European financial investors and environmental, social and governance risk: how Europe needs to more robustly regulate its financial sector

Briefing Paper in response to the European Commission's "Call for evidence: EU regulatory framework for financial services"

Global Witness and Friends of the Earth Europe

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Executive Summary

This briefing paper is based on the joint submission by Global Witness and Friends of the Earth, Europe in response to the European Commission's call for evidence on the EU regulatory framework for financial services.[1] This briefing is designed to serve as a stand-alone document, providing further references and detail beyond the scope provided by the call for evidence.

The Capital Market Union (CMU) project has tiptoed in the direction of promoting sustainable economic growth in the Green Paper and in accompanying speeches by Commissioner Hill.[2] But has now firmly stepped back from that position in the Action Plan, published September 2015.

The CMU now sits in stark contrast to major EU level policy initiatives, including the EU 2020 strategy[3], the Roadmap to a Resource Efficient Europe[4], the 7th Environment Action Programme[5] and the pledges made at the Paris climate conference (COP21) in December 2015[6]; all proposing measures to put the EU economy on a sustainable trajectory. In response to international and EU commitments, EU member states have also adopted strategies and programmes aimed at contributing to a greener development pathway. The September 2015 Sustainable Development Goals (SDGs)[7] will have a universal scope and will address all three dimensions of sustainability: social, economic and environmental. Yet the CMU barely mentions sustainability or environmental, social or governance considerations.

The CMU could play an important role in supporting these major EU initiatives, for example through channeling funds and innovation into sustainable growth. However, the Action Plan does little to integrate EU financial sector with wider international goals and commitments, or manage systemic risks relating to climate change and wider environment, social and governance (ESG) risks. While the Action Plan brings reviews of the European venture capital and social enterprise funds forward *"in light of the objective to work quickly to put in place the building blocks of the CMU"*,[8] there is little there to support the growing interest in ESG investing. This gap is particularly disappointing given that the European Council recommended that ESG considerations played a central role in the CMU.[9]

In addition to our concerns about ESG within the CMU, the published Action Plan also reinforces our concerns about the overall direction of financial market policy as currently led by DG FISMA. There are indications that a silo mentality has begun to reassert itself and that more focus has been put on a post-crisis agenda of seeking to identify and possibly repeal regulations applied during and after the crisis, and to possibly deregulate those measures which preceded them onto the EU law books such as the Prospectus Directive.

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[1] Further information available: http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm

[2] See for instance "Finance at you service – capital markets as an instrument of sustainable growth." Commissioner Hill speech 4 Feb 2015 Finance Watch. Brussels: http://europa.eu/rapid/press-release_SPEECH-15-4144_en.htm

[3] Further information available: http://ec.europa.eu/europe2020/index_en.htm

[4] Further information available: http://ec.europa.eu/environment/resource_efficiency/about/roadmap/index_en.htm

[5] Further information available: http://ec.europa.eu/environment/action-programme/

[6] Further information available on Europe's pledges at the Climate Conference are available here: http://ec.europa.eu/clima/policies/international/negotiations/future/index_en.htm

[7] Further information available: https://sustainabledevelopment.un.org/

[8] The Commission has launched a consultation on the review of the European Venture Capital Funds (EuVECA) regulation (No 345/2013): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0345; and European Social Entrepreneurship Funds (EuSEF) regulation (No 346/2013): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0346

[9] Council of the European Union Brussels, 16 June 2015 (OR. en) 9852/15 Draft Council conclusions on a Capital Markets Union.

We see evidence of this in the re-introduction of securitisations, the watering down of regulatory measures through the 'comply or explain' implementation mechanisms, and in the Action Plan's sidelining of ESG issues into the self-regulatory Green Bonds. In response to the financial crisis there was a move away from self-regulation with the establishment of the European Supervisory Agencies and the introduction of a single rule book approach and greater harmonisation. The self-regulated and widely discredited Credit Ratings Agencies were one of the first subjects for this policy. Today, the Commission appears to be supporting the development of an unregulated ESG ratings system with the Green Bond Initiative as a flagship mechanism. A lack of reference in the CMU Action Plan to the Non-Financial Reporting Directive and the Shareholder Rights Directive provides further evidence of the lack of cross-fertilization with the initiatives of other DG's.

We are concerned therefore that the call for evidence which this submission contributes to will result in further deregulation of Europe's financial sector, rather than the urgently needed strengthening of regulations around ESG. We are concerned that the silo'd approach evident in the CMU Action Plan and the approach to ESG which sidelines it (rather than mainstreaming) into Green Bonds, will have considerable long term and negative environmental, social and governance impacts.

These negative impacts have global as well as domestic implications. The CMU Action Plan fails to take into account, or even consider, possible impacts on non-European countries, despite the fact that the Commission has in theory committed itself (as part of "Better Regulation"[10]) to conducting economic, social and environmental impact assessments for all legislative proposals, initiatives or acts and also to include the international dimension, i.e. likely impacts on third countries. We discuss further below our specific concerns about the weak EU financial regulations contributing to the problems of land grabbing and deforestations overseas.

Our recommendations for remedying these regulatory gaps in the financial sector are as follows:

a) Develop a robust and standardized definition of ESG risks, as they pertain to the operations and impacts of Europe's financial sector, domestically and internationally. This definition should be aligned with and contribute to Europe's existing policy commitments to sustainability and climate change;
b) Embed binding regulatory provisions within Europe's regulatory systems governing the financial sector, to ensure that ESG risks are adequately assessed, understood and mitigated for by European investors' activities. Specific regulatory frameworks within which this can be done include the following:
    - Institutions for Occupational Retirement Provision II Directive
    - Packaged retail and insurers based investment products
    - Undertakings for Collective Investment in Transferable Securities
    - European Long-Term Investment Funds
    - Alternative Investment Fund Managers Directive
    - Shareholder Rights Directive
    - Prospectus Directive
    - Insurance – Solvency II Directive
    - Banks and asset managers, capital requirements
    - Credit ratings agencies regulations

[10] Better Regulation "Toolbox" The Toolbox presents a comprehensive array of additional guidance to assist practitioners in the application of Better Regulation. TOOL #30: DEVELOPING COUNTRIES 1. INTRODUCTION Assessing systematically the likely effects of different policy initiatives on developing countries is a requirement based on Article 208(1) TFEU, which stipulates that the EU "shall take account of the objectives of development co-operation in the policies that it implements which are likely to affect developing countries": http://ec.europa.eu/smart-regulation/guidelines/docs/br_toolbox_en.pdf

c) Ensure these regulatory provisions are implemented through demonstrable public disclosure requirements and that clear and effective sanctions are available to enable ease of compliance across European Member States;

d) Update the Capital Market Union Action Plan to mainstream understanding and management of ESG risks across its programme of reforms, both within policy and regulatory measures.

Structure of this briefing paper:

1) Background and introduction - why environmental, social and governance issues need to be given greater consideration within the EU's financial services regulation

Global Witness and Friends of the Earth Europe welcome this opportunity to contribute to part of the consultation exercises inspired by the moves to create a Capital Markets Union (CMU). In our response to the 2015 consultation on the Capital Markets Union Green Paper[11] we argued that long term prosperity and economic stability also requires urgent attention to environmental, social and governance (ESG) issues.[12]

In that document, we noted that CMU initially offered the opportunity to reset initiatives in the ESG area but that this has failed to materialise in the follow up Action Plan, apart from the active promotion of so-called Green Bonds – whose development has been largely outsourced to a private consortium of international financial market participants left to develop its own standards and proprietary techniques. We are concerned that this development is being taken by the Commission as the model for developing ESG in the marketplace and represents a reinstatement by the Commissions of the long standing reliance on self-regulatory mechanisms – a process severely undermined during the financial crisis.[13] This is connected to our concerns about the wider approach of the CMU, which now appears to be re-introducing high risk financial activities, such as securitization, whilst failing to tackle the systemic risks evident across the sector.

While the current CMU Action Plan does not plan to bring any new legislative measures regarding the mainstreaming of ESG measures, it is important to note that some of the important EU legislative groundwork has already been put in place (largely in the area of corporate governance and remuneration issues). We would therefore urge the Commission to ensure that rules on the books are brought up-to-date to provide an information infrastructure capable of underpinning a sustainable and trusted financial market both at retail and wholesale levels. In attempting to build trust in the wholesale markets, it is necessary to maintain the renewed commitment found in the institutional reforms over the crisis period (and which are now bedding down) to building consumer confidence and innovation (notably the mandates of the European Supervisory Authorities).

The CMU Green Paper and the Long Terms financing communication[14] show that the EU is putting a major bet on mobilizing the savings and investments of ordinary EU citizens to drive economic growth.

"*Boosting the flow of institutional and retail investment into capital markets would promote the diversification of funding sources. Growing occupational and private pension provision in Europe could result in an increased flow of funds into a more diverse range of investment needs through capital market instruments and facilitate a move towards market-based financing. Enhancing the confidence of retail investors in capital markets and financial intermediaries could increase the flow of household savings into capital market instruments which are now largely held in home equity and bank deposits. Increasing the global competitiveness and attractiveness of European capital markets in this way could also boost the flow of investment."*[15]

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[11] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=COM:2015:63:FIN&from=EN
[12] Comments from FERN, Global Witness and Friends of the Earth Europe on Public consultation on Building a Capital Markets Union. 13th May, 2015, available on request from: mmacinnes@globalwitness.org
[13] This institutional move by the Commission away from self-regulation was articulated by Michel Barnier in his speech of 31 Mar 2010. "Self-regulation has failed…We have seen in the past that regulatory gaps are always exploited." He goes on to cite Credit Default Swaps as an example: http://europa.eu/rapid/press-release_SPEECH-10-141_en.htm?locale=en
[14] Communication from the Commision to the European Parliament and the Council on Long-Term Financing of the European Economy COM/2014/0168 final: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52014DC0168
[15] Green paper: Building a Capital Markets Union 18.02.15 Com (2015) 63 Final para 4.2, p16

We can trace the foundations for a potentially coherent and strategic integration of ESG into key EU financial measures by looking at rules both pre-crisis and crisis driven; their forthcoming review points; and rules currently being evolved either at Level 1 or 2 of the EU legislative process. We therefore welcome the opportunity provided by this call for evidence to take stock of what has been adopted. Some key measures have their origin prior to 2008 and should not be dismissed as emergency interventions and driven solely by any particular crisis event.[16]

1.1) Definitions of ESG in EU financial services regulation, or the lack of them

Our analysis of the corpus of relevant EU legislation indicates that there is a clear lack of conceptual continuity or common definitions to cover ESG issues in relation to the financial sector. The CMU Call for Evidence refers to sustainable growth, the European Long-Term Investment Fund (ELTIF) regulation refers to "smart sustainable and inclusive growth" which we are apparently supposed to assume encapsulates ESG factors. Greater clarity of definitions is required both by legislators and by market participants. The lack of clear definitions has allowed a proliferation of interpretations to diffuse throughout the market (e.g. responsible investment, sustainable investment, green investment, social investment etc).

We have outlined in our submission (and below) the differences in disclosure requirements across the consumer /investor protection field notably a requirement in packaged retail and insurers based investment products (PRIIPs) is not carried forward into other directives such as the Institutions for Occupational Retirement Provision II Directive (IORP II), ELTIF or the prospectus proposal. There is no explanation as to why references are made in some legislative texts but never make it in to comparable texts. The inclusion seems arbitrary and the Commission should ensure that at the start of the process the relevant ESG message is written into the text and then it is for the other co-legislators to explain why it should be removed. The negotiations on IORP II and Shareholder Rights Directive are cases in point.

Similarly ESG concerns have yet to materialise in prudential level legislation. But as we point out, the UK Prudential Regulatory Authority[17] is looking at how climate change factors can be incorporated into solvency modelling. This is something that the Commission will have to consider as a matter of urgency.

As the Commission further integrates ESG into its legislative thinking, it must resist efforts to break up such measures into constituent parts with the 'E' via 'climate change' becoming the most acted upon. The Commission has given force to this approach with the CMUs apparent correlation of progress in ESG explicitly with its project champion the sole example of the Green Bond Initiative. We have pointed out that ESG needs to be comprehensive in its study of risks if it is to be truly effective in contributing to sustainable growth. As a basic step, we think it is crucial that there is a definition of ESG criteria, and this needs to be developed, as we also indicate below.

Our analysis indicates that there has been a remarkable hesitancy by the Commission and its co-legislators to take the opportunity before, and after, the financial crisis to fundamentally reform the informational underpinnings needed for an efficient and sustainable capital market. The CMU provided an opportunity to mainstream effective (but not over burdensome for business) ESG obligations into

[16] The Commission considers that some measures adopted in haste may be sub-optimal: "The EU put in place a wide range of measures in the wake of the crisis to restore financial stability and public confidence in the financial system. Many of those measures - over 40 in total - were adopted in difficult circumstances and in a short period of time." Frequently Asked Questions on the Call for evidence (Sept 2015): http://europa.eu/rapid/press-release_MEMO-15-5735_en.htm?locale=en

[17] Further information is available: http://www.bankofengland.co.uk/pra/pages/default.aspx

investment decision making. Failure to tackle these issues often leads to long term economic costs for companies and systemic risks for investors as society at large.

1.2) Major regulatory gaps and risks in the EU's current regulatory framework for financial services

The Call for Evidence rightly raises the question of regulatory 'gaps' (Interactions of individual rules, inconsistencies and gaps) and 'risks' (Rules giving rise to possible other unintended consequences).

1.2.a) The special case of "Land grabbing": material and moral risks involved and the need for a regulatory response

We have stressed throughout this response the need for the full inclusion of verifiable ESG disclosure across the value chain from the business model of the producer to marketing of investment funds to the public. However, a major regulatory gap exists when it comes to the issue of "land grabbing".[18] As the Commission begins to address ESG disclosures as a necessary prerequisite for long term sustainable growth it must recognise the importance of ensuring ESG factors regarding agribusinesses and land acquisition overseas are addressed to avoid the potential economic, social and environmental risks in the sector.

The global rush for land – driven by increasing demand for fuel, food, raw materials and financial speculation – has caused significant social and environmental harm across the world. Since 2000, at least 38.9 million hectares of land in developing countries, an area just larger than the size of Germany, has been leased to companies, or is under negotiation.[19] This is driven by increasing global demand for biofuel and raw materials, and speculation on land and agricultural commodities.[20]

Globally, the UK, USA, Germany, Netherlands and France consistently rank high amongst countries involved in large-scale overseas agribusiness investments.[21] By the beginning of 2015 for example, the top EU-based financial institutions (including banks, institutional investors and alternative investment funds) had provided nearly US$18 billion outstanding loans and recent underwriting services to foreign agriculture companies based in developing countries. EU financial institutions are also major holders of shares in stock-market listed agricultural companies based in developing countries; in early 2015 the top 20 institutional investors held US$2.8 billion.[22]

Despite increasing the increasing importance of EU investors in land grab risk projects, neither companies nor investors have yet developed systems able to assess such risks. We see European-based investors relying on commodity-based certification schemes as a proxy for due diligence into land-tenure risk on the one hand[23], while on the other Calvert – a US-based socially responsible investor – described

[18] We recognise that land grabbing takes place in a variety of settings and has a range of impacts, but in general use the phrase in this paper in line with the definition of land grabbing developed by the Tirana Declaration in 2011: http://www.landcoalition.org/en/resources/tirana-declaration

[19] Based on the most up to date information available in the Land Matrix database: http://www.landmatrix.org/en/

[20] Anseeuw, W., L. Alden Wily, L. Cotula, and M. Taylor. (2012): Land Rights and the Rush for Land: Findings of the Global Commercial Pressures on Land Research Project. ILC, Rome; available for download at: http://www.landcoalition.org/sites/default/files/documents/resources/ILC%20GSR%20report_ENG.pdf

[21] Deutsche Bank (2012) No low hanging fruit: https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000296807/Foreign+investment+in+farmland%3A+No+low-hanging+fruit.pdf

[22] Further information available: http://www.fern.org/sites/fern.org/files/Clear Cut.pdf

[23] See study in Profundo (2014) Opportunities for EU-regulatory reform concerning EU investments in non-EU agribusiness, available from mmacinnes@globalwitness.org on request

the lack of land tenure data used by financial markets; only one out of 2,167 standard environmental, social and governance criteria relates to land.[24]

1.2.b) Case studies of EU investors involved in land grabbing projects overseas:

a) HAGL rubber in Cambodia and Laos

In their 2013 report Rubber Barons[25], Global Witness published evidence that the German banking giant Deutsche Bank was an important source of finance for two Vietnamese rubber companies operating in Laos and Cambodia. The companies were responsible for a wave of land grabs that led to widespread evictions, illegal logging and loss of food security for local populations. Hoang Anh Gia Lai (HAGL) and the state-owned Vietnam Rubber Group (VRG) had acquired more than 200,000 hectares of land through a series of deals with the Lao and Cambodian governments that lacked transparency and did not comply with a range of legal safeguards.

According to Global Witness, HAGL and VRG's operations were characterised by a lack of consultation with communities, non-payment of compensation and routine use of armed security forces to guard plantations. Large areas of supposedly protected intact forest had been cleared, contrary to forest protection laws, apparently in collusion with Cambodia's corrupt elite. Their deals were part of a wider pattern of land grabs that has seen more than 3.7 million hectares of land handed over to companies since 2000, forty percent of which was for rubber plantations. The investigation, published in May 2013, found that at the time Deutsche Bank:

- Held US$4.5 million in shares in HAGL through its DWS Vietnam Fund Ltd;
- Had enabled HAGL to become the first Vietnamese company to be listed on London's Professional Securities Market, using Deutsche Bank Trust Company Americas as its depository bank;
- Held 1.2 million shares in Dong Phu, a subsidiary of VRG, worth US$3.3 million.

b) Wilmar palm oil in Indonesia

Friends of the Earth has conducted research into five palm oil plantations in Central Kalimantan that belong to the palm oil companies Wilmar International (WIL:Singapore) and Bumitama Agri Ltd. (BAL: Singapore). Despite the fact that both palm oil companies have adopted high-profile policies prohibiting burning, deforestation, and exploitation of peatlands, FoE has found that both companies appear to have flouted national laws, their own sustainability policies and the widely celebrated New York Declaration on Forests by developing palm oil on peatlands, causing or allowing the destruction of High Carbon Stock areas, and taking insufficient measures to prevent forest fires in their plantations. Financiers in the UK, Netherlands, France, the United States, and other countries are providing direct financing to these companies – many of them doing so despite having publicly committed to ESG that should prevent their financing such destructive activities.

Of eleven financiers in the EU and fourteen in the US to whom Friends of the Earth has sent this report for comments, seven have responded by the time of publication. The answers we received range from advice that FoE file a complaint with Wilmar itself or with the Roundtable on Sustainable Palm Oil (RSPO) – notably, a multi-stakeholder body without a legal mandate and with a notorious lag-time in addressing complaints[26] to a lengthy response arguing that Wilmar is in fact operating sustainably.

That is to say that, despite detailed, independent, satellite-based and groundchecked evidence on specific cases, even financiers that have committed to upholding environmental standards do not seem alarmed by the lack of

[24] Presentation made by Gabriel Andres Thoumi from Calvert at the World Bank Annual Conference on Land and Poverty, Washington DC, March 2015

[25] For further information, please see: http://www.globalwitness.org/rubberbarons/

[26] Environmental Investigation Agency and Grassroots. Who Watches the Watchmen: Auditors and the breakdown of oversight in the RSPO. November 2015. https://eia-international.org/wp-content/uploads/EIA-Who-Watches-the-Watchmen-FINAL.pdf

implementation of their own and their investee companies' policies during what many commentators are calling the largest environmental crisis of the 21st century.[27] Such a lax attitude bodes extremely ill for the efficacy of voluntary corporate commitments to social and environmental responsibility The most important EU investors in Wilmar are: HSBC; BNP Paribas; Rabobank; Crédit Agricole; and ABN Amro.

c) GAR / GVL palm oil in Liberia

In their 2015 report, The New Snake Oil, Global Witness exposed the social and environmental impacts resulting from palm oil plantations in southern Liberia owned by Golden Veroleum and reports that Liberians have been violently beaten, threatened and arrested for criticizing the companies' attempts to expand their concession areas.[28]

Golden Veroleum's only investor is Golden Agri-Resources, based in Indonesia and the world's second largest palm oil company. According to publicly available shareholder information, Golden-Agri Resources' financial backers include a number of European and US banks and investment funds. At the time of publication the following European-based banks and funds[29] held the following share values:

- Standard Chartered, US$710 million
- HSBC, US$409 million
- Delta Lloyd, US$37 million
- Deutsche Bank, US$26 million
- BNP Paribas, US$25 million
- Allianz, US$12 million
- Old Mutual, US$ 6.7 million

But the risks are significant and material. In 2012, research demonstrated that the financial risks for companies posed from not addressing land tenure were multiple, ranging from a delay in construction and cash flow loses due to suspension.[30] The escalation of such risk can be extremely rapid and irreversible, with the report concluding that the average global operating costs of a three-year investment of around USD$10 million could be as much as 29 times higher than normal if the project were forced to stop its activities because of local opposition. Whereas an assessment in 2014 of 73,000 mining, oil and gas, logging and agribusiness concessions in eight tropical forested countries, found that 93 percent of them involved land already inhabited by indigenous peoples and local communities.[31]

At present there are no useful standards from the financial sector available to deal with this risk. Out of the four globally recognised financial sector standards – the UN Global Compact, UN Principles of Responsible Investment (UNPRI), the Equator Principles and UNEP Finance Initiative – (apparently

[27] Among other sources see http://jakartaglobe.beritasatu.com/opinion/erik-meijaard-indonesias-fire-crisis-biggest-environmental-crime-21st-century/; http://www.democracynow.org/2015/10/27/massive_indonesian_plantation_fires_create_environmental; https://www.enca.com/world/indonesia-forest-fires-warships-put-standby

[28] Further information available: https://www.globalwitness.org/en-gb/campaigns/land-deals/new-snake-oil/

[29] Responding to a request for comment, HSBC and Citibank have stated that they do not invest directly in GAR projects, but rather hold GAR shares "in custody" for other ultimate "beneficial" shareholders. Also in response, Delta Lloyd stated that it "excludes companies" that "repeatedly or severely" violate FPIC and other rights, but that it would not comment on its investment in GAR. See Global Witness meeting with HSBC, 29 June 2015; Lowrance, Courtney, Email to Global Witness, 4 July 2015, Boerma, Hiske, Email to Global Witness, 2 July 2015

[30] Further information available: http://www.rightsandresources.org/documents/files/doc_5715.pdf

[31] RRI (2014) Communities as Counterparties: Preliminary review of concessions and conflict in emerging and frontier market concessions, Rights and Resources Initiative, 30th October 2014: http://www.rightsandresources.org/wp-content/uploads/Communities-as-Counterparties-FINAL_Oct-21.pdf?utm_source=Munden+Report&utm_campaign=Securing+Indigenous+and+Community+Lands&utm_medium=email

favoured by the Commission over direct regulation), only the Equator Principles made any mention of land issues, and this was only due to their being pegged to the performance standards of the International Finance Corporation.[32] Studies by the UN[33] (in particular the UN Environment Programme's Inquiry into the Design of a Sustainable Financial System) concluded that although sustainability reporting has become the norm, agreeing to a principle of policy was not enough and that such measures have not yet proven any improvements on social or environmental performance on the ground.[34]

The solution, we believe to the moral and material risks EU institutional investors are undertaking being involved in projects causing land grabbing (and other ESG problems such as deforestation) is EU regulations. Such regulations would be based on binding requirements that the agribusiness concession invested in be legal, and supplemented by regular, documented due diligence assessments. This could be achieved by the adoption of a "know your project" regulatory concept, building on the "know your client" model, implemented through the EU's anti-money laundering directive.[35] As such, we have identified a number of existing EU financial services measures which provide opportunities to integrate and expand ESG risk management and due diligence/screening requirements to include land rights and tenure risks. These range across the spectrum of public disclosure transparency in the marketing of products and in supervisory disclosure for business level prudential and risk management systems.

1.3) Growth in EU's political commitments towards sustainability

There is a need to couple CMU to the wide range of EU and international commitments the EU has already signed up to. There will be a need to ensure consistency with actions posed under CMU with wider stability and sustainability issues addressed in a number of major EU level policy initiatives, including the EU 2020 strategy[36], the Roadmap to a Resource Efficient Europe[37], the 7th Environment Action Programme[38]all propose measures to put the EU economy on a sustainable trajectory. In response to international and EU commitments, EU member states have also adopted strategies and programmes aimed at contributing to a greener development pathway. The new UN Sustainable Development Goals[39] (SDGs), adopted in September 2015 will have a universal scope and will address all three dimensions of sustainability: social, economic and environmental.

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[32] de Man, R. (2010) Land issues in voluntary standards for investments in agriculture, discussion paper submitted to the World Bank Annual Conference on Land Policy and Administration, available for download at: http://www.rdeman.nl/site/download/2010%20World_Bank_deMan.pdf

[33] UN Global Compact Office (2011), United National Global Compact Office Annual Review, available for download at: https://www.unglobalcompact.org/docs/news_events/8.1/UN_Global_Compact_Annual_Review_2010.pdf; UN Environment Programme (2009) Fiduciary responsibility: legal and practical aspects of integrating environmental issues into institutional investments, available for download at: www.unepfi.org/fileadmin/documents/fiduciaryII.pdf; UN Principles for Responsible Investment (2011) 5 Years of Progress, Report of Progress 2011: an analysis of signatory progress and guidance on implementation, available for download: http://www.unpri.org/viewer/?file=wp-content/uploads/2011_report_on_progress1.pdf; the findings of these reports are also summarised in the 2015 report by SOMO, Mobilising the financial sector for a sustainable future: mapping existing approaches to promote social and environmental sustainability goals in the financial sector, available for download at: www.somo.nl/publications-en/Publication_4255/at_download/fullfile

[34] UNEP Inquiry (2015) The financial system we need – aligning the financial system with sustainable development, available for download at: http://web.unep.org/inquiry/publications apps.unep.org

[35] Further information available: http://ec.europa.eu/justice/civil/financial-crime/index_en.htm

[36] Further information available: http://ec.europa.eu/europe2020/index_en.htm

[37] Further information available: http://ec.europa.eu/environment/resource_efficiency/about/roadmap/index_en.htm

[38] Further information available: http://ec.europa.eu/environment/action-programme/

[39] Further information available: https://sustainabledevelopment.un.org/

Forming a coherent approach to integrating these issues will be a clear test for President Juncker's concept of Project Teams. As stated earlier, one of our key concerns is that the CMU Action Plan appears to reflect a previous silo type approach among the Commission DG's.

1.4) Growth in the responsible investment market

According to the latest Eurosif survey[40], in Europe, sustainable and responsible investment strategies are continuing to grow, in aggregate, at a faster rate than the broad European asset management market. From the beginning of 2012 to the start of 2014, assets committed to sustainability-themed investments grew 30 percent in US dollar terms, and assets to which exclusionary screens were applied grew 90 percent. Impact investing is the fastest growing strategy, registering 146 percent growth over the period. Over the same period, the overall European asset management industry has grown by an estimated 22 percent in euro terms. Given this growth in the responsible investment market, we consider it essential that clearer guidance is given by governments and the regulatory systems in Europe catch up with the sector.

Action for better verification and enforcement of codes may be additionally stimulated by the recent interest of the Financial Stability Board and its chairman Mark Carney, who has remarked that in the case of climate change there are already nearly 400 initiatives to provide information about the costs, opportunities and risks created by climate change.[41] Existing schemes vary in their status (from climate disclosure laws to voluntary guidance); scope (from greenhouse gas emissions to broader environmental risks); and ambition (from simple disclosure to full explanations of mitigation and divestment strategies). Carney points out that *'The existing surfeit of existing schemes and fragmented disclosures means a risk of getting "lost in the right direction" '.*

We believe that this is a problem the Commission will need to address in the area of ESG "responsible investment". The current lack of mainstreaming of ESG issues across the CMU Action Plan only exacerbates the situation.

1.5) Impact of ESG events on market sentiment and public trust

There are increasing signs that investors are becoming more demanding and sensitive to ESG events reported in the mass media and are beginning to expect social and ethical responsibility in all aspects of corporate operating practices including gender diversity, human rights and environmental sustainability. Not all of this interest reflects a search for superior financial returns. An interesting study highlights a growing trend among the so-called "millennials" (birth years ranging from the early 1980s to the early 2000s) and their impact on values-based investing.[42] While economic returns will remain important, this group are increasingly demanding investment solutions that ensure their money also has a positive environmental and social impact. The survey found that nearly half (48 percent) of respondents affiliate with some form of 'principles-led' investment, and 45 percent feel strongly about the environment. 63 percent were confident in thinking that values-based investing delivers the same or better financial returns, whereas only 27 percent have no ethical concerns that would impact investment decisions.

The move towards socially responsible investments has been facilitated by increasing literature and studies indicating that funds which focus on sustainable investments perform better in the long run. A

[40] Further information available: http://www.eurosif.org/publication/view/european-sri-study-2014/

[41] Breaking the tragedy of the horizon - climate change and financial stability - speech by Mark Carney, 29 September 2015: http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx

[42] U.K. poll for Standard Life Investments reported in: http://www.forbes.com/sites/dinamedland/2015/10/19/the-younger-the-investors-the-more-they-care-about-values/#4325b1c71dec

major influence was the publication by Goldman Sachs of its “GS Sustain Report” at the UN Global Compact Summit in July 2007 which reflected a correlation between ESG consideration and stock performance.[43] Some recent examples of evidence support this link.[44]

Hence, there is a growing acceptance among asset managers and investors about the importance of ESG factors to investment returns and in winning mandates for pension funds.[45] This approach is increasingly being seen as a risk management tool that helps companies avoid harm to their reputation that can result from behaving badly. And in these days of social media and instant communication, a hit to reputation can quickly translate to the bottom line.

1.5.a) Example of the Directive on Non-Financial Information (2014/95/EU)

The Non-Financial Information Directive (2014/95/EU)[46] requires approximately 6,000 large companies and groups across the EU to disclose in their management reports relevant and material information on policies, outcomes and risks, including due diligence procedures that they implement. They will also have to disclose information on relevant non-financial key performance indicators regarding environmental, social and employee related issues, including human rights, anti-corruption and bribery matters, and diversity of their boards of directors. The preparations and implementation of this Directive will affect the investment industry encouraging and facilitating more investors to take ESG criteria into account in their portfolio management processes and in their marketing profiles. It will also bring additional information into the public domain for scrutiny by civil society and consumer groups. This could have major reputational (and therefore economic) risks to companies.

According to recent revisions to the Accounting Directive[47] meanwhile, undertakings should report on their activities relating to environmental, social and employee matters, respect for human rights, anticorruption and bribery matters. It is clearly stated that reporting on these matters is the minimum. However, it is not always clear what sanctions are applied in the case of non-compliance of this reporting requirement, as further elaborated below. Independent studies of the implementation of the UK’s Corporate Governance Code highlight that more than a third of FTSE 350 companies failed to comply with the Code in 2014, treating the ‘comply or explain’ implementation mechanism as a voluntary measure, rather than the binding requirement it was intended to be.[48]

1.5.b) Problems of National Fragmentation in ESG identification and reporting

Creating a single market remains one of the key objectives of the CMU programme. EU measures in financial services have aimed to prevent Member States taking divergent and uncoordinated action to address shortcomings in investor protection measures and it is likely that this development would continue in the ESG area.

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[43] Goldman Sachs “GS Sustain Report” UN Global Compact Summit in July 2007: https://www.unglobalcompact.org/docs/summit2007/gs_esg_embargoed_until030707pdf.pdf

[44] Further information available: http://oecdinsights.org/2015/11/02/can-companies-really-do-well-by-doing-good-the-business-case-for-corporate-responsibility/; http://www.brookings.edu/research/papers/2014/12/08-sustainability-corporate-performance-profit-serafeim; and http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11

[45] For instance see UK EnvAgency Pension Fund recently announced a ground-breaking strategy 2 reduce climate risk. What can others learn?: http://www.shareaction.org/blog/201510/what-does-environment-agency-pension-funds-decision-mean-other-funds

[46] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095

[47] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0034

[48] Further information is available at: http://www.grant-thornton.co.uk/Global/Publication_pdf/Corporate-Governance-Review-2014.pdf

Despite this, we are already seeing fragmentation at the national level in the ESG arena most notably in the area of labelling initiatives. For instance:

- LuxFLAG[49] launched its European ESG label on 21 May 2014. The ESG Label is granted to investment funds which meet specific criteria related to their respect of Environment, Social and Governance objectives. The Label is available to UCITS and AIFMD funds domiciled throughout Europe or in equivalent jurisdictions.
- The French government has announced the development of a French SRI label.[50]
- The Non-Financial Information Directive described above, leaves companies free to choose the format they use to disclose the relevant information, from international, European, or national guidelines, including the UN Global Compact, ISO 26000, or German Sustainability Code.

In terms of the single market completion agenda of CMU these divergent approaches to disclosures relating to ESG products and services impede the development of a level playing field between different fund managers and those advising on, or selling, these products, and thus distort competition and lead to unequal levels of investor protection within the European Union. Such divergence represents an obstacle to the establishment and smooth functioning of the internal market.

2) Call for Evidence on the EU's regulatory framework for financial services – our detailed submission

The following sections detail the submissions we make to the Commission's Call for Evidence, which focuses on two key sections:

A) Rules affecting the ability of the economy to finance itself and grow
 Issue 3: Investor and consumer protection
B) Unnecessary regulatory burdens
 Issue 6: Reporting and disclosure obligations

In our submission, we identify the reporting provisions, both general public, retail and institutional investors and to supervisory authorities, which do not meet sufficiently the objectives needed to underpin a competitive and sustainable capital market and where streamlining/clarifying the obligations would improve quality, effectiveness and coherence.

2.1) Question A - Rules affecting the ability of the economy to finance itself and grow

2.1.a) Issue 3: Investor and consumer protection

2.1.a. A) Public disclosures in consumer and retail investments
i/ Institutions for Occupational Retirement Provision II (IORP II) Directive (COM/2014/0167 final - 2014/0091 (COD))

The Institutions for Occupational Retirement Provision (IORP II) Directive[51] is being revised including the formulation of new rules on the governance of schemes and the information that schemes should provide to their beneficiaries.

We welcomed the Commission proposal[52] in particular Article 29 (and Recital 41) – which in the Risk Evaluation for Pensions included *"(h) a qualitative assessment of new or emerging risks relating to*

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[49] LuxFLAG - The fund labelling organisation: http://www.luxflag.org/

[50] French government to launch their SRI label: http://www.investmenteurope.net/regions/france/french-government-to-launch-an-sri-label/

[51] Further information is available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014PC0167

climate change, use of resources and the environment." Furthermore, we welcomed the vote by the European Parliamentarian ECON committee on 25th January 2016[53], which, amongst other things, suggested these sections be strengthened in relation to ESG risks, as follows:

- Recital 41: On the need for IORPs to have proper risk management systems and risk assessment: *"[…] That risk assessment should also be made available to the competent authorities and should include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ("stranded assets")"*
- Article 29: Risk Evaluation: *(2) The risk assessment referred to in paragraph 1 shall cover, where appropriate to the nature, scale and complexity of the institution's activities: […] (h) an assessment of new or emerging risks, including risks related to climate change, use of resources, the environment, social risks and risks related to the depreciation of assets due to regulatory change.*
- As well as changes agreed by ECON to Articles 22, 26 and 32

Nevertheless, as with the Shareholder Rights Directive, we are worried about the introduction of loopholes to these requirements which may water down their implementation and subsequent impact. Articles 26 and 29 only apply to institutions as appropriate due to their size, nature, complexity etc. How it would be decided which institutions would therefore have to apply the provisions is very unclear and debatable. Article 5 states that member states can choose not to apply the whole Directive (except a few articles) to institutions with less than 100 members or under € 25 million assets.

In addition, the result of the ECON vote is another example of the use of "ESG", ethical, and stranded assets issues terminology being inconsistent throughout the Directive (let alone Europe's wider regulatory framework) resulting in some provisions being vulnerable to being deleted or amended at Trialogue phase.

As this Directive now moves into Trialogue, the removal or weakening of this provisions during its subsequent passage through the legislative process puts savers, the economy and environment at risk and is inconsistent with recent policymaking developments in the EU and beyond which encourage consideration of ESG factors by investors and companies (noted above in relation to PRIIPS, Shareholder Rights Directive (public disclosure requirements for institutional investors' engagement policies) and Non-Financial Information Directive). The Commission's 2020 strategy for smart, sustainable and inclusive growth recognise the role institutional investors must play in supporting jobs and growth by adopting more long-term strategies and becoming more engaged, responsible owners of EU corporations. The IORP II Directive must be aligned with these developments.

We urge the Commission to remind its co-legislators[54] of the centrality of the original provision as proposed by the Commission, and the subsequent amendments by ECON. The opportunity to do so through the revision of the IORP Directive must not be wasted

Clarification of fiduciary duty within IORP II

The Directive requires investment in accordance with the 'prudent person principle' and in the best interests of beneficiaries. Similar legal concepts exist in different member states, such as the concept of fiduciary duty in the UK. These legal duties cause significant confusion and have come to be interpreted very narrowly as a requirement to maximise profit in the short-term. Despite a number of legal reviews[55],

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[52] Further information available: http://ec.europa.eu/finance/pensions/iorp/index_en.htm
[53] Further information available: http://parltrack.euwiki.org/dossier/2014/0091%28COD%29
[54] A copy of our letter to MEPs outlining in detail our concerns and proposed amendments can be obtained from mmacinnes@globalwitness.org
[55] The most recent being Principles for Responsible Investment, 'Responsible Investment and Fiduciary duty', 2015: http://www.unpri.org/wp-content/uploads/3.Responsibleinvestmentandfiduciaryduty.pdf; and Law Commission, 'Fiduciary

uncertainty remains. Unless the law is explicit and clear concerning the factors IORP can consider, narrow, overly cautious interpretations of these duties will continue, preventing proper management of ESG risks.

We note that DG Environment has published the results of a study into investors' fiduciary duties after growing concern that this area of the law is a barrier to resource efficient, low carbon investment.[56] We therefore also welcome the amendment to the Directive introduced by ECON on 25th January 2016, adding a clause relating to the prudent person principle, as follows: Article 20(1): Investment Rules (Prudent Person Principle): *(aa) the 'prudent person' rule shall not prevent institutions from taking into account the potential long-term impact of investment decisions on environmental, social, governance or ethical factors.*

We would hope that in the spirit of joined-up Commission thinking, DG FISMA will reflect on these various legal reviews and the amendment proposed to the Directive by ECON. We also hope that stakeholders will have an opportunity to comment on the DG Environment report and its recommendations, as we note that one of the objectives of the report is to provide "policy advice" on the integration of environmental and resource efficiency issues into the fiduciary duties of institutional investors (e.g. pension funds, insurance companies, asset managers, etc.) in the European Union.[57]

Build upon Member State developments of SIPP (Statement of Investment Principles[58] for IORPs)
Under the auspices of the original IORP Directive, a number of Member States have introduced initiatives which sought to reflect growing pension savers desire to have a say in where there investments are placed, particular with respect to responsibility issues captured by ESG. SIPPs should be important tools used by occupational pension funds to closely think about their investment strategy and investment process, but quality of these documents is often poor. Support and codification for best practice of such initiatives would help prevent fragmentation in the single market and the Commission should reinforce its position in negotiations on IORP II to clarify this important disclosure measure.

ii/ Packaged retail and insurance based investment products (PRIIPs)
Packaged retail and insurance based investment products[59] are part of a wider legislative package dedicated to rebuilding consumer trust in financial markets. PRIIPs intended to tackle the divergence in financial regulation with regard to highly similar, but legally distinct, investment products available to retail investors and the risks of arbitrage. It represents a potential upgrading of disclosure requirements which could set a horizontal standard across the EU financial services market if developed and applied correctly across all sectors.

Its central innovation from a disclosure tool perspective is the inclusion in the regulation on key information documents (KID) for PRIIPs investment products (Regulation 1286/2014).[60] Article 8(3c)

Duties of Investment Intermediaries', 2014:
http://www.lawcom.gov.uk/wpcontent/uploads/2015/03/lc350_fiduciary_duties.pdf

[56] Resource Efficiency and Fiduciary Duties of Investors (2015):
http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf

[57] A discussion of the report's findings will be important in that it is not recommending legislative clarification yet still noted that "The conservative interpretation of fiduciary duty as solely focusing on the highest financial returns through short- and medium-term investments without taking wider social and environmental issues into consideration in investment decisions still seems to persist among certain legal advisers and investment consultants".

[58] Further information is available:
http://www.europarl.europa.eu/RegData/etudes/BRIE/2015/573885/EPRS_BRI%282015%29573885_EN.pdf

[59] Further information is available: http://ec.europa.eu/finance/finservices-retail/investment_products/index_en.htm

[60] REGULATION (EU) No 1286/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 November 2014 on key information documents for packaged retail and insurance-based investment products: http://eur-lex.europa.eu/legal-

states that this document sets out, among other things, the nature and main features of PRIIPs, including a description of the underlying instruments, a specification of the markets the PRIIP invests in, and *"where applicable, specific environmental or social objectives the product targets"*, as well as how the return is determined. The KID also needs to describe the risks, and the possible maximum loss of invested capital.[61] PRIIPs were intended to reduce regulatory arbitrage across investment products through horizontal application across financial services providers. Its KID format initially lent heavily on the model of the Undertakings for Collective Investment in Transferable Securities (UCITS) but has moved ahead of the UCITS product by being the first retail financial services Directive to explicitly mention that ESG factors need to be taken into account by the undertakings.

The Commission acknowledges in Recital (19) that *"Increasingly retail investors pursue, along with the financial returns, also additional purposes such as social or environmental goals of their investment. However, information on social, environmental outcomes being sought by the PRIIP manufacturer can be difficult to compare or may be absent".* [62] It clarifies further *"Therefore, anticipated sustainable environmental and social developments in financial investments"* … could …*"be more appropriately integrated into and further fostered by the EU law. However at this point there are no certain criteria or a formal procedure to objectively verify the target of these investments as being socially or environmentally friendly"*.

Article 25 of the Regulation decrees that four years after the date of entry into force of the regulation (ca. mid 2018), the Commission shall undertake a review including the feasibility, costs and possible benefits of a label for social and environmental investments. This review is to be submitted by the Commission as a report to the European Parliament and the Council, accompanied, if appropriate, by legislative proposals. Our organisations, and others, have undertaken a significant amount of work regarding the principles and criteria this label could include, which relate to assessing land and resource risks for large-scale investments and are happy to share this development work with the Commission.[63]

We would urge the Commission to consider the label for social and environmental investments as a matter of urgency given the momentum in the responsible investment market as outlined in our introduction. It is also pertinent in relation to the risk of fragmentation posed by the introduction of national retail labelling schemes described above.

iii/ Undertakings for Collective Investment in Transferable Securities (UCITS) (Directives 2009/65/EC, 2010/43/EU and 2014/91/EU)

We see UCITS[64] as a major regulatory framework for setting ESG standards at the retail level, given the priority the Commission has put on mobilising individual savings and investments aggregated in pension funds and other investments. Dating back to 1985, UCITS is widely recognised as the EU's most successful intervention in creating a highly regulated cross-border friendly investment product type. Over

content/EN/TXT/?uri=celex%3A32014R1286; Published in Official Journal on November 26, 2014 and with Corrigendum in December 2014

[61] The details of what Article 8 requires will need to be worked out in technical standards to be drafted by the Joint Committee of the European Supervisory Authorities (ESAs, i.e. the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)).

[62] Recital 19, REGULATION (EU) No 1286/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 November 2014 on key information documents for packaged retail and insurance-based investment products

[63] For details of this work contact Megan MacInnes, Global Witness, mmacinnes@globalwitness.org

[64] Further information available: http://ec.europa.eu/finance/investment/ucits-directive/index_en.htm

the years it has gone through a number of important iterations and evolution leading the industry to call it "state-of-the art" in terms of its risk management.[65]

"UCITS enjoy a very high level of recognition in Europe and beyond. UCITS has become a global brand of a well-regulated and risk diversified investment fund that can be marketed to retail investors. The advantages of this framework and brand have also attracted a large number of institutional investors. UCITS has proven to be a great success story not only in Europe but also outside, particularly in Asia. Indeed, more than 40% of UCITS sales take place outside Europe nowadays. It is therefore an attractive business proposition to structure a product as a UCITS when aiming for a Europe-wide or even global distribution."[66]

In order to maintain its well-regulated status (the UCITS 'brand') we have identified a number of areas in which improvement is rapidly needed for it to grow in a broader responsible investment culture. We believe that clarifications are required regarding the policy development path of UCITS. We understand that there is an ongoing consultation on a possible "UCITS VI" without any fixed timetable and a regulatory requirement for the Commission to seek to align UCITS with PRIIPs KID disclosure requirements which include ESG.

The PRIIPs Regulation identifies UCITS as falling within its scope. But because of the recent changes to UCITS, they will be given a transitional period of five years and UCITS will continue to use the KIID provided in the UCITS directive, as they do today. After that 5 year period, the relevant KIID provisions shall be repealed from the UCITS directive or maintained but aligned. There is also a possibility to extend the transitional period. This will follow a review of the effectiveness of the PRIIPS Regulation which is set to take place four years after its implementation.

Because of the importance of UCITS as a product category and the growing demand for ESG linked investments we believe that this transition period will have to be reviewed and ultimately shortened to align with the PRIIPs product. While the CMU Action Plan brings reviews of the European Venture Capital Funds (EuVECA) and European Social Enterprise Funds (EuSEF forward) *"in light of the objective to work quickly to put in place the building blocks of the CMU"*,[67] there is nothing to support an early alignment of PRIIPS and UCITS and the growing retail interest in ESG investing.

During this period, where PRIIPs itself will be under review for developing ESG methodologies we believe that the following aspects of UCITS will need to be addressed[68]:

Investment Due diligence and ongoing monitoring for UCITS

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[65] "It should therefore be emphasised that risk management in UCITS is already state of the art, and will be enhanced even further by the entry into force of the UCITS IV Directive on 1 July 2011. These new rules include many, even more detailed provisions on internal control mechanisms for the UCITS management company. The rules cover the risk management, compliance and internal audit functions, risk management policies, risk measurement, counterparty risk and issuer concentration risk calculation, as well as procedures to value OTC derivatives." P8 THE EVOLVING INVESTMENT STRATEGIES OF UCITS EFAMA report on the so-called "Newcits" phenomenon 08.04.2011: https://www.efama.org/Publications/Public/UCITS/11-4028_Final_EFAMA_Newcits_report_08042011.pdf

[66] Ibid.

[67] The Commission has launched a consultation on the review of the European Venture Capital Funds (EuVECA) regulation (No 345/2013): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0345; and European Social Entrepreneurship Funds (EuSEF) regulation (No 346/2013): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0346

[68] Upcoming review of UCITS expected: The Commission initiated a very open ended consultation in July 2012 covering eight wide-ranging areas and is dubbed "UCITS VI" as it is seen as the basis for a further set of reforms to the UCITS framework – "rolling back complexity" as a possible theme. We would urge the Commission to take action in two elements which are very important from an ESG perspective related to agribusiness and land issues.

With regard to UCITS, Article 23 of Directive 2010/43/EU[69] requires fund managers to employ a high degree of due diligence, however, no clear stipulation for what such requirements have been given. There is room therefore for the Commission propose the inclusion of ESG factors within in the due diligence processes, in the form of regulatory standards.

<u>Eligible assets ESG perspective related to agribusiness and land issues</u>
We are concerned that currently there is a risk that UCITS compliant exchange tracker funds (ETFs) which invest in, or be exposed to, agribusiness companies and projects that engage in illegal land grab activities, physical agricultural commodities, can benefit from the UCITS 'brand' and thereby risking the integrity of the UCITS framework internationally. We recognize that the Commission has become concerned about the appropriateness of sophisticated investment strategies embedded under the UCITS banner and will look at eligible assets as part of its review to see whether the eligible and non-eligible/forbidden assets in which a UCITS ETFs can invest, should be changed. It is important that a 'UCITS VI' should not allow a UCITS ETF to invest in shares, bonds, other transferable securities that relate to farm land acquisition and agribusinesses involved in (such land) activities which are illegal, nor in shares of funds with securitized loans towards land acquisition projects or agribusinesses involved in it.

Rather than being part of an open ended UCITS review, we recommend these steps form part of the transitional programme which seeks to align UCITS with PRIIPs.

iv/ European Long-Term Investment Funds (ELTIFs) (2013/0214 (COD))

In addition to our comments on PRIIPs, UCITS and the Alternative Investment Fund Managers Directive (AIFMD), see below, we believe that the Commission could do more to clearly mainstream ESG criteria into European Long-term Investment Funds.[70] With a review on the horizon due at the latest by June 2019, we believe there is an opportunity to develop key aspects of ELTIFs in line with ESG concerns.

The stated objective of the ELTIF Regulation is to raise and channel capital towards European long-term investments in the real economy, in line with the Union objective of "smart, sustainable and inclusive growth". Therefore, the explicit inclusion of ESG criteria as fundamental management tool for such Funds would enable the Commission to explicitly demonstrate the importance of such considerations within the European approach to fostering economic growth through sustainable investment.

The Commission clearly hopes to target particular groups through ELTIFs (municipalities, churches, charities and foundations) which should be able to request to be treated as professional investors (non-retail). These are likely to be more interested in ESG compliant investments. Yet there seemed to be little interest in enshrining the notion of fostering socially and environmentally sustainable growth as part of ELTIFs' investment goals, other than an oblique reference to sustainability. The Commission should therefore seek to amend the regulation to include a requirement for asset managers launching ELTIFs to disclose their approach to socially responsible investment.

An important and underreported aspect of ELTIF is the approach to non-EU states or "Third Countries". We explained in our introduction potential risks of the CMU barely mentioning the flow from EU capital markets to investments in non-EU states. ELTIF provides an opportunity for the Commission to demonstrate that it seeks to apply ESG criteria to investments also made by EU investors outside the EU. The current Regulation limits the countries that an ELTIF can invest in, on (i) account of money

[69] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010L0043
[70] Article 37 Review. Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015R0760

laundering or financing terrorism, or (ii) status as a tax haven.[71] We would seek to have countries with high degrees of land grabbing associated problems added to this list.

v/ Alternative Investment Fund Managers Directive (AIFMD) (Directive 2011/61/EU)

The Alternative Investment Fund Managers Directive[72] is due for a review by the Commission in 2017. We understand that the Commission will consider whether further alignment between AIFMD and UCITS is required. In line with our proposal for a horizontal approach to ESG across Europe's investment universe we call for an adjustment to AIFMD to include ESG in risks assessment / mitigation / due diligence measures via the 2017 review of AIFMD and the development of delegated technical standards.

At present Chapter 2 Article 15 of AIFMD describes the policies regarding the AIFMs risk management. Our concern is that this Directive currently potentially permits land grabbing activities because of the lack of clarity about the extent to which AIFs have to consider ESG and land tenure risks within their due diligence and risk analysis.

The main questions raised by land grabs concern degree of 'due diligence' that investors make before concluding a deal and the moral and material risks arising from ESG difficulties. AIFMD contains no provisions on operational risks beyond a requirement that they be suitably managed, with risk limits and policies that are reviewed every year. It does not subject such matters (including 'due diligence' in acquiring an asset) to regulatory sanctions but requires insurance cover for them.[73] Examples cited include 'the loss of documents evidencing title to investments' and 'failure to carry out sufficient due diligence on an investment that turned out to be fraudulent.'[74] We believe that the AIFMD would benefit from introducing greater clarity in this area through mandatory sanctions for serious failures in due diligence, covering such areas of risk as fraud, legal title to investments and counterparty risks arising from contested ownership.

2.2) Question B - Unnecessary regulatory burdens

2.2.a) Issue 6: Reporting and disclosure obligations

2.2.a.B) Investors/issuers

i/ Shareholder Rights Directive (2007/36/EC)

In April 2014, the Commission published proposals to amend the existing Shareholder Rights Directive[75] (SRD) in line with its 2014 Communication on the Long-Term Financing of the European Economy, its 2013 Green Paper of the same topic, and its 2012 Corporate Governance Action Plan, as well as related public consultations. The current Directive was adopted in 2007 to improve corporate governance by defining minimum rights for shareholders in listed companies across the EU. The SRD revision process continued throughout 2015 and into 2016, with the Directive currently in trialogue negotiations.

The Commission's stated intention in introducing the amendment is to improve corporate governance of listed companies by strengthening shareholder engagement and thereby to contribute to the

[71] REGULATION (EU) 2015/760 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 29 April 2015 on European long-term investment funds Article 11 1b. Qualifying portfolio undertaking.
[72] Further information available: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF
[73] European Commission (2012), op. cit., Articles 13 and 12 respectively.
[74] European Commission (2012), op. cit., Article 12.2(a) and Recital 33 respectively.
[75] Further information available: http://ec.europa.eu/internal_market/company/shareholders/indexa_en.htm

competitiveness and long-term sustainability of those companies. The revision of the SRD is a key opportunity to improve transparency and accountability in Europe's investment system and tackle corporate governance failings at the companies that European investors own around the world. This Directive will potentially give investors and asset managers more powers and obligations to scrutinise and hold to account investee companies, including on environmental, social and corporate governance issues. Europe's asset management industry controls €17 trillion of assets so if this Directive succeeds in encouraging more responsible, engaged ownership behaviour, the effects will be far reaching.[76]

In July 2015 the European Parliament agreed amendments which would strengthen the inclusion of ESG risk assessment requirements and public disclosure of investors, in the SRD. Particularly, strengthening Article 3f to require that *'Member States shall ensure that institutional investors and asset managers develop a policy on shareholder engagement, including how to monitor investee companies, including on their non-financial performance, and reduction of social and environmental risks'*.[77] However we are concerned about the introduction by Parliament of a loophole requiring this reporting to only be done through a 'comply or explain' basis.[78]

The UK, with its Stewardship Code introduced in 2010, is widely seen as being at the forefront of shareholder engagement strategy. The code had the aim of clarifying the rights and responsibilities of institutional investors and asset managers.[79] This has led to significant improvements in reporting, quality of policies and demand for responsible investments. For example between 2011 and 2013 alone there was a 31.8% increase in use of voting and engagement by UK asset managers.[80] 80% of UK pension fund's Request for Proposals to asset managers now include ESG issues[81] and 82% of the largest 33 asset management firms operating in the UK now disclose voting records; such disclosures are simply a matter of making public data these firms already hold internally.[82] Therefore, the frequently used argument by trade groups that such disclosures will have little impact on encouraging shareholder engagement and would be burdensome red-tape which could undermine Europe's economic recovery simply is not borne out by the facts.

Despite this progress in the UK, many laggards in the UK's investment sector are resisting becoming more transparent, responsible or engaged; they are neither 'complying' nor 'explaining' why they are not following the Code. A survey by Grant Thornton in 2014 of compliance by FTSE 350 companies found that more than one third (39%) failed to comply with the UK's Corporate Governance Code in full in 2014.[83] One reason for this is that the Financial Reporting Council does not have adeqaute enforcement powers to take these laggards to task. There is currently little clarity on the crucial question of how member states would monitor and enforce the provisions required by the Shareholder Rights Directive.

[76] European Commission Green Paper, 'Building a capital markets Union', 2015, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015DC0063
[77] Further information available: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2015-0257+0+DOC+XML+V0//EN#title2
[78] As introduced through Article 3(f)(4) in the European Parliament approved text for the SRD.
[79] Further information is available here: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx
[80] Eurosif, 'European SRI Study', 2014, available for download: http://www.eurosif.org/publication/view/european-sri-study-2014/
[81] National Association of Pension Funds, 'NAPF Engagement Survey: pension funds' engagement with investee companies', 2014
[82] ShareAction 'Encouraging responsible, long-term shareholder engagement: briefing note on proposed revisions to the Shareholder Rights Directive .. and dispelling some myths', April 2015
[83] Further information is available at: http://www.grant-thornton.co.uk/Global/Publication_pdf/Corporate-Governance-Review-2014.pdf

An example of a more robust and clear ‘comply or explain’ mechanism is that introduced by the Swedish Corporate Governance Code requirement: *“If a company finds that a certain rule is inappropriate due to particular circumstances, it can choose another solution than that found in the Code. The company must, however, clearly state that it has not complied with the rule, along with an explanation of the company's preferred solution and the reasons for this. Companies must also give an account of how they have applied the Code in an annual corporate governance report, including any alternative solutions and the reasons for them.”*[84] Of note is the requirement that the company must clearly state that it recognises it has not complied with the rule.

We therefore see the Shareholder Rights Directive trialogues are a key test of whether the Council will stand by this supportive statement on ESG.

ii/ Prospectus Directive (Directives 2003/71/EC, amended by 2010/78/EU, 2013/50/EU and 2014/51/EU)

The Prospectus Directive[85] (applied at Member State level in November 2015) details how new share issues should be marketed, and provide detailed explanations about the issuing company, fund, etc, and is included in the CMU Action Plan.

The Directive is the primary document that investors use to make informed decisions about future investments. As such, it should contain all the facts that an investor needs in making that decision. The facts that are considered to be material and relevant and the type of information that has to be included in the prospectus are regulated by the Prospectus Directive, amended in December 2010 by the ‘Amending Directive’. Investment decision making processes could be improved by including compulsory explanation by agribusiness or land tenure project issuers of shares or bonds, how they avoid socially and environmentally harmful activities and illegal land grabbing, if they apply standards such as human rights, free, prior and informed consent etc. The current directive has no reference to ESG issues.

We are seeking the inclusion of ESG risks assessment / mitigation / due diligence measures in the recently published legislative proposals for operation of Directive.[86] Although the prospectus regime functions well overall, certain requirements of the Prospectus Directive might still be improved to alleviate administrative burden for companies which draw up a prospectus (especially SMEs) and to make the prospectus a more valuable information tool for potential investors. Further alignment of the prospectus rules with other EU disclosure rules (e.g. the Transparency Directive and KID regulation under PRIIPs) could enhance the efficiency of the prospectus.

The review of the Prospectus Directive is singled out in the Capital Markets Union Action Plan as one of its early and high-priority actions. Our concern is that the overarching rationale of this review appears to be deregulatory and aimed at reducing one of the principal regulatory hurdles that issuers face when offering their equity and debt securities to the investing public. It would be major missed opportunity if the opportunity to incorporate ESG criteria was not included at this important stage of CMU development and the need for sustainable investments and growth.

2.2) Question B - Unnecessary regulatory burdens

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[84] For further information please see: http://www.corporategovernanceboard.se/the-code/comply-or-explain

[85] Further information available: http://ec.europa.eu/finance/securities/prospectus/index_en.htm

[86] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prospectus to be published when securities are offered to the public or admitted to trading. Brussels, 30.11.2015 COM(2015) 583 final 2015/0268 (COD): https://ec.europa.eu/transparency/regdoc/rep/1/2015/EN/1-2015-583-EN-F1-1.PDF

2.2.a) Issue 6: Reporting and disclosure obligations

2.2.a.C) Supervisory disclosures

The main focus of EU regulation on retail financial services had been on disclosure and distribution. DG FISMA recently issued a Green Paper on Retail Distribution and consultation from 10.12.2015 to 18.03.2016[87], which focused on soft EU intervention (self-regulation, comply or explain) and on issuers/shareholders and consumer protection. While ESG disclosure and transparency at the product marketing and service level are need to be enhanced by the Commission, we would also recommend the integration of ESG considerations into internal firm risk management systems and governance structures.

An exemplar of this more intrusive and intensification of supervision of governing processes and the products they can deliver is through the prudential regulation incorporated in Solvency II. This will involve enhancing risk management across the company, upgrade information systems and embed risk awareness more closely into the governance strategy and operation of their business. We believe that the Commission will increasingly have to oversee the development and management of internal risk models to ensure they keep pace with real world risks to sustainability – areas covered by ESG analysis.

A number of key actions by the Financial Stability Board and Bank of England will create the need for the Commission to consider modifications to the capital adequacy regulation of financial institutions and risk management innovation and systems.

iii/ Insurance - Solvency II Directive (Directive 2009/138)

The Solvency II Directive[88] aims to improve insurer's risk assessment by obliging insurance firms starting from 2016 to assess their solvency needs through their Forward Looking Assessment of Own Risks (FLAOR) formerly known as Own Risk and Solvency Assessment (ORSA), in which scenario planning plays an important role. This is the own risk capital assessment which, performed by the company, tries to understand how much capital companies need to hold on the basis of the risk that they are bearing and of their medium and long term planning, in order to make sure that they will meet their objectives.

Insurance companies are required to report on their solvency and financial conditions. These reports include information regarding their performance, assessments of the adequacy of their risk profile, description for each risk class of their exposure, concentration, mitigation and sensitivity, and a description of their capital management.

What is not clear is how far these internal models and systems take into account "non-financial risks" such as those covered by ESG analysis. The European Insurance and Occupational Pensions Authority (EIOPA) should be encouraged to require that the risk class descriptions also explicitly include ESG risks. As insurance companies and pension funds gain a clearer understanding of ESG risks of their own portfolio through this requirement, it will be easier to then require them to implement mechanisms to reduce these risks. For example, through closer analysis of ESG profiles of equity investments by investigating issues of operations on contested land, the use of violence and force, or disregard for customary rights regarding land titles. Existing portfolios can also be screened on these requirements, leading to either divestment or engagement.

[87] GREEN PAPER on retail financial services Better products, more choice, and greater opportunities for consumers and businesses: http://ec.europa.eu/finance/consultations/2015/retail-financial-services/index_en.htm
[88] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2009.335.01.0001.01.ENG

Currently the "Guidelines on Forward Looking Assessment" of own risks do not include requirements to take into consideration land tenure risks of equity investments, or ESG risks in general. EIOPA could be required to include such requirements in subsequent guidelines, or require specific guidelines regarding the 'investment' element of risk-management systems. Similarly, ESG factors play a role within the underwriting and reserving, and reinsurance and other risk-mitigation elements.

In this regard, we would urge the Commission to take account of recent developments in the UK.[89] The UK Prudential Regulatory Authority (PRA) is to give further consideration as to how best to incorporate the identified climate change risk factors into its existing framework and supervisory approach. This may include, amongst other actions: (i) reviewing the PRA's business model analysis and stress-testing framework to ensure the latest view of climate change risk factors is captured; (ii) continuing to build in-house technical expertise to support supervisors in their understanding and assessment of climate change risks as they relate to insurers; and (iii) a thematic review of firm ORSAs to evaluate the extent to which climate change risk factors are being appropriately identified and assessed. The Commission would need to ensure that best practice is codified and adopted across the EU supervisory landscape.

iv/ Banks and Asset Management, capital requirements

Banks need to more thoroughly evaluate the extent to which ESG issues might cause financial risks for their clients and to how they might impact their financing needs. The risk assessment and risk management methodologies used by banks have been updated but are still being reviewed by the Basel Committee on Banking Supervision.[90] This may result in a requirement for the Commission to propose new EU legislation on risk management by banks in the next few years if recent developments on ESG issues such as climate change are taken into account.

So far, discussions have not included material and non-material ESG aspects, or socially and environmentally harmful agricultural/agribusiness activities and illegal land grabbing. A recent survey highlighted this lacunae in risk management[91]:

"…the annual E&S (environment and social) risk identification and assessment process is the task of the bank's sustainability department and has not yet been systematically integrated in the bank-wide annual risk identification and assessment process of principle risk categories like market, credit, and liquidity risks. For example E&S issues are not yet part of most bank's scenario analysis or stress tests. In addition, at almost all banks E&S risk identification and assessment process is qualitative and not yet quantitative in nature as part of, for example, the internal capital adequacy and assessment process (ICAAP) of the bank. In general, the surveyed banks have difficulties with quantifying E&S impacts on their business. This limited ability to adequately quantify E&S impacts could restrict further integration of E&S factors in credit risk management. E&S risks not yet integrated in bank-wide annual risk identification and assessment process."

<u>Integrating ESG criteria within the Internal Ratings Based approach</u>

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[89] Prudential Regulation Authority (2015) The impact of climate change on the UK insurance sector: A Climate Change Adaptation Report by the Prudential Regulation Authority: http://www.bankofengland.co.uk/pra/documents/supervision/activities/pradefra0915.pdf

[90] Further information available: https://www.bis.org/bcbs/

[91] Banking Ready-or-Not. An assessment of sustainability integration in the European banking sector (2015): https://www.kpmg.com/NL/nl/IssuesAndInsights/ArticlesPublications/Documents/PDF/Banking-en-Leasing/Ready-or-not-Survey-WWF-KPMG-Sustainable-Banking.pdf

The European Banking Authority (EBA) regulates banks at the EU level through the supervisory framework consisting of Directive 2013/36[92] and Regulation 575/2013.[93] Based on Article 74-78 of the Directive and Article 144 of the Regulation, the EBA could require large banks wishing to use an Internal Ratings Based (IRB) approach to integrate ESG criteria in their risk assessment procedures. These regulatory standards offer a good opportunity for the Commission to work with the EBA to encourage the inclusion of ESG criteria in the IRB approaches of banks as one of the assessment criteria.

v/ Credit Ratings Agencies (Regulations 1060/2009 and 462/2013)

Regulations 1060/2009[94] and 462/2013[95] stipulate that a Credit Rating Agency (CRA), in order to be recognized by the European Securities and Markets Authority (ESMA), among others *"shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing."* We believe that the regulation of CRAs provides an area of legislation where further work could be considered by the Commission (and ESMA) in terms of issuing regulatory standards requiring CRAs to integrate ESG risks assessment / mitigation / due diligence in their analysis.

CRAs were widely criticized as contributing to the financial crisis in 2008, through their opaque ratings methodologies. We hope to see that the integration of ESG into the internal risk management systems of financial institutions will mean less reliance (or outsourcing) to CRAs for risk analysis. But given they are part of the financial services infrastructure we believe that the Commission must ensure that ESMA should be required to issue regulatory standards which require credit rating agencies to integrate ESG-criteria better in their analyses (criteria barely present currently). In particular, the back-testing requirement offers opportunities, as it would allow ESMA to ask credit rating agencies analyse if ESG-criteria played a role in corporate defaults which were rated too high by the credit rating agencies in the past - and vice versa.

<u>A reminder to the Commission on the risks of over reliance of industry self-regulatory codes of conduct</u>

European Union CRAs were traditionally relatively unregulated entities in the EU, although their activities and relevance were recognized by three Directives including the Capital Requirement Directive[96]. The Commission relied on the IOSCO Code of Conduct implemented through self-regulation to ensure the accountability of CRAs. Market participants' appeals to continue to rely on the ability of CRAs to regulate themselves were partially taken on board by those in positions of political responsibility. The foundations for regulatory measures were laid by the G-20 summits in Washington, DC and London. In the final declaration of the 2008 Washington summit, the participants stated: *"We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct*".[97].

[92] Further information available: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:En:PDF
[93] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013R0575
[94] Further information available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32009R1060
[95] Further information available: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ%3AL%3A2013%3A146%3ATOC
[96] The Directives are: the Market Abuse Directive (2003/125/EC), the Capital Requirements Directive (2006/48/EC), and the Markets in Financial Instruments Directive (2004/39/EC). See European Securities Markets Expert Group (2008) Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 7-9.
[97] G20 2008. Declaration of the Summit on Financial Markets and the World Economy. Washington, DC: http://www.g20.org/Documents/g20_summit_declaration.pdf

3) Conclusion

The Capital Market Union is described as the final piece of Europe's regulatory response to the 2008-9 financial crisis. As such, we would have expected it to outline a robust approach to tackling the causes of the financial crisis, learning lessons from the past and setting Europe on an alternative route to a more stable and sustainable future, where finance serves the needs of society instead of simply the needs of capital. It is also reasonable to expect an approach aligned with the EU's broader policy initiatives, such as the recently launched Sustainable Development Goals.

Instead, the Action Plan of the CMU launched in September 2015 re-introduces high risk financial activities such as securitisations which are associated with systemic risks, proposes to water down regulatory measures, side-lines environmental, social and governance (ESG) considerations and completely fails to integrate the CMU within Europe's broader sustainability policy agenda.

This briefing paper contributes to a key initial activity within the CMU Action Plan; the European Commissions "Call for evidence: EU regulatory framework for financial services". It outlines our concerns about the lack of standardisation of ESG risks across Europe and the potential impacts of further fragmentation. It focuses in our specific area of concern relating to the lack of consideration of ESG risks within European financial investors operations: the ongoing involvement of European based investors in land grabbing projects overseas, with devastating environmental and human rights consequences. Following this, we analyse the current degree to which ESG risks are considered and acted upon, across Europe's financial regulatory structure.

Our conclusions are that urgent action is needed to strengthen the way in which ESG risks are defined by the Commission and addressed in the different types of regulation, how such risks are assessed and mitigated against, and also that robust enforcement of such measures is essential. The current and ongoing involvement of European investors in land grabbing overseas, despite having made commitments to responsible environmental and social behaviour, makes clear that the solution lies in robust regulations rather than voluntary initiatives.

Our recommendations for remedying these regulatory gaps in the financial sector are as follows:

1. Develop a robust and standardized definition of ESG risks, as they pertain to the operations and impacts of Europe's financial sector, domestically and internationally. This definition should be aligned with and contribute to Europe's existing policy commitments to sustainability and climate change;
2. Embed binding regulatory provisions within Europe's regulatory systems governing the financial sector, to ensure that ESG risks are adequately assessed, understood and mitigated for by European investors' activities. Specific regulatory frameworks within which this can be done include the following:
   - Institutions for Occupational Retirement Provision II Directive
   - Packaged retail and insurers based investment products
   - Undertakings for Collective Investment in Transferable Securities
   - European Long-Term Investment Funds
   - Alternative Investment Fund Managers Directive
   - Shareholder Rights Directive
   - Prospectus Directive
   - Insurance – Solvency II Directive
   - Banks and asset managers, capital requirements
   - Credit ratings agencies regulations

3. Ensure these regulatory provisions are implemented through demonstrable public disclosure requirements and that clear and effective sanctions are available to enable ease of compliance across European Member States;
4. Update the Capital Market Union Action Plan to mainstream understanding and management of ESG risks across its programme of reforms, both within policy and regulatory measures.

We have made this substantial contribution to the call for evidence because we believe it is not too late for the CMU and its Action Plan (as part of Europe's wider financial regulatory system) to change its direction. It is within the power of DG FISMA and Europe as a whole to take the necessary steps (as outlined above) to strengthen ESG-focused regulations, to eliminate high risk activities which contributed to the previous financial crisis, and to ensure that Europe's financial sector is fully integrated within its broader sustainable policy ambitions so as to stop financial institutions from providing financial services to landgrabbing companies..