MANAGED FUNDS ASSOCIATION

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Directorate-General for
Financial Stability, Financial Services
and Capital Markets Union
European Commission
1049 Brussels
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Response submitted via web portal

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Dear Sirs and Madames,

AIMA and MFA Response to the consultation on institutional investors and asset managers' duties regarding sustainability

The Alternative Investment Management Association Ltd (AIMA)[1] and the Managed Funds Association (MFA)[2] welcome the opportunity to respond to the European Commission's public consultation on institutional investors and asset managers' duties regarding sustainability (the 'Consultation').

Investor interest in responsible investment and consideration of environmental, social and governance (ESG) factors with respect to their investment portfolios has been increasing over recent years. However, even among interested investors, there are differences in what they individually think the appropriate ESG factors and limitations on an investment portfolio ought to be, reflecting differing values-based

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 80 members that manage $500 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

[2] MFA, Managed Funds Association, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

economic and social priorities. Investors who are interested in the application of ESG factors for their investments have two broad options when choosing a way to access the services of an asset manager to assist them in making these investments: (i) enter into a bilateral agreement for the management of a separate account or (ii) invest in a collective investment scheme managed by the asset manager.

While many asset managers and asset management strategies have incorporated ESG factors in their investment process, it is our understanding that the most mature part of the market in this regard is made of equity and fixed income funds investing in public markets where ESG data is more readily available. As an investment strategy moves further away from the traditional long-only model, the application of ESG factors becomes more complex. For some alternative strategies, incorporating ESG factors may not be applicable to the types of investments being made. Due to these complexities, alternative strategies often pursue a thematic approach, such as renewable energy or real assets. Rather than mandating ESG factors be incorporated by asset managers, we encourage EU policymakers to consider adopting some guidance for ESG-compliant investment strategies that investors could rely on when selecting a manager. Such a voluntary approach could avoid the potential competitiveness concerns for EU managers that could arise from obligating EU managers to adopt a different standard than the ones applying to other managers in their respective jurisdictions, while permitting the EU to introduce a framework that could be emulated in other jurisdictions if it proves commercially successful.

For the reasons discussed below, we believe that the change in investment processes being sought by the Commission in this consultation would be best achieved though creating incentives for investors on the demand side of the asset management process rather than imposing requirements (especially any proscriptive requirements regarding factors which must be applied as part of an asset manager's fiduciary obligations) to asset managers on the supply side of the asset management process. When designing incentives for investors to incorporate ESG factors into their investments, policymakers should recognise it may be impracticable, or even impossible, to incorporate all ESG factors into every investment, as opposed to a framework that incentivises investors to incorporate different ESG factors into different investments over time. We believe this approach would better achieve the goal of having investors incorporate ESG into their investment decisions while efficiently allocating their capital to different companies and industries.

The asset management industry operates using an agency business model, whereby a principal (the asset owner or the client in this instance) designates an agent (i.e., the asset manager) to act on its behalf. This relationship is contractually framed and the agent's primary duty is to protect and enhance the principal's assets. In certain markets, this duty is called 'fiduciary duty'. Where the principal wants investments on its behalf to be made applying specific ESG factors (whether these are set by the principal as a matter of preference or by reason of regulatory requirements applicable to the principal), those requirements can be incorporated into the contractual arrangement and, in this way, the application of the factors will automatically become part of the fiduciary duty owed by the agent. No separate statutory fiduciary duty is necessary. Where the application of ESG factors is handled this way, each principal is able to set its own ESG factors and should not be affected by the preferences and requirements of other principals/investors contracting with the same agent/asset manager.

If the ESG factors to be applied are instead driven by regulatory requirements applicable to the agent and therefore to be applied to all contractual relationships the agent enters into, those constraints may result in a misalignment of objectives between the agent and the principal who may have different ESG factors preferences than those imposed, or may even be subject to conflicting or incompatible regulatory requirements, thereby breaking the basic duty the agent owes its principal. AIMA and MFA members believe this fundamental distinction of roles in the principal-agent relationship that dominates the asset management industry needs to be at the heart of any consideration regarding the most efficient and efficacious means of integrating ESG factors into asset management / institutional investor relationships.

In the fund context, the asset manager that sponsors a fund product will play a key role in establishing the investment strategy of the fund, based largely on its investment expertise and its view of investor demand for the manager's investment strategies. Once the investment strategy and any ESG factors to be applied are agreed as part of the investment management agreement with the fund, the asset manager will owe a fiduciary duty to the fund to apply those ESG factors as agreed and no further statutory duty is necessary to make this the case. Even though the asset manager has a strong role in establishing any ESG factors it intends to use in the fund context, we believe that it is nevertheless inappropriate to impose on the asset manager an external set of ESG factors which must in all instances be incorporated. Indeed, when an asset manager is selecting ESG factors to apply in a fund context, it is not incorporating the preferences of a single investor as would be the case in a separately managed account: it is seeking to establish a product that will be appropriate for a wider selection of potential investors, each of whom will have its own preferences and may be subject to potentially conflicting or incompatible regulatory requirements. ESG factors imposed by law in the fiduciary duty of the asset manager would negatively affect the capacity of the asset manager to design a product primarily directed to serve investors' heterogenous preferences and objectives and may limit the asset manager's ability to attract investors who do not want their investments to be subject to the same ESG factor requirements to which the asset manager is subject. If a fund cannot attract enough investors, the cost on a per share basis may become so high that the fund is not economically viable and is forced to close, resulting in a lost opportunity for those investors who were initially interested in the strategy. Moreover, such regulation might also affect the asset manager's capacity to design innovative and competitive products because they might fall afoul of inflexible ESG factors or criteria which have been developed through the legislative process and can only be changed in that way. These market responses could ultimately harm the European asset management industry and European investors, contrary to the goals of the Capital Markets Union. As such, for an impactful penetration of sustainability in funds, we would strongly recommend that the European Commission focus on the funds' investable assets and on improving the disclosure of their ESG factors by EU corporates.

As regards existing fiduciary duty, we would like to highlight that by essence fiduciary duties are high level principles, and should remain so, to enable the agent to be fully aligned with its principal's objectives and interests. Substantive ESG requirements, which by their nature would necessarily reflect political choices, should not be forcefully imposed on the principal by regulation of the asset manager/agent. Asset managers often service clients from many different locations and each will be subject to its own regulatory requirements and have its own political views about which aspects of an ESG programme are most important and what the decision factors should be. If these choices are taken away from the client because the asset manager is required to manage assets subject to specific ESG requirements, many clients may choose to take their business to asset managers who will implement an ESG programme subject to the needs and desires of the client rather than subject to the strictures imposed externally.

As was noted above, many asset managers already integrate ESG factors to address their clients' requests or appetite, notably by following the guidance suggested by the United Nations Principles for Responsible Investment (UN PRI), with which AIMA and other market participants have partnered to design a specific standard due diligence questionnaire for hedge funds taking into account ESG factors. These asset managers currently face a few hurdles and challenges which should be treated as a priority in the consideration of the promotion of the application of ESG factors:

1. A challenge some managers wanting to take up ESG factors voluntarily face is linked to fiduciary duty interpretation. We recognize that some interpretive guidance exists for managers[3] regarding whether the fiduciary duty of the asset manager would permit it to integrate ESG factors in its

[3] http://www.oecd.org/cgfi/Investment-Governance-Integration-ESG-Factors.pdf.

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investment strategy without conflicting with fiduciary principles such as best profit outcome. To the extent there remains legal uncertainty in this regard, however, further clarification and guidance that asset managers may incorporate ESG factors consistent with their fiduciary duty when the agreement between the manager and its clients permits the incorporate of such factors would be welcome.

2. There is currently insufficient data available in relation to ESG factors from issuers, which is not helpful to asset managers who use such data to consider ESG risks when conducting fundamental analysis of listed corporates or related derivatives. Strong and empirical data showing the link between ESG factors consideration and long-term performance in financial terms would help in providing incentives to investors when making their asset allocations.

3. Shareholder engagement is crucial to address material exposure to sustainability risks as engaged shareholders can contribute to shaping a corporate board's strategy to improve its sustainability performance by using available corporate governance tools, such as the right to put a resolution on an AGM agenda, the right to vote for or against a resolution, etc. Unfortunately, in some countries, the national law often protects a specific type of shareholders to the detriment of active minority shareholders. In France, for example, the Loi Florange grants a double-voting right to shareholders who have been holding registered shares for more than two years. Given the complexity of the local process to register shares, this right is effectively benefitting large French long-term shareholders to the detriment of non-French asset managers or shareholders.

We respectfully suggest that the European Commission carefully consider the above comments before it starts designing a more substantive piece of legislation in relation to ESG factors and the asset management industry.

We remain open to discuss these and any other points raised in our more detailed responses to the questionnaire, should the Commission consider it helpful.

Yours sincerely,

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