STRENGTHENING STEWARDSHIP IN THE EU

5 KEY RECOMMENDATIONS TO THE EUROPEAN COMMISSION

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PRI Association

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INTRODUCTION

The PRI defines stewardship as '*the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns, and clients' and beneficiaries' interests depend*.'[1] Stewardship and ESG incorporation (which sees investors include ESG factors in their investment and capital allocation decisions) are complementary strategies. Responsible investment involves both, including each feeding back into the other, for example by using insights garnered from engagement to enhance investment decision making – and vice versa[2].

The 2018 EU Sustainable Finance Action Plan[3] places significant emphasis on the allocation of capital to companies and activities that are deemed "sustainable", through policies such as the EU taxonomy. This has the benefit of giving greater clarity to consumers of financial products about the sustainability of their underlying investments and improving the access to capital of companies involved in sustainable activities. It also may encourage companies with lower proportions of taxonomy-aligned activities to dedicate more resources to green activities.

Yet a policy approach that focuses solely on investors' role as providers of capital overlooks the broader influence investors have over investee companies, the financial system and the economy at large. As shareholders, investors have unique levers to support companies to transform their activities to be more sustainable, such as the right to vote at Annual General Meetings and to bring litigation in the event of corporate misconduct. Across asset classes, investors have influence through engagement directly with investees or with other stakeholders, such as standard-setters, policymakers and communities affected by corporate activities. Investors have a responsibility to use these forms of influence to encourage corporate transition to sustainable practices and thus support long-term value creation. They also have a responsibility to inform beneficiaries whether and how their assets are being managed sustainably.

A policy environment that incentivises alignment between the EU's sustainability goals and the role of investors as both providers *and stewards* of capital is essential to the creation of a sustainable financial system.

This position paper sets out 5 key recommendations to the European Commission. The revision of the EU Sustainable Finance Strategy offers a significant opportunity to accelerate ambition on stewardship. The PRI encourages the Commission to use this renewed strategy to build on its recent commitment to facilitate shareholder engagement in Action 12 of the renewed Capital Markets Union Action Plan[4] .

[1] https://www.unpri.org/investment-tools/stewardship. Stewardship is sometimes referred to as "active ownership".
[2] PRI, An introduction to responsible investment: Stewardship.
[3] Sustainable finance: Commission's Action Plan for a greener and cleaner economy (europa.eu)
[4] Capital markets union 2020 action plan: A capital markets union for people and businesses | European Commission (europa.eu)

RECOMMENDATIONS

1. Explain how stewardship tools can support the overarching goals of the 2018 Action Plan, by clarifying and strengthening related disclosure rules under the SFDR as well as relationship with the Taxonomy Regulation.
2. Revise the Shareholder Rights Directive (SRD II) to highlight the importance of investor engagement with non-issuer stakeholders, make stewardship disclosures mandatory with an increased scope and provide transparency on the extent to which stewardship activities are implemented, resourced and incentivised.
3. Clarify that a financial market participant has a fiduciary duty to consider how it should undertake stewardship activities relating to sustainability risks and impacts to pursue fund objectives and serve clients' “best interests” and may incur reasonable costs in doing so. Further, provide regulatory guidance how an approach to stewardship and investing which addresses system-level issues is required by or compatible with fiduciary duties.
4. Revise the Institution for Occupational Retirement Provision Directive (IORP II) to better account for beneficiary sustainability preferences.
5. Develop regulatory guidance clarifying how investors can collaboratively engage without being deemed to be acting in concert.

1. STEWARDSHIP WITHIN THE EU ACTION PLAN ON SUSTAINABLE FINANCE

Comprehensive policies defining stewardship and promoting responsible active ownership in alignment with the broader sustainability goals were largely absent from the 2018 EU Action Plan on Financing Sustainable Growth and the EU Green Deal. **The European Commission must clarify how investors can use the stewardship tools already available to them to support the goals of these overarching projects.**

The SFDR

The regulation on sustainability-related disclosures[5] (SFDR) requires (under Article 4.2(c)) financial market participants to disclose '*brief summaries of engagement policies in accordance with Article 3g of Directive 2007/36/EC, where applicable',* as part of their entity-level website disclosures where they consider principal adverse impacts (PAIs) of investment decisions on sustainability factors. Under Article 3g of SRD II, institutional investors and asset managers must disclose, on a comply or explain basis, their engagement policy which includes a description of how they '*monitor investee companies on relevant matters, including […] social and environmental impact*'. There is no explicit requirement to consider environmental and social impacts beyond the monitoring of companies.

Furthermore, in paragraph (18) of the recital of the SFDR, it states procedures for considering these PAIs *might* include financial market participants discharging their sustainability-related stewardship responsibilities or other shareholder engagements.

Evidently, there must be greater detail and clarity of the disclosure obligations regarding stewardship activities. The draft SFDR RTS[6] suggest the summaries of the engagement policies shall also include:

- a description of the indicators for adverse impacts considered in those policies and how those policies adapt where there is no reduction of the principal adverse impacts over more than one reference period (Article 8.2, draft RTS); as well as
- a brief summary of any other engagement policies relating to reducing principal adverse impacts (Article 8.1(b), draft RTS).

PRI supports these proposals, particularly the emphasis on using stewardship to minimise adverse impacts and ensuring this process is continually effective.

Recommendation 1.1: The PRI recommends the European Commission maintain the proposed Articles 8.1(b) and 8.2 of the draft RTS and add the following disclosures under Article 8.2 RTS. FMPs should disclose:

- whether reduction of PAIs is their primary stewardship objective; and
- how they anticipate their stewardship activities will lead to a reduction in PAIs.

[5] Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector
[6] Final Report on draft Regulatory Technical Standards, ESAs, February 2021

The EU Taxonomy

As part of its [communication on the sustainable finance package](), the European Commission describes how the Taxonomy can support the transition, stating that the climate delegated act performance criteria '*create a common language for businesses and investors, allowing them to communicate about green activities with increased credibility and helping them to navigate the transition already under way […] Companies, if they wish, can reliably use the EU Taxonomy to plan their climate and environmental transition and raise financing for this transition.'* This statement also indicates how the Taxonomy can support stewardship activities – through target setting and more meaningful dialogue between investors and companies. However, the connection is not explicit.

Stewardship plays a central role in the transition to a low carbon economy. The Taxonomy will support investor stewardship by providing a practical tool to bridge the gap between international sustainability goals, like the Paris Agreement, and investment practice. Investors can use the Taxonomy to set transition plans, targeting certain levels of alignment or setting goals to be within a certain percentage of the thresholds detailed in the technical screening criteria.

> Recommendation 1.2: PRI recommends the Commission clarify and strengthen the relationship between the Taxonomy and stewardship activities by:
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> - ensuring that the transition-supporting policies published in the Renewed Sustainable Finance Strategy are linked to Paris Agreement targets through the Taxonomy and their dependency on stewardship activities is made explicit; and by
> - requiring engagement policy disclosures under the SFDR to include alignment to certain sustainability outcomes and Taxonomy targets.
>
> PRI recommends disclosure of alignment with the EU's 2050 net zero goal and the Paris Agreement, human rights conventions and other SDGs. Investors and asset managers can reference the activity thresholds described by the EU Taxonomy as transition targets.

By mirroring the approach used to incorporate PAIs in engagement policy disclosures under the SFDR RTS, the Commission could include Taxonomy targets in SFDR engagement disclosures by adding a new requirement to disclose:

- a description of the environmental objectives considered (or Taxonomy alignment target set) in engagement policies and how those policies adapt where there is no increased Taxonomy alignment regarding that environmental objective over more than one reference period; as well as
- a brief summary of any other engagement policies[7] relating to meeting certain levels of Taxonomy alignment for an environmental objective.

[7] For example, engagement with non-issuer stakeholders, such as policymakers and communities affected by corporate activities. This subclause may not be needed provided the engagement policies described in Article 3g of SRD II are improved upon as described in section 3 of this document.

2. THE SHAREHOLDER RIGHTS DIRECTIVE

The Shareholder Rights Directive (SRD II, EU 2017/828)[8] recognises that shareholders often exert short-term pressure on investee companies, at the expense of longer-term value creation and ESG issues. The Directive seeks to mitigate this by addressing some principal agent problems in the investment chain and provides a minimum baseline for stewardship activities, effective stewardship and long-term investment decision making.

Article 3g of SRD II sets out the engagement policy requirements for institutional investors and asset managers. Yet, further obligations need to be recognised and mandated to account for stewardship activities and expectations across all asset classes; and actions investors have taken to implement the stewardship policies and their effectiveness (who have they engaged with, on what topics, what were the outcomes). The revised SRD must also modify the compliance basis from comply or explain to mandatory.

STEWARDSHIP ACTIVITIES AND EXPECTATIONS ACROSS ALL ASSET CLASSES AND ACTORS

SRD II applies to institutional investors and asset managers, but it does not set adequate stewardship expectations across all asset classes, nor other important actors in the investment chain. It's limitation to listed equity does not fulfil the needs of investors to engage across any assets that are not listed companies. Proxy advisors that play a significant role in the investment chain face limited disclosure obligations.

> Recommendation 2.1: The revised SRD should contain stewardship requirements for a broader range of asset classes including not only listed equity but also fixed income, private markets (i.e. private equity, real estate, infrastructure, other real assets) and hedge funds.
>
> Recommendation 2.2: Proxy advisers should be required to disclose whether and how they consider sustainability impacts in their voting analysis and recommendations, For coherency purposes, proxy advisers could be encouraged to use PAIs as referred in SFDR, to guide their engagement.

[8] Summary of SRD II: https://eur-lex.europa.eu/summary/EN/uriserv:l33285

ACTIONS INVESTORS HAVE TAKEN TO IMPLEMENT STEWARDSHIP POLICIES, AND THEIR EFFECTIVENESS

The engagement policy requirements under Article 3g of SRD II focus only on engagement with investee companies or "relevant stakeholders" of the investee companies.

> Recommendation 2.3: The revised SRD should also explicitly recognise the importance of investor engagement with non-issuer stakeholders, such as policymakers, standard-setters and communities affected by corporate activities.

Furthermore, SRD II does not require disclosure of resourcing dedicated to stewardship activities. This is an important disclosure tool to enable clients to understand the significance an institutional investor or asset manager places on stewardship activities.

The PRI recommends following the structure of Principle 2 of the UK Stewardship Code (2020) which requires signatories to explain how:

- their governance structures and processes have enabled oversight and accountability for effective stewardship within their organisation and the rationale for their chosen approach;
- they have appropriately resourced stewardship activities, including:
  - their chosen organisational and workforce structures;
  - their seniority, experience, qualifications, training and diversity;
  - their investment in systems, processes, research and analysis;
  - the extent to which service providers were used and the services they provided; and
- performance management or reward programmes have incentivised the workforce to integrate stewardship and investment decision making.

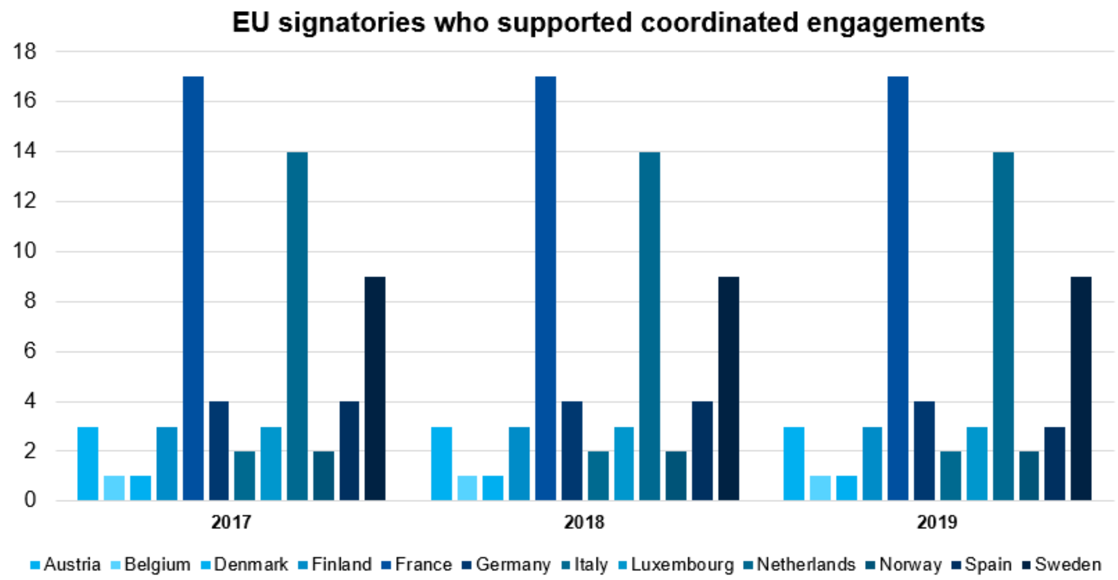
> Recommendation 2.4: The revised SRD should include a governance disclosure requirement, to provide transparency on the extent to which stewardship activities are implemented in the overall structure of the organisation, and how they are resourced and incentivised both internally and via service providers.

MODIFY THE COMPLIANCE BASIS FROM COMPLY OR EXPLAIN TO MANDATORY

Finally, Article 3g of SRD II only requires institutional investors and asset managers to either comply with or explain their obligations on engagement policies. This has been insufficient in incentivising an uptake in stewardship activities (see Graph 1).

In Europe, more than 1500 organisations have signed up to the Principles for Responsible Investment. The following chart shows the number of single PRI signatories in EU that have supported coordinated engagement between 2017 and 2019 based on data from the PRI's collaboration platform and Proxy Insight data[9].

Graph 1: PRI signatories supporting coordinated engagements.



Graph 1 shows that since the implementation of SRD II in 2017, the level of stewardship activities has remained very stable, with less than one fifth of signatories in each country supporting coordinated engagements.

Recommendation 2.5: The revised SRD must make disclosure requirements around stewardship and engagement mandatory for financial market participants within its scope.

[9] PRI's collaboration platform is a tool that offers PRI signatories a platform for their collaborate engagement. Proxy Insights data was used to match the findings from the collaboration platform.

3. FIDUCIARY DUTIES

Fiduciaries should act with due care, skill and diligence, investing as an 'ordinary prudent person' would[10]. This should include being an active owner, encouraging high standards of ESG performance in the companies or other entities in which they are invested.

Regulators should adopt targeted fiduciary duty amendments to require investors to use the stewardship tools at their disposal to engage on impact. In the EU, this could be addressed through targeted fiduciary duty amendments to the Level 2 regulations under MiFID, AIFMD and UCITS. The PRI considers that its specific concerns around stewardship, set out in its consultation response have not been addressed in the six final amending delegated acts.

The PRI, together with The Generation Foundation and the UN Environment Programme Finance Initiative (UNEP FI), are currently undertaking the project 'A Legal Framework for Impact' starting with commissioned legal analysis on the extent to which current law enables investors to consider sustainability impacts in investment decision-making. The analysis will also suggest areas for reform where it determines that there are impediments for investors to do so.

The full report will be available in 2021, and followed by a three-year work programme, but early findings indicate that whilst there is scope for investors to factor sustainability impact into investment decision-making and stewardship in some circumstances, the current formulation of investment duties and powers are, to some degree, restrictive. This represents a significant inconsistency between EU financial regulation and climate goals, and such impediments need to be addressed for greater alignment of capital markets to sustainability goals. For example, as stated in PRI's consultation response, UCITS must avoid undue costs. This could restrict UCITS management companies from incurring costs by, for example, procuring enhanced ESG data or undertaking some stewardship activities, where the action cannot be directly linked to increased financial return over the time horizon of the fund. Incurring such costs may currently not be considered consistent with the "best interests" of UCITS[11]. Furthermore, the UCITS Directive encourages stewardship activities but does not establish a general duty to engage for investment impact, which is increasingly considered to be central to meeting financial obligations[12]. Choosing not to pursue stewardship activities is a permitted route where justified in line with the Directive[13].

On 21 April, the Commission published, as part of its sustainable finance package, six amending delegated acts regarding sustainability preferences, fiduciary duties and/or product governance under UCITS, AIFMD, IDD, Solvency II and MiFID II. While the amendments provide greater clarity on sustainability risk, they do not amend the principle of acting in the "best interest" and therefore do not increase flexibility to invest for sustainability impact, nor establish a duty to do so.

> Recommendation 3.1: In considering a review of delegated acts relating to UCITS, AIFM and MiFID under the Renewed Sustainable Finance Strategy, the European Commission should clarify that the financial market participant has a duty to consider how it should undertake stewardship activities relating to sustainability risks and impacts to pursue fund objectives and serve clients' "best interests" and may incur reasonable costs in doing so.

[10] PRI Fiduciary duty in the 21st century Final report
[11] In general, the best interest of the UCITS is understood to be served where financial return is maximised in return with the stated investment objective. See Delegated Directive 2010/43/EU. Moreover, the UCITS Directive itself contains no obligation to assess beneficiaries views, nor would they be considered relevant to understand the best interests of the UCITS.
[12] PRI Active Ownership 2.0
[13] i.e. under UCITS where they can demonstrate that it is not in the exclusive benefit of the UCITS to cast votes, for example, when offering a very low-cost passive product.

The relationship between fiduciary duties and stewardship should also be clarified in the upcoming review of the IORP II Directive. Under Article 19.1(b), the directive states that, within the prudent person rule, Member States are required to allow an Institution for Occupational Retirement Provision (IORP) to consider sustainability impact. However, there is no obligation for an IORP to do so.

In their response to question 91 of the European Commission's consultation on the Renewed Sustainable Finance Strategy, the European Insurance and Occupational Pensions Authority (EIOPA) states that '*it is relevant to consider the impact an insurer or pension fund can have on environmental or social factors, through its investment or, for insurers, underwriting decisions […] The stewardship approach of pension funds or insurers is an essential element for acting on negative externalities. This may include undertakings' active engagement with investees to achieve sustainable investment outcomes through voting strategies or other investment strategies such as for example exclusions (negative screening), norms-based screening, ESG integration, best-in-class (positive screening), sustainability themed investments or impact investing'.* This was re-iterated by Gabriel Bernardino in his exit interview as chair of EIOPA: '*There is this dual role of pension funds that is not in the IORP Directive now that I think would be very important […] And this will go along the line of what the societal move is, and pension funds, through their stewardship role, making sure that the real economy takes steps to transition to a greener economy.'*

Recommendation 3.2: As part of the review of the IORP II Directive, the Commission should strengthen Article 19.1(b) so that the consideration of sustainability impact is a clear obligation of an IORP as part of its fiduciary duty. This is necessary to bring alignment with the Principal Adverse Impact (PAI) disclosure requirements for IORPs under Article 4 of the SFDR.

REGULATORY GUIDANCE ON STEWARDSHIP PRACTICES

As noted above, regulatory obstacles remain which impede investors from investing and engaging in stewardship for sustainability impact. Yet even within the existing regulatory framework, the permitted scope of their stewardship activities is often interpreted quite narrowly by investors, reducing their potential contributions to positive outcomes. The European Commission should produce regulatory guidance setting out a more expansive view of investors' permitted or required stewardship approach.

Stewardship originally evolved as a way for companies to manage idiosyncratic, or company-specific, risk[14]. Investors were encouraged to monitor investee companies to stay abreast of the risks and opportunities that they faced and engage with those companies where appropriate. This reflects the investment industry's traditional focus on generating alpha, which has been previously estimated to be the source of 60% of the industry's expenditures[15].

Whilst this remains the dominant focus of investor stewardship today and serves an important function, there is increasing evidence that an approach focused on generating alpha and managing idiosyncratic risk alone may not be optimised for long-term value creation for beneficiaries. This is due to its focus on maximising individual companies' value rather than the value of a given portfolio as a whole, and its related neglect of an important, if not principal, source of investment risk: system-level risk.

Many large investors are classifiable as "universal owners"[16], with well-diversified, multi-asset, global portfolios, whose holdings are sufficiently diversified across industries and asset classes that they effectively hold a slice of the overall market. Universal owners are therefore concerned with both individual asset returns (alpha) and overall economic performance (beta).

This means that, to secure beneficiaries' long-term interests, investors must not only consider the interests of individual investees but consider how those investees may be contributing to system-level risk which may undermine returns of other investees and thus the performance of the portfolio as a whole[17].

System-level risk is undiversifiable. Notably, this means that divesting assets which are significant contributors to system-level risk will generally not shield the remainder of a portfolio from the negative financial impacts associated with that risk. For example, divesting a high-emitting fossil fuel company will not reduce the exposure of an investor's real estate or insurance assets to climate risk[18]. Thus a robust stewardship approach will often be the most effective way for investors to reduce their system-level risk exposure.

Recommendation 3.3: The European Commission should produce regulatory guidance on stewardship for investors that clarifies how an approach to stewardship and investing which addresses system-level issues is required by or compatible with fiduciary duties.

[14] See, for example, Principle 3 of the 2012 UK Stewardship Code – '*When monitoring companies, institutional investors should seek to keep abreast of the company's performance; keep abreast of developments, both internal and external to the company, that drive the company's value and risks'*.
[15] State Street Center for Applied Research, The Folklore of Finance.
[16] See, for example, Quigley, Universal Ownership in the Anthropocene.
[17] Gordon, Systematic stewardship.
[18] This is not to say that divestment may not be an effective tool in an investor's escalation strategy as part of their stewardship approach.

4. INCORPORATING BENEFICIARIES' SUSTAINABILITY PREFERENCES

The goal of stewardship is to ensure that assets are managed in a manner aligned with the long-term interests of the ultimate beneficiaries. For this goal to be achieved, policymakers need to encourage greater attention to beneficiaries' broad interests in investment decision-making and ensure beneficiaries are empowered to make sustainable choices.

Beneficiaries' interests have often been interpreted in a narrow sense as solely seeking to maximise financial returns over a given time period. Yet there is increasing evidence that this alone does not satisfy the investment objectives of many beneficiaries[19]. These beneficiaries want their intermediaries to consider the impact of their investments on people and planet alongside financial performance. In some cases, beneficiaries have gone so far as to prefer lower financial returns to achieve a desired level of sustainability performance[20].

Recent amendments to MiFID II, the Insurance Distribution Directive and Solvency II[21], which will require relevant entities to understand the sustainability preferences of clients and offer products aligned with these preferences, are a welcome move to integrate wider concerns and objectives of retail investors. The EU should introduce similar requirements for other investors not covered by these regulations, such as pension funds.

Recommendation 4.1: The EU should revise the IORPs Directive to require asset owners to obtain an understanding of the sustainability preferences of their beneficiaries and align their investment practices with those preferences where possible.

Recent guidance produced by the PRI sets out steps that many asset owners globally are already taking to understand their beneficiaries' preferences on sustainability issues and how this is influencing investment decision-making[22]. European pension funds were found to be one of the most advanced groups in this respect, though it remains far from common practice in most of the region.

The benefits of achieving greater alignment between beneficiaries' preferences and investment outcomes would not be limited to beneficiary satisfaction; it can also support other public policy objectives such as increasing pensions savings rates and improving the financial literacy of the investing public[23].

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19 PRI, Understanding and aligning with beneficiaries' sustainability preferences, pg 9.
20 Bauer, Rob and Ruof, Tobias and Smeets, Paul, (2019), Get Real! Individuals Prefer More Sustainable Investments.
21 https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en
22 PRI, Understanding and aligning with beneficiaries' sustainability preferences.
23 Franklin Templeton, The power of emotions.

5. ACTING IN CONCERT

There is need for regulatory guidance on acting in concert. While ESMA has provided guidance on acting in concert in relation to the Takeover Bids Directive, in some cases national regulators have adopted different definitions of acting in concert. This has created uncertainty on the application of the ESMA guidance in these countries, deterring investors from engaging collaboratively with issuers on ESG issues. In addition, no such guidance has been provided with regards to the definition of acting in concert under the Transparency Directive and how it relates to investors' collaborative engagement.

Recommendation 5.1: PRI recommends that the EU develops regulatory guidance clarifying how investors can collaboratively engage on ESG issues without being deemed to be acting in concert. The EU should further work with national regulators to ensure acting in concert and antitrust regulations do not impede collaborative engagement by investors around common sustainability goals.

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is now a not-for-profit company with over 4,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US $100 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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