

180821 FESE Position on Sustainable Finance Initiatives

Introductory remarks

The Federation of European Securities Exchanges (FESE) represents 36 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

FESE is a keen defender of the Internal Market and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE represents public Regulated Markets. Regulated Markets provide both institutional and retail investors with transparent and neutral price-formation. Securities admitted to trading on our markets have to comply with stringent initial and ongoing disclosure requirements and accounting and auditing standards imposed by EU laws.

At the end of 2017, FESE members had 8,456 companies listed on their markets, of which 12% are foreign companies contributing towards the European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,107 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. FESE is registered in the European Union Transparency Register with number 71488206456-23.

FESE members organise markets dedicated to sustainable finance and offer products that contribute to sustainable development, facilitate management of climate risk and incorporate carbon reduction in investment strategies, as well as allow the tracking of sustainable companies' performance. Moreover, FESE members actively engage in the UN Sustainable Stock Exchanges initiative to promote sustainable capital markets, through which companies are encouraged to perform greater disclosures of relevant ESG issues.

Introduction and summary of FESE views

On 8 March 2018, the Commission published an Action Plan on 'Financing Sustainable Growth'. It includes a series of actions aimed at: reorienting capital flows to sustainable investments, managing financial risk related to climate change, environmental and social issues, and foster transparency. The Commission's intention is to implement these actions by 2019.

Based on the Action Plan, on 24 May 2018, the Commission then published a series of legislative proposals, to: create a taxonomy to identify what is environmentally sustainable; ensure that asset managers and institutional investors include ESG factors in procedures for investment decisions and advise, create new benchmarks categories for low-carbon and positive-carbon impact benchmarks, and ensure that investment firms and insurance distributors take clients' sustainability preferences into account when offering advice.

FESE welcomes and supports the commitment by the European Commission's as part of the Action Plan on Financing Sustainable Growth to find collective solutions to the urgent threat posed by climate change and considers that initiatives on sustainable finance can complement regulatory actions taken to fight climate change. A transparent and consistent approach in line with ESG-aspects by the real economy, financial industry and regulators holds great opportunities for the international capital markets, both in the area of risk assessment and for the identification of new business areas. A clearly defined taxonomy, whereby agreement on what constitutes environmentally sustainable assets is found, is a necessary starting point for other actions, such as standards and labels.

Regarding the proposed review of corporate reporting of non-financial information, FESE considers that disclosure obligations on listed issues should be well-calibrated and proportionate. We would caution against increasing non-market-related disclosure obligations on listed issuers alone as this would risk disincentivising companies from listing on public markets, which would not increase transparency.

FESE supports the Commission's intention to assess short-term market pressure and believes there are several measures that could be taken to incentivise market agents towards long-term orientation.

With respect to the proposal on low carbon and positive carbon impact benchmarks, FESE supports the Commission's intention, since, while there is currently a spectrum of low carbon benchmarks available to the market, consistently applied, clear definitions would be welcome. However, FESE considers that the proposal, in its current form, lacks clarity, which would facilitate evasion. Moreover, in the context of the Benchmarks Regulation being reviewed, FESE would like to remind policy makers of key concerns regarding the definition of regulated data benchmark that should be addressed.

The below paper outlines FESE's position on the actions proposed in the Action Plan and the legislative measures most relevant to exchanges.

Taxonomy

The intention behind the proposal to create a taxonomy is to provide clarity on the activities that can be considered sustainable and based on this determine the degree to which assets are sustainable.

FESE supports the creation of a taxonomy as this would favour both comparability and transparency. We also welcome the proposal to define sustainable activities, rather than basing the assessment on types of companies or assets, as this will enable distinguishing between various activities carried out by companies and does not favour any asset class over another. Activities should include planned activities and respective achievements linked to those planned activities.

FESE supports the intention to establish the taxonomy by involving experts at an early stage, first through the expert group, and at a later stage through a dedicated platform. In addition, basing the technical screening criteria on conclusive scientific evidence should ensure that the EU taxonomy is defined by streamlining and enhancing existing international frameworks (including the Global Reporting Initiative, the UN Global Compact and the TCFD-recommendations), as well as national frameworks and that the creation of a new parallel taxonomy is avoided. The intention to make the taxonomy proportionate to the scale of the economic activity is also very welcome.

FESE considers that a clearly defined taxonomy, whereby agreement on what constitutes environmentally sustainable assets and activities (existing, planned and achieved ones) is found, is a necessary starting point for other actions. For instance, ensuring availability of high quality, consistent and comparable data is a prerequisite for the creation of meaningful sustainability standards and labels. While the Commission's legislative proposal is at first aiming to focus on establishing a unified classification system related to climate change, there is also an important need for classification of environmentally and socially sustainable activities. We therefore consider that it is important to align the timeframe and calendar of the various taxonomy workstreams. As a result, the process of embedding the taxonomy into EU law would be smoothed. FESE welcomes the technical orientation of working groups yet also considers that the process to establish a taxonomy should not be expedited and should integrate expert dialogues at the level of the member states.

Standards and labels for green financial products

The Action Plan indicates that the technical expert group will prepare a report on an EU green bond standard and that the Commission will specify content of green bond prospectuses by 2019. The Commission will also explore the use of the EU Ecolabel framework for certain financial products, once the taxonomy is adopted.

FESE considers that defining standards, labels and classifications would be critical as it would bring about three pivotal changes:

- 1) to encourage more rigorous disclosure/reporting to meet clearly defined expectations;
- 2) to improve readability and comparability of performance;
- 3) to reward high performers and thereby incentivising change.

These high performers could be identified based on planned and executed activities, in accordance with the taxonomy.

The green bond space can be seen in this light, where market standards have in recent years developed and could now benefit from further strengthening by recommendations or some level of regulation.

Should the Prospectus Regulation be modified to impose additional requirements on green bond issuers, FESE considers that consideration should be given to ways of incentivising green bond issuance, for instance by introducing a waiver of the external review requirement or by making the prudential regulation associated with green bonds more attractive.

Company disclosures

FESE members' experience is that true development on sustainability is driven by market demand rather than by regulatory intervention as more and more businesses see benefits in adapting to more sustainable business models and communicating it in ESG reports. Policy measures which can support and facilitate such development in an appropriate way is welcome.

FESE supports high-quality, comparable, consistent, investor-relevant disclosures by listed issuers. We agree that on many occasions imposing a greater disclosure burden on public issuers is appropriate and justified. This is however not applicable when it comes to requiring issuers to disclose material ESG risks: reporting of these topics should be equally integrated into audited annual reports for both listed and non-listed companies.

FESE would also like to remind that ESG disclosure requirements for businesses should always be rooted in material analysis depending on the company, not one-size-fits-all regulation. This is because the relevance of different aspects of ESG and sustainability depends on the type of business, size, stage of growth, internationalization, etc. Disclosure requirements should therefore accommodate for room for non-enforcement in cases where the materiality and relevance for the company is questionable or peripheral.

FESE does not support disproportionate disclosure obligations on listed issuers and we would caution against introducing non-market-related disclosure obligations on listed issuers alone. We believe that the relative attractiveness of public markets should be preserved and that it should not be possible to avoid complying with further disclosure requirements by remaining private as this would disincentivize listing and result in decreased overall corporate transparency. Should additional disclosure requirements become legally binding, it is important that these disclosures also apply to private firms with comparable economic, social, and environmental footprints. Moreover, if a legally binding approach is selected, this should be implemented on a phased-in basis to allow sufficient time for market participants to adapt.

Another crucial point is that the scope and targets of policy measures related to sustainability need to remain detached from the type of financing a company has opted for. Same rules should apply to companies which have opted for debt financing as have opted for equity financing.

We would caution against simply adding to existing disclosure requirements and would rather suggest reviewing reporting requirements more broadly to streamline the information listed issuers are required to report. Therefore, FESE welcomes the Commission's intention, as indicated in the Action Plan, to "assess whether public reporting for listed and non-listed companies are fit for purpose" and the related [Commission's fitness check](#) on public reporting that aims to assess whether the EU public reporting framework is fit for purpose while promoting sustainability and digitalisation.

FESE welcomes that the Action Plan indicates that the Commission will revise the guidelines on non-financial information by Q2 2019 based on metrics developed by the technical expert group and in line with the FSB Task Force on Climate-related Financial Disclosures (TCFD). The Action Plan also outlines that a European Corporate Reporting Lab will be established to develop best practices in corporate reporting. FESE supports the recommendations by the FSB TCFD as we consider these will contribute positively to achieving greater certainty about the type of climate related information that preparers of financial information should disclose. Therefore, we welcome the Commission's intention to build on the TCFDs and to facilitate implementation by companies and investors. FESE considers additional disclosure obligations should be proportionate to the scale of the economic activity of issuers. The reporting of material ESG risks and opportunities should be further developed, based on the Non-Financial Reporting Directive. However, the scope should be extended to non-listed companies.

Fostering long-termism in financial and economic activity

The Action Plan indicates that the Commission will analyse further if undue short-term market pressure hinders sustainable development by favouring short-term over long-term action. FESE believes several measures could be taken to incentivise market agents towards longer-term orientation, including:

- Ensuring that accounting standards do not overly incentivise short-term behaviour and accommodate longer-term perspectives, which are important in respect of sustainable financing.
- Reassessing the range of factors needed to incentivise market participants in assessing longer-term risks.

FESE considers that the emergence of specialised credit rating agencies should be made possible. In parallel, all credit rating agencies should be required to share their current practices on TCFD-related information in their credit ratings.

Financial regulation can facilitate sustainable investments by introducing further transparency, standards and requirements on products; ultimately investment decisions will however be based upon an assessment of profitability, which is determined based on market developments and regulation of the economic activity. Therefore, to increase investments made in sustainable products, unsustainable activities have to become more expensive to carry out. This is not to say that other initiatives cannot facilitate sustainable investments. However, as markets respond to incentives, the first objective of the Commission's Action Plan "to reorient capital flows towards sustainable investments" could be achieved by appropriately tackling unsustainable economic activity. Ultimately, a shift in all economic agents' mind-set is likely the most crucial component of a successful transition to a low-carbon and resource-efficient economy that is geared towards inclusive growth and awareness of long-term risks.

Benchmarks

FESE members are index providers that in many cases provide green, sustainable and social benchmarks. FESE welcomes the opportunity to present its views on the Commission's proposal to amend the Benchmarks Regulation and define 'low carbon' and 'positive carbon impact' benchmarks.

Concerns regarding the definition of regulated data benchmarks

Firstly, FESE would like to reiterate key concerns in relation to the original Benchmarks Regulation (Regulation (EU) 2016/1011). While FESE fully supports the objectives of the Benchmarks Regulation to ensure the accuracy, robustness and integrity of benchmarks and of the benchmark determination process, we have serious concerns regarding how the definition of regulated data benchmark has been interpreted since the conclusion of Level 1. We would therefore call for a clarification to be provided in the context of the current Level 1 proposal.

Under the current definition (Article 3.1 (24)), benchmarks based on regulated data sourced from the original source as outlined in the regulation, but from a technical service provider, would not be considered a regulated data benchmark. However, benchmark administrators, like many other Capital Market participants, rarely connect to all regulated data sources directly but usually obtain such data via data vendors. Data vendors act as the technical link between multiple trading venues and the benchmark administrator, without changing the original data content (e.g. price and volume data). This way of sourcing data reflects standard market practice for administrators to connect to numerous markets, enabling them to provide a broad variety of standardized products to the benefit of EU investors. However, some regulators have argued that this practice should be considered outsourcing. FESE does not share this view, but considers that benchmark administrators obtaining regulated data via data vendors should continue to fall within the scope of 'regulated data benchmark', as long as the transaction data content itself (e.g. price and volume data) remains unaltered.

Moreover, it is important to consider that the Benchmarks Regulation framework for regulated data benchmark was set considering that input data from trading venues is transaction based, supervised and already subject to stringent regulatory requirements under, among other pieces of regulation, MiFID II/MiFIR and MAR/MAD, which ensure the undisputed quality of regulated data. Receiving the data via a data vendor as outlined above does not in any way affect the data quality.

FESE has, since the conclusion of Level 1, repeatedly stated the need to clarify the provisions regarding the definition of regulated data benchmark to ensure that regulated data benchmarks will be able to benefit from the category the co-legislator designed for them. We were therefore surprised when the Commission presented its proposal, amending the Benchmarks Regulation, to create two new categories of benchmarks, without taking the opportunity to also address the issue regarding the definition of regulated data benchmark.

However, based on statements made during the scrutiny session of the European Parliament's ECON Committee on 11 July, FESE understands that there is support in the European Parliament to address this issue through a Level 1 amendment to the Benchmarks Regulation. FESE strongly welcomes the willingness of policy makers to address this and encourages the Commission to engage in dialogue with the European Parliament to find a timely solution.

The proposal on low carbon and positive carbon impact benchmarks

The Commission indicates that its proposals stems from a lack of "appropriate and objective low-carbon indices that could be used as a reference index" and that there is a risk of greenwashing as the levels of disclosures of methodologies are different. FESE supports the intention of the Commission's proposal, since, while there is currently a spectrum of low carbon benchmarks available to the market, consistently applied, clear definitions would be welcome.

However, FESE considers that the proposal to define low carbon benchmarks, where shares would be “selected so that the resulting benchmarks portfolio has less carbon emissions when compared to the assets that comprise a standard capital-weighted benchmark”, lacks clarity, which would facilitate evasion. Taken in isolation, this provision would mean that any standard benchmark could qualify for the definition simply by omitting shares from one company with carbon emissions. However, the Commission also proposes a second set of conditions setting minimum standards to be defined through the use of Delegated Acts. FESE considers that it is the investor that should set up exclusion criteria. However, should the criteria nonetheless be defined in legislation, exclusion criteria should be decided at a political level since this would not be a technical assessment. Moreover, this process should be open to input from a broad range of stakeholders and regulators.

Furthermore, as regards the definition of ‘positive carbon impact benchmarks’ which shall be “selected on the basis that their carbon emissions savings exceed the carbon’s footprint”, FESE deems it necessary that both companies’ planned activities and achievements on planned activities are taken into consideration when selecting the benchmark constituents. This information should be provided as auditable figures.

Regarding the methodology requirements, FESE considers that disclosures need to be well-suited to the individual benchmark. Therefore, it should be pointed out that some of the provisions proposed by the Commission are very far-reaching and do not consider that certain aspects of an index provider’s methodology can, and should be, published; whereas others are proprietary information. For instance, disclosing the positive carbon impact of each underlying asset instead of aggregated figures as suggested in Recital 17 may breach administrators’ contracts with external data providers. Therefore, FESE considers that disclosure requirements for the methodology should be further streamlined to achieve the objectives the Commission is targeting, while respecting the confidential nature of some aspects of the methodology.

Regarding the criteria and method for the weighing of the underlying assets of a benchmark, FESE stresses that it is important to take into account the fact that in the weighing of underlying assets basic weighing factors as diversification and risk limits can be mutually exclusive with ESG considerations.

Furthermore, it should be noted that, any data index administrators obtain, is usually only licensed for the provision and calculation of their indices. Therefore, such data may not be shared with others without the initial explicit consent of the data provider. However, should a benchmark administrator obtain such consent, this would alter its business model turning it into the role of a market data vendor. In order to avoid significant unintended consequences, FESE considers that requirements to this effect requires further consultation.