pools can provide robust returns and diversification as part of a larger asset allocation strategy. But there are added challenges to be addressed - particularly in relation to liquidity, diversification and valuation. For example, many social impact investments fall into the category of illiquid assets. While research suggests that allocation to less liquid, longer-term investments is likely to enhance portfolio returns over time, the financial services ecosystem has developed in a way that biases towards daily pricing and trading.[5] This is the case even though these are neither legally necessary nor practically required for pension plans or savers with a long term investment horizon.

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2 See, for example, BMO Asset Management, Responsible Investing Perspectives, December 2017, available at: https://bmogamviewpoints.com/wp-content/uploads/2017/12/BMO-ESG-Viewpoint-Performance-with-Principles_Final.pdf

3 See, for example, IOSCO Growth and Emerging Markets Committee, Sustainable Finance in Emerging Markets and the Role of Securities Regulators, Consultation Report, CR01/2019, February 2019, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD621.pdf

4 See, for example, Recommendations of the Task Force on Climate-related Financial Disclosures Final Report, June 2017, available at: https://www.fsb-tcfd.org/publications/final-recommendations-report/

5 Growing a Culture of Social Impact Investing in the UK, Advisory Group, November 2017.

(cont'd)

In this regard, we note the UK Financial Conduct Authority's ("**FCA**") recent work on patient capital,[6] which aims to reduce potential harm for retail investors in funds that hold inherently illiquid assets and benefit consumers by allowing funds to choose investment opportunities that match their investment needs of consumers more effectively. Measures proposed by the FCA include revised wording to broaden investment range, increasing limits on illiquid assets in unit linked insurance pools and authorized funds (UCITS), and the introduction of appropriate risk warnings to help consumers understand the investment and liquidity risks involved. Proposals such as these suggest that, with appropriate research, diligence and deliberation, apparent barriers to increased sustainable investment can be overcome.

CONSULTATION QUESTIONS

In relation to question 1, we note that the proposed amendments to the Commission Directive 2010/43/EU and Commission Delegated Regulated (EU) 231/2013 are drafted so that their impact depends entirely on the definition of "sustainability risks". We support equal emphasis on environmental, social and governance issues within the meaning of "sustainability risks". We consider it essential that the notion embraces the breadth of the sustainability landscape in order to ensure coherence and that all investor objectives can be met. We support the broad definition of 'social' in the Commission's legislative proposals, as those issues relating to the "rights, well-being and interests of people and communities." We refer ESMA to the recent Investment Association Consultation on Sustainability and Responsible Investment, which includes proposals for the meaning of ESG integration and impact investing which we support.

We are concerned that the current tendency to progress consideration of environmental factors at a faster rate than social factors will lead to inconsistent and sporadic development in sustainable investment. The Sustainable Development Goals (SDGs) illustrate, social and environmental issues are difficult to separate. Strong societies and sustainable environments are inter-dependent. As noted in the consultation paper, the Commission and the co-legislators' sustainable finance taxonomy currently focuses on the identification of environmentally sustainable economic activities. It is essential to develop a comprehensive classification system to ensure development of high and consistent standards for each of E, S and G, especially given that the proposed taxonomy will drive investment flows for years to come. Ensuring a consistent approach to ESG will avoid the unintended consequences of a single dimensional focus.

In relation to questions 2, 5, 6 and 9, we support the high-level and principles-based approach to the integration of sustainability factors and risks into the UCITS Directive and AIFMD. This approach is well-suited to the existing governance, investment and risk management framework laid down by both directives. Primarily, a principled-based approach provides a useful mechanism to broaden investors' familiarity with ESG risks and rewards over time, and to incorporate ESG factors into decision-making processes without imposing an unduly prescriptive and static regime at this early stage.

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[6] FCA Patient Capital and Authorised Funds Discussion Paper, DP18/10, December 2018 and FCA Consultation on proposed amendment of COBS 21.3 permitted links rules, Consultation Paper, CP18/40, December 2018, both available at: https://www.fca.org.uk/news/press-releases/fca-proposes-changes-facilitate-investment-patient-capital

We generally agree with ESMA's approach to management oversight, resources, operating conditions, due diligence and asset allocation. As recognized by the consultation paper, ESG factors should be integrated within each aspect of the overall investment process and governance framework, and put on the same footing as other investment criteria.

This means that there must be commensurate Senior Management attention to the integration of sustainability risks and factors as part of the overall responsibility for the implementation of fund investment policy and strategies. And management companies must have the necessary processes, expertise and support (including analysis, research and legal advice) to effectively integrate sustainability risks and factors into their investing. In particular, we see merit in identifying and gathering further evidence on the impact of material sustainability risks, factors and indicators on the financial return of investments.

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We are grateful for the opportunity to comment on this consultation and would be pleased to provide any further information, evidence or clarification as required.

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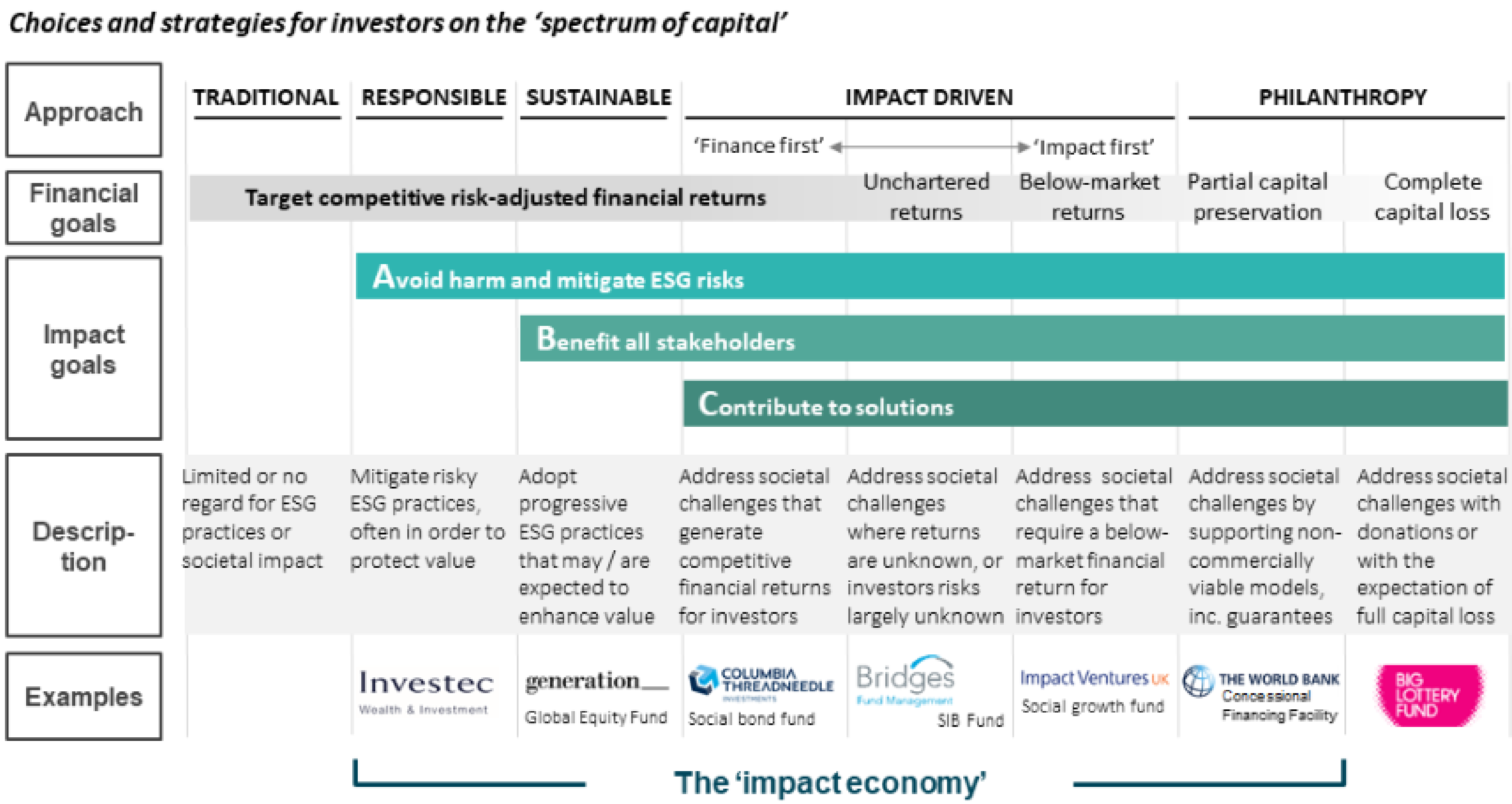
APPENDIX 1: SPECTRUM OF CAPITAL

The Spectrum of Capital



Source: Bridges Impact+ and the Impact Management Project