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Public Comment on Recommendations on Sustainability-related Practices, Policies, Procedures and Disclosure in Asset Management

From Morningstar Inc. and Sustainalytics, a Morningstar Company

Submitted by email to consultation-01-2021@iosco.org

14th August 2021

Dear Sirs,

Morningstar welcomes the opportunity to comment on the Recommendations on Sustainability-related Practices, Policies, Procedures and Disclosure in Asset Management. We bring several perspectives to this comment letter. First, we have a long track record of categorizing and rating mutual funds that pursue different sustainability strategies. Second, our equity analysts use environmental, social, and governance (ESG) analysis as part of their approach to assessing investments. Third, Sustainalytics, which is now part of the Morningstar family, is a leading global provider of ESG ratings, research and data to asset owners, investment managers, financial institutions, issuers/corporates, and a variety of other financial intermediaries. For the avoidance of doubt, references in our response to either Morningstar or to Sustainalytics apply equally to both entities.

Disclosure is an increasingly important topic, as the past three years have seen a steady increase in assets in sustainable funds globally, as identified by Morningstar's Q2 2021 Global Sustainable Fund Flows report. 4,929 sustainable funds are currently available, and many others now formally consider ESG factors in a non-constraining way to better manage risks and improve returns. Product launches globally remained strong, with 177 new products entering the market. The majority of the new launches (63%) took place in Europe. The U.S. saw 25 new sustainable products hit the shelves, closely followed by Japan, with 23, and Asia ex-Japan, with 13.

We will be happy to engage further, answer questions or provide additional information that may be helpful.

Yours faithfully,

Andy Pettit
Director, Policy Research (EMEA)
Morningstar

Question 1: Will the recommendations outlined below sufficiently improve sustainability related practices, policies, procedures and disclosure in the asset management industry and address the issue of greenwashing? Are there other areas of sustainability-related practices, policies, procedures and disclosure in the asset management industry not mentioned in this consultation report that should be addressed as separate recommendations?

The recommendation undoubtedly constitutes good practice, but, in and of itself, would have little direct impact in limiting greenwashing. Different countries have, or are, taking different approaches to the issues outlined, from very detailed prescriptive new rules in some cases, to clarifying how existing asset management rulebooks should be considered and applied in connection with sustainability issues.

The recommendation itself focuses predominantly on climate and, in this regard, we are supportive of the TCFD Framework being the reference. What might also be helpful for investors would be a standardised summary of a firms' TCFD report that is easier to consume and compare.

The recommendation also doesn't distinguish between entity and product disclosures, with the latter being more relevant both to investors, and to combating greenwashing, where specific metrics to quantify stated ambitions will be most valuable.

Question 2: The key areas identified are based on the key pillars of the TCFD Framework. Do you agree with this approach?

We agree with the approach and suggest that some flexibility be retained to also incorporate other standards that may emerge from the IFRS work.

Question 3: Should the scope of this recommendation cover all asset managers or be limited to only those asset managers that take sustainability-related risks and opportunities into consideration in their investment process?

Morningstar believe that the scope should apply to all asset managers, at a minimum on a 'comply-or-explain' basis. A permissible disclosure could be that a firm does not take sustainability related risks and opportunities into consideration.

Early regulatory text allowed for disclosure of ESG factors only if relevant, making it difficult for regulators to police disclosure and, more important, for investors to be fully aware of an investment product's credentials and understand more about the extent, if any, of a product's internal and external approaches to sustainable investing. The 'comply or explain' approach has been an important and positive development in ESG disclosure regulations elsewhere, although Morningstar believe that its time is now past and that a base level of mandatory disclosure is needed.

This is particularly the case with respect to issuers and some of the topics covered in the IOSCO Final Report FR04/21 on Sustainability-related Issuer Disclosures, and is explained further in our attached research paper - Corporate Sustainability Disclosures: An Improving Picture, But Regulation Would Induce a More-Complete and Comparable Baseline of Material Information for Investors.

Question 4: Should securities regulators and/or policymakers, as applicable, consider setting out different disclosure requirements for products with sustainability-related investment objectives as compared to products that promote sustainability-related characteristics? If so, for which of the different areas of disclosure listed above should the requirements vary, and how should they vary? In addition, if so, should securities regulators and/or policymakers, as applicable, consider specifying thresholds or other criteria for determining whether a product has sustainability-related investment objectives as compared to sustainability-related characteristics, and what should those thresholds or criteria be?

Investors, and advisors, need to be able to identify products that match their investment aims. In turn, products should be required to make disclosures that support their stated objectives. Whilst it has met with some criticism, and details are still being ironed out, the EU approach offers one example of a framework for achieving this. The SFDR requirement for manufacturers to define their products in one of three ways – no specific sustainability considerations; products promoting environmental or social characteristics; and products with a sustainable investment objective – dictates the nature and extent of sustainability related disclosures required for each product.

The most important factor is that products' ambitions and objectives are clearly articulated in language that retail investors can reasonably be expected to understand; and that investors are informed about how progress will be measured quantitatively and reported on, on a regular basis.

Question 5: Should naming parameters permit the product name to reference sustainability only if the investment objectives refer to sustainability?

We understand that in many markets, naming of funds following an ESG factor strategy would be subject to the general prohibition on misleading names. We believe that such principles-based regulation is sufficient and appropriate in the case of funds with "ESG," "Sustainability," or other nonfinancial terms in their names.

We also think a prescriptive percentage limit rule is generally inappropriate for ESG funds, as ESG funds tend to follow strategies rather than investing in particular asset types. Nonetheless, we think a principles-based approach toward regulation should focus on intentionality and whether ESG funds evaluate all aspects of ESG, both qualitatively and quantitatively. The funds Morningstar identifies as "Sustainable Investment" funds often incorporate terminology in their names to reflect that ESG or sustainable investing is a core tenet of their investment strategy.

We address individual topics further in the following questions.

Question 6: Should a product need to have an ESG, SRI or similar label in order to be marketed as a sustainability-related product?

In our view, this should not be a requirement. More important is that products make disclosures, with quantifiable metrics to support the sustainability attributes that they make. Various labels and indicators already exist, and will likely grow in number, each measuring different elements. Some of these are quasi-governmental and others from commercial organisations. Arbitrary use of different such labels would likely provide a level of mis-understood comfort to investors when comparing and contrasting potential investments.

Even in the instance that individual countries create a recognized scheme, the potential for confusion exists, especially in open markets where a range of foreign products are available to investors alongside domestic products. Such a scenario could see one internationally marketed product needing to comply with multiple national requirements, and/ or create a risk of a label that is eligible in one country being misused or misinterpreted by investors in another.

Question 7: Do you agree with the specified areas of investment strategies disclosure?

We agree. Disclosure about the criteria for identifying eligible investments and how that differs to an equivalent whole-of-market choice is important information for investors. However, the most valuable information for investors will come from specific metrics that a product defines to measure its success in meeting its stated investment strategy.

Question 8: Should the disclosures address how past proxy voting and shareholder engagement records align with the investment objectives or characteristics of a sustainability-related product?

Investment managers engagement with businesses in order to help them become more environmentally friendly can be an important strategy. However, more transparency is needed because it is often opaque and difficult for the end investors to form a view on the merit of engagement.

More information on the way asset managers vote and engage with companies around sustainability will help to maintain accountability, and while there has been progress in some regions, the U.S. remains the most advanced market in this area.

Question 9: Should securities regulators and/or policymakers, as applicable, also address the format and presentation of marketing materials and website disclosure for sustainability related products?

In our view, marketing and website disclosures should be treated synonymously with other regulated disclosures. They will frequently be the pre-eminent referenced point for investors, more than other regulated disclosures, due to their being more visually attractive to consume, relatively more concise and generally less intimidating appearance.

Question 10: Should securities regulators and/or policymakers, as applicable, encourage the use of specific metrics or key performance indicators to assess, measure and monitor the sustainability-related product's compliance with its investment objectives and/or characteristics? Should these metrics be subject to self-selection, or should there be a standardised approach?

The concept of a baseline set of core mandatory metrics for products to disclose, supported by contextual information, is one of the most important recommendations. International agreement on such metrics would be a major achievement. When used in practice by securities regulators we advocate for them to be supplemented by product providers with additional metrics specifically relevant to each product.

Question 11: Should periodic reporting include both quantitative and qualitative information about whether a sustainability-related product is meeting its sustainability-related investment objectives and/or characteristics?

Yes. both elements are important, to provide a full picture to investors about a products performance in meeting its sustainability-related investment objectives and/or characteristics.

Question 12: Do you agree that securities regulators and/or policymakers, as applicable, should encourage industry participants to coalesce around a set of consistent sustainability related terms?

Encouragement by securities regulators and/or policymakers has a role to play in moving toward badly needed consistent sustainability related terms.

Question 13: Are there any sets of standardized sustainability-related terms being developed by international organisations that should be considered by securities regulators and/or policymakers, as applicable?

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Question 14: Do you agree that securities regulators and/or policymakers, as applicable, should promote financial and investor education initiatives relating to sustainability, or, where applicable, enhance existing sustainability-related financial and investor education initiatives?

It is incumbent on all industry participants to improve financial and investor education. Securities regulators and policymakers can play a part by promoting initiatives and good practices that they become aware of.

Question 15: Are there any specific sustainability-related financial and investor education initiatives not mentioned in this consultation report that could be considered by securities regulators and/or policymakers, as applicable?

A further UK example is the PIMFA ESG Academy, designed to equip Financial Advisers with the information they need about ESG investment. It is established for advisers to learn at their own pace and in their own time, via access to a library of ESG content.