THE INVESTMENT ASSOCIATION

IA Response to FCA Discussion Paper 23/1 'Finance for Positive Sustainable Change: governance, incentives and competence in regulated firms'

About the Investment Association

The IA champions UK investment management, supporting British savers, investors and businesses. Our 250 members manage £10 trillion of assets and the investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity;
- Help people achieve their financial aspirations;
- Enable people to maintain a decent standard of living as they grow older;
- Contribute to economic growth through the efficient allocation of capital.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

Executive summary

The IA welcomes the opportunity to respond to the FCA's Discussion Paper (DP) 23/1 'Finance for Positive Sustainable Change: governance, incentives and competence in regulated firms'.

The investment management industry plays an important role in creating a more sustainable economy focused on long-term returns. Our industry serves millions of individuals, helping them to achieve their goals by generating an income from their investments and in many cases, by investing with a specific purpose. Commitment to strong governance and a healthy culture, both within firms and in firms' approaches to developing and marketing investment products, is integral to achieving this fundamental objective. The ultimate aim of our industry is always to work in the best interests of clients and consumers and to deliver long-term value. As such, we welcome the FCA's encouragement of discourse on these important topics and efforts to highlight good and evolving practices across governance, incentives and competence in regulated firms.

As the FCA observes, an increasing number of regulated firms are publicly committing to sustainable objectives, with climate-related commitments the most prevalent. Climate change is one of the greatest systemic risks we face and in 2020, with the full support of our members, the IA outlined a public position and industry commitment to climate action. The IA calculates that investment managers with more than £7.8trn of assets under management in the UK are signatories to the Net Zero Asset Managers initiative. Central to this initiative is a commitment to work in partnership with asset owner clients on decarbonisation goals. This includes setting an interim target for the proportion of investments to be managed in line with the attainment of net zero emissions by 2050 or sooner, and a process to review interim targets at least every five years, with a view to increasing the proportion of assets which are managed in line with a net zero ambition.

The investment management industry is naturally inclined towards providing the long-term patient capital that is necessary for transition. Our focus is on understanding the risks and opportunities that face investments across the range of asset classes in which we invest on behalf of asset owner clients. We are clear that a truly economy-wide transition to net zero will require a transition within most, if not all, companies in which we currently invest. Accordingly, it is critical that the government has policy measures in place to achieve the UK's legally binding net zero target, including measures to achieve an orderly transition in the assets in which our members invest. For investment managers and asset owners who have made net zero commitments, there has always been a clear statement that their ability to decarbonise investment portfolios, while maintaining their fiduciary duty to clients, is contingent on appropriate action from government across the whole economy.

We recognise the FCA's intention for this DP to act as an early-stage conversation about how the regulated finance sector is equipping itself for the broader sustainability challenges ahead. We fully agree with the need for proportionate and balanced accountability around the delivery of investment managers' objectives and commitments, including those related to sustainable investment.

However, we do not think that further regulation on governance, incentives, and competence within member firms is the way to achieve how firms are equipping themselves for the broader sustainability challenges for several reasons.

Pre-existing and forthcoming regulation and guidance
Firstly, current and planned forthcoming regulation already sets out robust standards and expectations and provides the FCA with the necessary tools to take action against firms and/or individuals deemed not to be meeting those standards. Given that current and planned regulation is sufficient, any further regulation is not only unnecessary but could create significant confusion amongst regulated firms.

Under the FCA's rules on TCFD, investment managers are required to make entity-level disclosures across the key pillars of governance, strategy, risk management, and metrics and targets. Ultimately, in order for members to report on TCFD in a meaningful way, sustainability considerations across these three areas will have to be embedded across a firm's operations. Thus, the FCA's TCFD rules act not just as a reporting exercise, but a tool for companies to consider how they are governing risks and opportunities.

Sufficient pre-existing regulation is particularly clear in relation to product governance. Not only does the FCA Handbook already require that communication regarding financial products is clear, fair and not misleading, this will be reiterated in the FCA's 'anti-greenwashing rule' as proposed in its 2022 consultation on Sustainability Disclosure Requirements and Investment Labels. The Consumer Duty - which the FCA has recognised in its recent Dear CEO Letter of January 2023 is a significant shift in expectations of firms - already introduces a more outcomes-focused approach to consumer protection and sets higher expectations for the standard of care that firms give customers. As with TCFD reporting, the FCA should give sufficient time for the Consumer Duty to be implemented and bed in before contemplating setting additional regulatory expectations or guidance on product governance.

Given the FCA is a member of the Steering Group and Delivery Group of the Transition Plan Taskforce (TPT), it will be aware of the recommendations in its draft Disclosure Framework. The Disclosure Framework advises that companies describe how they are building a culture aligned with the strategic ambition in their transition plan, how they are aligning remuneration and incentive structures with the stated objectives and priorities in transition plans, and how they are ensuring they have the appropriate skills, competencies, and knowledge. This guidance will apply equally to companies which are FCA regulated entities and the TPT is currently undertaking the preparation of Asset Management Sector Reporting Guidance. As the FCA develops and reviews TCFD-aligned disclosure rules and draws on the TPT's outputs to review its expectations on transition plans for FCA regulated firms, it should ensure that there is a coherence between the best practice developed collaboratively by the TPT and any regulatory expectations which might subsequently be expressed. The TPT's approach of developing sector guidance which signposts existing industry-led resources should also be recognised, and we would encourage the FCA to allow for an environment in which industry can develop differing approaches to culture, incentives and knowledge while explaining the choices that have been made.

In addition, while the scope of DP23/1 is wider, it is worth noting that many of our members have already implemented the EU's UCITS and AIFMD delegated acts clarifying how investment managers should integrate sustainability risks and, where relevant, other sustainability factors in the areas of organisational requirements, operating conditions, risk management and product governance. The EU co-legislators have adopted a high-level principles-based approach, amending existing provisions within sectoral delegated acts (e.g. UCITS, AIFMD and MiFID II), most of which, if not all, already exist within the FCA Handbook. This approach clarifies that firms should take into account material sustainability risks and opportunities when complying with existing rules as opposed to proposing new ones.

Further regulation, such as additional Prescribed Responsibilities under SM&CR, could risk turning this area into a tick-box exercise, diverting the attention of those who are meant to be collectively driving forward sustainable change – through stewardship activities, designing sustainable investment products etc. – towards ensuring regulatory compliance with an ever-increasing body of rules. Furthermore, given changes that may derive from the Financial Services and Markets Bill and the recent reduction of the FCA's backlog of SMF applications, we would not favour any changes at present.

As various aspects of the FCA's Environmental, Social and Governance (ESG) Strategy are being considered at different times, a holistic view across these various initiatives is crucial. This will ensure that proposed interventions are coherent and consistent and firms are not implementing requirements on a piecemeal basis, or indeed, implementing requirements only to find that the regulations have been further amended. This includes allowing sufficient time for regulation across the value chain, starting with corporate reporting (for example, against TCFD), to bed in and mature before introducing further regulation.

A rapidly evolving area

Given that sustainable investment is an area that is developing rapidly, it is important that we ensure firms are operating in an environment where there is flexibility and room for evolution and innovation. Given different firm business models and strategies, adopting additional and/or more prescriptive rules – and particularly a one-size-fits-all approach – would stifle innovation, damaging not only the UK's ability to achieve its net zero target, but also its international competitiveness. This in turn would impact the FCA's ability to meet its own operational objective to promote effective competition in consumers' interests.

The importance of promoting international competitiveness, enabling a cross-border industry, and supporting innovation and evolution within investment management are all key pillars of our response to the FCA's Discussion Paper on Updating and improving the UK regime for asset management (DP23/2).

Investment managers as global firms

As it currently stands, the FCA's Discussion Paper does not give concession to the fact that many member firms operate across jurisdictions. This is problematic for several reasons. Firstly, investment managers are already complying with regulation from many other jurisdictions. The UK-based investment management industry is global in nature and has always been a strong proponent of international coordination and the harmonisation of sustainable finance rules. Fragmented approaches across different jurisdictions – including for example, gold-plating at a national level – run the risk of not treating clients consistently and fairly. Secondly, the decision to implement much of what the DP is suggesting simply does not sit at a UK entity level. Instead, the UK entity approach will most likely be derived from group-level strategy so as to ensure that firms do not operate different and competing regional strategies. Finally, consideration of the international nature of member firms is particularly pertinent when it comes to attitudes towards achieving net zero. For member firms who operate in certain countries, there are sensitivities at a firm-wide level around allying to net zero commitments, having a sustainability business objective and linking remuneration to sustainability related considerations. In some jurisdictions, this would be simply inconsistent with local regulatory expectations and requirements.

Investment management as an agency business

It is also important to note that investment management is fundamentally an agency business. As investment managers, the money members invest belongs to their clients and member firms will only apply sustainability related considerations – beyond those to mitigate risk affecting financial returns – to investments if requested by clients. This is consistent with one of the commitments that members sign up to as part of being a signatory to the Net Zero Asset Managers initiative: to work in partnership with asset owner clients on decarbonisation goals. As such, we urge the FCA to ensure that any proposed intervention, if deemed necessary, takes into account potential challenges and limitations particularly when acting as agents of clients with different, or potentially no, sustainability preferences. A regulatory approach which does not take account of these different preferences could place significant limitations on consumer choice.

Consistent treatment of sustainability with other risk factors

Separately, we urge the FCA not to consider sustainability risks exceptionally compared to other risk factors that are assessed by members as part of the investment process. Investors consider a broad range of risks and opportunities when investing, including management and financial strength, competitive position, potential for technological disruption, as well as sustainability issues. Sustainability risk should not be seen as a stand-alone risk which needs gold-plated rules on governance. Nor should sustainability commitments be subject to a higher bar with regards to governance, incentives and competence.

Diversity of regulated firms
We would urge the FCA to take a sector-by-sector approach rather than adopting a single approach for all regulated firms. The scope of the DP is the entire financial industry and while a focus on other regulated entities is welcomed, we note that different regulated firms have very different client bases and operate in very different ways, towards different ends. Investment managers have a well-developed and comprehensive approach across many of the areas mentioned in the DP – regulation that targets all financial services firms risks not taking this into account.

Under this regulated firm umbrella, it is also important to remember that firms come in many different forms – small, large, retail, institutional etc. Proportionality and recognition of different structures and business models is essential in ensuring that all firms are able to drive forward the sustainability agenda. We would therefore caution against a one-size-fits-all approach to the areas covered in the DP. Where deemed of use, the IA would be happy to consider producing industry best-practice guidance in conjunction with members on various aspects and as appropriate for the investment management industry.

Suitability requirements
As expressed in our response to FCA CP22/20 on SDR and investment labels, we would encourage the FCA to make clear to the market as soon as possible its plans regarding how to integrate sustainability requirements into the suitability process for the distribution community. Given various sustainability-related initiatives are already in train, we believe it is important for the FCA to ensure that effective dates of complementary rules are aligned in order to avoid the same sequencing issues encountered by financial market participants in implementing the various initiatives associated with EU's sustainable finance agenda.

Below we outline a high-level summary of the key IA views expressed in the IA response to the DP:

1. While we welcome an open dialogue with the FCA on the areas addressed in the DP, we do not think that further regulation on governance (firm or product), incentives and competence on sustainability-related matters within member firms is appropriate at this time.
2. Many of the areas in the DP are captured by existing and forthcoming regulation – for example TCFD, existing regulation on product governance (question 7), Consumer Duty and the upcoming rules on SDR. Investment management is a global industry - the FCA must recognise the importance of globally-consistent and comparable standards for client outcomes. We urge the FCA to also be conscious of the differences in international attitudes towards to achieving commitments in this space, in particular, net zero. Furthermore – and separately - the decision to implement much of what is discussed in the DP simply would not sit at UK entity level.
3. A one-size-fits-all approach will not work - given that the sustainability space is developing rapidly, it is important to keep flexibility and room for innovation and evolution. Regulating too early in the areas outlined in the DP could stifle innovation and impede UK industry's international competitiveness.
4. The FCA seems to be treating sustainability exceptionally compared to other risk factors that are assessed by firms as part of the investment process. In reality, sustainability related factors and sustainability is very integrated into firms' processes and is treated as a risk like any other significant risks.
5. We agree that where firms make public sustainability related commitments, they should be expected to develop and evidence a business strategy which delivers on those commitments. However, firms do not necessarily need to have a sustainability objective to drive positive change. (question 1).

6. Regarding a firm's culture and behaviours supporting positive sustainable change (question 2) - as the area of sustainability continues to evolve and organisations work to embed these values into their culture, the guidance provided by the IA's Culture Framework will continue to support them on this journey. As the IA already provides well-adapted guidance on culture, we do not believe additional regulation is necessary. Additionally, culture is unique to each organisation and therefore a regulatory one-size-fits all approach is not advisable.
7. We do not think that new regulatory expectations on skills and knowledge on boards are necessary (question 4). There is not (and there should not be) a rigid formula towards ensuring that boards have the right skills and knowledge relating to material climate- and sustainability-related risks, opportunities and impacts. Approaches between firms vary based on such factors as business model, size and investment approach. Instead, market-led industry guidance and sharing of ideas can help to develop best practice in a more organic and nuanced way.
8. There is no one right approach to embedding climate and sustainability related considerations across a firm's operations. The diversity of approaches, outlined in question 4, coupled with measures already in place, such as TCFD disclosures, makes it clear that new regulatory expectations would not be appropriate or necessary. Allowing firms flexibility in their approach to integrating sustainability factors into their operations - based on size, business model, and other factors – will be key.
9. Regarding management information (MI) used by senior management to monitor and oversee climate and sustainability-related developments (question 5), in the vein of fully supporting transparency and holding firms to account for binding commitments and standards, we would advise against introducing regulation into an evolving space. The FCA should not look to treat sustainability-related MI differently to any other MI.
10. We do not consider it necessary to implement regulatory expectations or guidance on senior management responsibilities for a firm's sustainability related strategy (question 6).
11. The IA has for many years set out expectations on how remuneration should be structured for the executives of UK Listed companies and as significant investors of these companies, we consider a similar approach, outlined in answer to question 8, should also be taken for regulated firms. We believe the current regulatory expectations on remuneration are sufficient and that the FCA already has a robust and comprehensive set of rules and guidance on remuneration.
12. The Stewardship Code has played an important role in improving disclosure on the resourcing and governance of stewardship as well as the management of conflicts of interest (question 10). While stewardship, through engagement with investee companies, can help with the management of market-wide and systemic risks, this can be supplemented with policy engagement in order to change the ecosystems within which companies operate, discharge our duty to act in the best interests of clients, maintain market integrity, and effectively manage risk to long-term value stemming from material market failures (question 11).
13. The investment management industry recognises that sustainability-related knowledge gaps across the financial sector can harm consumers and undermine credibility in the financial services sector. Therefore, training and upskilling employees in this space is a key priority for the industry – with a variety of approaches by members to address this (outlined in detail in questions 12 and 13). Consideration of regulation in this area must be mindful of the risk of absorbing resource to meet duplicative reporting requirements, inadvertently encouraging volume of activity over quality, or incentivising short-term decision-making when meaningful action in relation to sustainability requires a long-term focus.

CHAPTER 3 – ESG GOVERNANCE, REMUNERATION AND INCENTIVES IN REGULATED FIRMS

Q1: Should all financial services firms be expected to embed sustainability related considerations in their business objectives and strategies? If so, what should be the scope of such expectations? Please explain your views.

We support the FCA's use of terminology around 'embedding' material sustainability considerations. We also agree that where investment managers make public sustainability commitments, these firms should be expected to develop and evidence a business strategy which delivers on those commitments. However, we stress that sustainability should not be seen as a standalone objective or strategy and should instead act as an additional lens through which existing objectives and strategies are viewed. Nor should sustainability risk be viewed as a standalone risk but rather as a factor of existing types of risks that should be considered and embedded in existing processes, structures and internal systems and controls. For this reason, and others mentioned below, it would not be appropriate for regulation to be introduced in this area.

As the FCA is aware, the purpose of the investment management industry is to meet clients' investment objectives while delivering long-term financial returns. These clients are individual retail savers as well as institutional investors such as pension funds, insurers, charities and governments. Investment objectives are typically financial and require the consideration of financially material risks in the investment process.

In fulfilling their role as agents, our members have a fiduciary duty to take into account a wide range of factors which could impact their fundamental goal of achieving long-term value for clients. This includes risks related to sustainability and climate change. As such, financial market participants will naturally embed material sustainability-related considerations into their business objectives and strategies, subject to proportionality considerations and relevant limitations, for example, when investment managers are acting solely as agents for clients governed by bespoke mandates. In a recent survey[1] of IA members, 80% of those who responded stated that their firm had set sustainability-related objectives/purpose as a firm and is building that into their business models and strategies.

The business perspective is also key. There are many ways in which investment managers can drive forward the sustainability agenda – firms do not necessarily need to have a sustainability objective in order to do so. Many investment managers within the IA's membership are listed businesses that are seeking to deliver long-term returns to their owners/shareholders. It is increasingly accepted that to deliver these long-term returns, businesses must embed material sustainability risks and opportunities into their strategy and business model.

Given that many investment managers are international businesses, they will be listed or owned in other jurisdictions - the sustainability approaches of these owners might differ depending on the cultural expectations of that jurisdiction. The FCA should ensure that it is not requiring a single approach. It is ultimately the responsibility of the board of directors and management to determine the most appropriate approach to sustainability-related risk and opportunity within their business model and strategy. Boards are accountable to their shareholders and shareholders have certain rights and obligations to hold boards to account, particularly where there is a risk to long-term value.

[1] In April 2023, the IA issued a survey to members in order gain further statistics and colour for the IA's response to DP 23/1. The survey asked questions of members across four areas: governance; remuneration; stewardship; and training and culture. In total, 21 member firms responded to the IA's survey.

It is also critical to recognise the challenges faced by members operating across jurisdictions and political landscapes. As of 31 December 2021, 60% of total UK AUM is managed by firms with a parent company headquartered outside of the UK, according to the IA's Investment Management Survey. For investment managers operating in countries with a more contested approach to net zero commitments, there are sensitivities around making company-specific net zero and other sustainability-related commitments. A requirement or even expectation that they should do so would be damaging. This is not only to firms operating globally but also to the wider economy given the potential impact on the competitiveness of the UK investment management industry if it takes a different approach to other countries where no explicit requirement or expectation exists.

However, we should note the comments of a small number of member firms who believe that there is a role for the FCA to enhance existing regulation in order to promote effective governance on sustainability. These members have requested the enhancement of regulation such that the FCA requires a stronger demonstration of the link between business model, strategy, KPI, risk, remuneration and governance structures. This, however, would only work if the FCA takes a principles-based approach to regulation. If the FCA does see the need for further intervention in order to embed sustainability considerations into business objectives and strategies, we would suggest an approach similar to that of the EU which has implemented a proportionate principles-based approach by way of amendments to existing provisions within sectoral delegated acts (e.g. UCITS, AIFMD and MiFID II). However, it should be acknowledged that much of this approach already exists within the FCA Handbook. Alternatively, soft regulatory levers like best practice guidance could possibly be considered.

Q2: Beyond the FCA's ongoing work on diversity and inclusion, and introduction of the Consumer Duty, should we consider setting regulatory expectations or guidance on how firms' culture and behaviours can support positive sustainable change? Please explain your views.

The IA welcomes the FCA's work on culture as part of the Consumer Duty, as well as the expectations from the Financial Reporting Council (FRC) as part of the UK Corporate Governance Code for a company board to establish its purpose, values and strategy, and satisfy itself that these and its culture are aligned.

We also strongly support the FCA's continued commitment to meaningful improvement on diversity and inclusion in the financial services sector, including the 2021 joint Discussion Paper from the regulators: DP21/2 'Diversity and inclusion in the financial sector – working together to drive change'. Culture, diversity, and inclusion have long been a priority for both the IA and our member firms.

At this stage, we consider that this pre-existing and ongoing work from the regulators, as well as industry initiatives, is sufficient to effectively ensure that firms' culture and behaviours can support sustainable objectives, and as such, we do not believe that further regulatory expectations or guidance on integrating a culture of sustainability are needed.

In our response to DP21/2 'Diversity and inclusion in the financial sector – working together to drive change', we stated that organisations that fully embrace diversity will be better equipped to foresee and act on risks and opportunities, make better long-term decisions, nurture talent, and command the trust of the consumers they serve. Businesses with healthy cultures create an environment where people want to work, feel challenged, are able to use their talents, and are valued.

In particular, diversity within leadership positions is essential to building a company that can continue to adapt and deliver value for savers. To this end, our members feel that significant progress has been made through industry and investors setting expectations and holding boards of investee companies to account on greater diversity at the board level. For example, the IA has long supported the FTSE Women Leader's Review (and its predecessor reviews, the Hampton Alexander and Davies Reviews) and their targets for 40% female representation on the boards and executive committees and their direct reports by 2025. Similarly on ethnic diversity, investors have been pleased with the progress made to date by FTSE 350 companies to align with the Parker Review recommendations to improve ethnic diversity at the board level. For several years, the IA has also set out investor expectations on diversity as part of its annual Shareholder Priorities and corresponding Institutional Voting Information Service (IVIS) approach. For 2023, we welcome the changes made to the FCA's Listing Rules to incorporate additional diversity reporting and diversity targets, on a comply-or-explain basis, and alignment with the FTSE Women Leaders Review.

While investors are generally pleased with the progress that has been made to tackle the lack of diversity at the board level, there is also an increased interest in understanding how diversity is reflected across the wider workforce and in the round. To help achieve this aim, theF IA and its members have made a commitment to several key initiatives, namely: Change the Race Ratio, Race at Work Charter and Women in Finance Charter. Commitments to these initiatives demonstrate the industry's continued efforts to make sustainable change. Additionally, the recent Ethnicity Pay reporting guidance will aid members on their journey of data collection and reporting.

The introduction of these initiatives has already begun to demonstrate progress. For example, the Women in Finance Charter Five-Year Review has revealed, since 2016, the average percentage of women on executive committees in the UK financial sector has climbed from 14% to 22%, and on boards, from 23% to 32%. Progress has also been demonstrated in the FTSE Women Leaders. As of 2023, the FTSE 350 has achieved 40% women on boards. There is clear evidence that these initiatives have made a vital contribution to driving long-lasting, sustainable change and will continue to do so.

Our members recognise that D&I is crucial for the industry's success and sustainability and, accordingly, that building greater D&I is a business imperative. Importantly, we also recognise that there is more that the industry can do to promote diversity and inclusion. With that in mind, we look forward to engaging with the FCA and PRA on their upcoming consultation paper on this topic in H1 2023.

The IA has also undertaken its own initiatives on D&I and culture in order to support members in this area:

Culture

Our members appreciate the importance of diversity and inclusion in helping to achieve a healthy firm-wide culture and its impact on achieving greater business outcomes. Defining, monitoring and measuring culture are vital steps that organisations should put in place to achieve a healthy culture. It is for this reason that the Investment Association created its Culture Framework in 2019. This Framework was most recently updated in November 2022.

The IA's Culture Framework is a practical resource created to aid members in understanding culture, how it develops and how it can be measured and monitored in a meaningful way. Recognising that there is no one-size-fits-all approach and that culture is a reflection of the individual organisation, the framework sets out clear guidance for investment managers to aid them in their culture journey. The framework is not prescriptive and encourages organisations to consider the values and purpose that it is trying to foster.

As the area of sustainability continues to evolve and organisations work to embed these values into their culture, the guidance provided by the Framework will continue to support them on this journey. Additionally, given the FCA's on-going work on Consumer Duty and the forthcoming consultation paper, we do not believe additional regulation is necessary. Culture is unique to each organisation and therefore a regulatory one-size-fits all approach is not advisable.

Inclusive Talent

The IA also continues to support members in cultivating an inclusive culture, as well as attracting, developing, retaining, and promoting a high-quality diverse workforce - as driven through the IA's Culture, Talent and Inclusion Strategy. It is through this strategy that we support firms in upskilling and recruiting talent to address the future needs of the industry, including sustainability.

Investment20/20, the investment management industry's talent solution, has been instrumental in changing the recruitment infrastructure to drive greater D&I and address the skills gap. Investment20/20 provides routes into investment management for young people from all backgrounds and gives members direct access to diversified talent. Over 2,500 people have started their career in investment management through the Investment20/20 trainee programme.

Diversity Data

The IA agrees with the FCA's view that effective data collection is necessary to ensure meaningful and lasting change. As such, in April, the IA, in collaboration with the Thinking Ahead Institute, launched its first annual Equity, Diversity and Inclusion (EDI) Survey. The regulator has been clear on their expectation for more robust data collection, and as mentioned above, we welcome the upcoming consultation on diversity and inclusion in the financial sector. The results from the survey will help investment managers gain a better understanding of how they can drive forward meaningful change, with firms able to benchmark their journey against the wider industry.

We will be publishing the results later this year. Our report will analyse EDI at UK investment management firms across different levels of seniority and business functions. The survey will also take a closer look at the initiatives and interventions being implemented and whether data is being used to inform these programmes. This will also help to create a central resource of good practice, so that firms can understand how to recruit and support a more diverse pool of talent.

We would welcome clarification from the FCA as to the interaction between this DP and the above-mentioned upcoming consultation on diversity and inclusion. Furthermore, as stated in our response to DP21/2, it will be important for the FCA to be cognisant of the need to develop a proportionate approach with regards to how firms seek to implement initiatives and the outcomes they are expecting to see as a result. The IA's membership is diverse and, when sharing its own good practice and guidance, we seek to ensure our support is non-prescriptive and considers how firms can apply their own optimal approach which is proportionate to their size and model. The introduction of the annual EDI survey will support firms in their data collection process to ensure that interventions and initiatives are effective and sustainable.

Finally, as outlined in our answer to question 1, the Consumer Duty – which the FCA has recognised in its recent Dear CEO Letter of February 2023 is a significant shift in expectations of firms – already introduces a more outcomes-focused approach to consumer protection and sets higher expectations for the standard of care that firms give customers. The FCA should be careful to give sufficient time for the Consumer Duty to bed in before contemplating setting additional guidance on how firms' culture and behaviours can support positive sustainable change.

Q3: What steps can firms take to ensure that they have the right skills and knowledge relating to material climate and sustainability-related risks, opportunities and impacts on their boards? Should we consider setting any regulatory expectations or guidance in this area? If so, what should be the scope of such expectations?

SYSC 4.3A.3 requires that members of the management body of a firm possess sufficient knowledge, skills and experience to perform their duties as well as adequate collective knowledge, skills and experience to understand the firm's activities, including the main risks. Furthermore, firms are also required to have procedures for monitoring the collective adequacy of the knowledge, skills and experience of its management body as well as of its individual members.

Additionally, regulated firms, to the extent that they are also listed entities, are encouraged to follow the Principles and Provisions of the Financial Reporting Council's (FRC) UK Corporate Governance Code, on a 'comply or explain' basis. This recognises that one size does not fit all and provides companies with enough flexibility to choose bespoke governance arrangements that are most suited to their business circumstances. The FRC has also produced non-prescriptive guidance on board effectiveness which encourages consideration of how boards carry out their role and improve their effectiveness as they consider applying the Code. It is the role of investors to hold boards to account on the decisions that they have taken and question whether this helps to uphold the high standards of governance expected by UK PLCs.

Each board member and more importantly, the board as a whole, should have the appropriate skills, experience and knowledge to be able to take into account material climate and sustainability related matters and considerations. The board will need appropriate training and the right information from the company to make the suitable decisions on these issues. With regards to net zero commitments, while these undertakings may have initially emerged from corporate strategy or corporate responsibility teams, the board plays a significant role in monitoring, overseeing and approving transition plans, targets and overall execution.

Of members that responded to a recent IA survey, two-thirds of respondents provide training to their board on sustainability and climate risks and opportunities. Training is led by both internal and external practitioners and advisers. In addition to regular training, investment managers frequently provide internal briefings to their boards on key sustainability issues, for example stewardship, the FCA's work on Sustainability Disclosure Requirements (SDR) and Investment Labels, and TCFD disclosure requirements.

However, we do not think that new regulatory expectations in this space are necessary, and indeed they may be unhelpful. There is not (and there should not be) a rigid formula towards ensuring that boards have the right skills and knowledge relating to material climate- and sustainability-related risks, opportunities and impacts. Approaches between firms vary based on such factors as business model, size and investment approach. In such a rapidly evolving area, it would be very difficult to define a specific set of skills or expectations and policymakers would risk regulatory intervention fast becoming obsolete. Accordingly, boards should be given the flexibility to determine the best way to discharge their responsibilities. This could involve seeking guidance from others with relevant technical expertise or the addition of sustainability experts to the board. In our survey of members, 45% of those surveyed stated that one or more of their board members have a background or expertise in sustainability-related matters.

In light of the above, we do not believe that additional rules are needed to ensure that firms have the right skills and knowledge relating to material climate and sustainability-related risks, opportunities and impacts on their boards.

As a side note, we encourage the FCA to be precise around its use of language in terms of management in the context of where responsibility sits. We think it is essential that the FCA, through its actions and language, continues to recognise that it is the role of boards to lead, oversee and challenge, not conduct day-to-day management. Some members are concerned that the casual use of "managing" in regards to board actions and responsibilities at best confuses this issue and at worst can contribute to the erosion of this important distinction.

Q4: What are likely to be the most effective strategies in embedding climate and sustainability related considerations across a firm's operations? What is the potential benefit of initiatives such as the appointment of functional 'champions', or the creation of dedicated working groups or forums? And how can the value of such initiatives be enhanced?

There is no one-size-fits-all strategy which will be most effective in embedding climate and sustainability related considerations across a firm's operations.

We note – and agree with - the FCA expectation that firms should be accountable for their sustainability-related claims and commitments. We agree that for firms to make progress towards their sustainability objectives, their governance arrangements, incentive structure, capabilities, and culture must evolve and keep pace with the broader sustainability agenda. As with all material investment risks, investment managers work carefully to embed material climate and sustainability-related considerations across their operations. Indeed, all members that responded to our survey indicated that they have a body, committee or individual within their firm responsible for the oversight of sustainability-related risks and opportunities. Within this, members adopt a wide variety of approaches towards embedding sustainability across their operations and accordingly there is no single approach to how sustainability initiatives should be integrated within firms.

Under the FCA's rules on TCFD, investment managers are required to make entity-level disclosures across key pillars of governance, strategy, risk management, and metrics. Ultimately, in order for members to report on TCFD in a meaningful way, sustainability considerations across these three areas will have to be embedded across a firm's operations. The FCA has stated that once fully implemented, its TCFD rules will apply to 140 investment management firms – as such, we would expect that a very significant proportion of the industry will be not only reporting on, but actively integrating, sustainability in their operations. A number of our members also utilise the PAII Net Zero Investment Framework, a methodology commonly applied by signatories of the Net Zero Asset Managers initiative. This Framework recommends that the board or investment committee should be responsible for: committing to a goal of achieving net zero portfolio emissions; agreeing principles and publishing beliefs in relation to Paris alignment; adopting an investment strategy; updating mandates and performance objectives to align with any net zero investment strategy; and monitoring the implementation of the net zero investment strategy.

Furthermore, the approach taken by firms will also be dependent on numerous factors, for example, the business model and size of firms as well as their culture and existing governance structures. One of the most popular approaches amongst those surveyed was the operation of a dedicated group (such as a sustainability committee, forum, or working group) focused on firm-wide integration of sustainability risks. 86% of respondents to the IA survey used this approach (among others).

However, some member firms consider that separate sustainability committees run the risk of not integrating sustainability considerations across a firm. Other options, for example, having sustainability champions across different teams, can provide members a more agile way to embed sustainability considerations. In addition to sustainability champions and sustainability committees, some further examples of initiatives used within member firms include:

- Specific technical and advisory roles to support portfolio managers in investment decision-making and engagement;
- ESG enablement teams to achieve net zero commitments;
- Climate Change Working Groups;
- Corporate Responsibility Committees;
- Sustainability Committees comprised of individual 'Sustainability Champions';
- Sustainability Committees as a sub-committee to the Executive Committee; and
- Group-level ESG Committee and local-level ESG Committees comprised of local CEOs and 'Heads-of'.

The potential benefits of using such initiatives are wide-ranging. A sustainability committee can be used to assist the board in overseeing major sustainability related risks and take on some responsibilities for oversight. The use of these committees, as well as other initiatives, can improve the resilience of firms' operations as well as foster an inclusive and engaged workforce. Some members further note that boards should prioritise using a materiality matrix to help identify the most material issues to their business, which increasingly includes sustainability considerations. This can help to identify and weigh those issues that matter most to a company and its stakeholders (including its shareholders) and place them alongside its strategic priorities and key risks. If done well, members believe that this can help to provide a foundation stone for strategy development, risk management as well as stakeholder management.

We believe that this diversity of approach, coupled with measures already in place, such as TCFD disclosures, make it clear that new regulatory expectations would not be appropriate or necessary. Allowing firms flexibility in their approach to integrating sustainability factors into their operations - based on size, business model, and other factors – will be key. This exercise of judgement by senior management is likely to be more effective than seeking to create further regulation to embed sustainability.

Q5: What management information does senior management use to monitor and oversee climate and sustainability related developments, and to monitor progress against public commitments? Should we set expectations or guidance for decision making processes, including systems and controls, audit trails and the flow of management information to key decisionmakers? If so, what should be the scope of such expectations?

In line with our response to other questions within this DP and in the vein of fully supporting transparency and holding firms to account for binding commitments and standards, we would advise against introducing regulation into an evolving space.

Many members, for example, have only recently set net zero commitments and are still determining exactly what their targets should look like. We would also emphasise that the FCA should not look to treat sustainability-related management information (MI) differently to any other MI. If firms have embedded sustainability and are reporting against risks, no additional MI should be mandated.

SYSC 4.1.4 already requires firms to (a) establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the firm and (b) establish, implement and maintain effective internal reporting and communication at all relevant levels of the firm. When complying with these requirements, firms are already expected to take into account the nature, scale and complexity of their businesses, including the nature and range of financial services offered. As such, we do not believe that the FCA should set further expectations or guidance for decision-making processes, including systems and controls, audit trails and the flow of management information to key decision-makers.

Senior management within IA member firms use a wide range of management information to monitor and oversee climate and sustainability related developments, and to monitor progress against public commitments. While it is appropriate that the board or Investment Committee should ultimately be responsible for overseeing climate-related targets and delivery against them, individuals across the firm will need to play their part to meet objectives. Each of the three lines of defence will have its own set of responsibilities.

In a joint report with Deloitte produced with input from a working group of IA members, 'How risk and compliance functions can support the net zero transition', we advise that risk and compliance functions can have a role in providing the board and relevant committees (including the Risk Committee, Risk and Compliance Committee, and Investment Committee) with robust information on delivery of net zero plans and performance against KPIs, metrics and targets. There should be metrics across all asset classes for which targets have been set. MI should focus on where exposures to high greenhouse gas emitting companies or sectors are greatest. MI design should be sufficiently flexible so that it can be augmented at a later stage as necessary, and should be clear on gaps and uncertainties in data, with an ongoing process to address them. This spread of duties across functions does not negate the responsibility which ultimately lies with the board to approve the transition plan and targets and oversee transition plan execution, or senior managers for the execution of the plan and managing the associated risks.

Finally, we would urge the FCA to avoid mandating new data sets be produced to monitor and oversee climate and sustainability related developments and progress against public commitments. A requirement that the industry must produce further data would not only increase the regulatory burden for members but will also add a substantial cost burden through additional data requirements and the development of credible methodologies.

Q6: Should we consider setting new regulatory expectations or guidance on senior management responsibilities for a firm's sustainability related strategy, including the delivery of the firm's climate transition plan? If so, which existing SMF(s) would be the most suitable to assume these responsibilities? Please explain your views.

We do not view sustainability as a standalone strategy or responsibility, instead the consideration of material sustainability risks and opportunities should be embedded within existing strategies and objectives. This should be implemented throughout the firm so that each individual is familiar and aware of what is expected of them. Furthermore, we note that the industry is already expecting changes to SM&CR via the Financial Services and Markets Bill.

As such, we do not consider it necessary to implement regulatory expectations or changes to SM&CR regarding specific functions.

Q7: Should we consider introducing specific regulatory expectations and/or guidance on the governance and oversight of products with sustainability characteristics, or that make sustainability claims – for example to clarify the roles and expectations of governing bodies such as Fund Boards? If so, which matters in particular would benefit from clarification?

We note that this question – unlike the others in the DP – refers to product-level, as opposed to entity-level governance.

As with our answers to the questions posed at entity level, we believe that there already exists sufficient regulation at product-level (both pre-existing and forthcoming) regarding the governance and oversight of products with sustainability characteristics, or that make sustainability claims. Many of our members have already introduced an advanced level of internal product governance and oversight architecture within their firms as part of normal governance processes and the implementation of existing regulations, including the Markets in Financial Instruments Directive (MiFID) II, the EU's Sustainable Financial Disclosure Regulation (SFDR), and TCFD.

MiFID II introduced a series of product governance obligations on both manufacturers and distributors of products, including the obligation to provide each other with appropriate information to enable each party to act in the best interests of the investor. The European Securities and Markets Authority (ESMA) provided more clarity on these obligations in their 2017 Guidelines on MiFID II Product Governance Requirements. The FCA then implemented MiFID II through its Product Intervention and Product Governance (PROD) Sourcebook with one significant difference: that the requirements are applied to non-MiFID firms – including fund managers operating in the UK - as guidance. However, while PROD rules apply to UK authorised fund managers (AFMs) as guidance, members understand that the FCA expects them to carefully consider these rules when meeting their obligations to ensure they comply with the FCA's Principles and other relevant rules. Product oversight and governance in the PROD context clearly refers to systems and controls firms have in place to design, approve, market and manage products throughout the products' lifecycle to ensure they meet legal and regulatory requirements, regardless of whether they have sustainability characteristics, or make sustainability claims. Furthermore, PROD 3.2.19 already requires firms to regularly review the financial instruments they create. This regular review includes an assessment of whether the financial instrument remains consistent with the needs, characteristics and objectives of the identified target market. We would naturally expect oversight of products with sustainability characteristics or that make sustainability claims to form part of this assessment.

The FCA's rules on TCFD require disclosures on governance at entity level as well as product-level disclosures where the approach is materially different to the governance approach at entity level. These rules will naturally act as more than just a reporting exercise for members and will provide a tool for firms to consider how they are governing risks and opportunities.

In addition, the Consumer Duty introduces a more outcomes-focused approach to consumer protection and sets higher expectations for the standard of care that firms give customers. The FCA needs to give firms sufficient time for the Consumer Duty to bed in before contemplating additional product governance regulatory expectations or guidance on how firms' culture and behaviours can support positive sustainable change.

With regards to funds making sustainability claims, there are also current rules and guidance within the FCA Handbook on communication and transparency obligations on firms. The FCA's Guiding Principles on design, delivery, and disclosure of ESG and sustainable investment funds are an important part of the UK's regulatory architecture and help to ensure good customer outcomes and a well-functioning fund market with the consumer at the core. There is also the forthcoming introduction of an 'anti-greenwashing' rule, as part of the SDR proposals, to ensure that the naming and marketing of financial products and services in the UK is clear, fair and not misleading, and consistent with the sustainability profile of the product or service. Furthermore, under SDR, the FCA has proposed that products receiving a sustainable investment label must meet certain qualifying criteria, including principles on resources and governance. This will create an additional layer of governance for products that qualify for a sustainable investment label under the proposed rules.

Finally, with regards to the FCA's suggestion that it might look to clarify the roles and expectations of governing bodies such as Fund Boards, we believe that the current rules and guidance under SYSC 4.3A.3 are sufficient. Here, it is specified that members of a management body of a firm should possess sufficient knowledge, skills and experience to perform their duties and have procedures to monitor that adequacy.

Q8: What matters should firms take into consideration when designing remuneration and incentive plans linked to their sustainability related objectives? In particular, we welcome views on the following:

- **the case for linking pay to sustainability related objectives**
- **whether firms should break down their sustainability related commitments into different factors, allocating specific weightings to each**
- **whether short term or long term measures are more appropriate, or a combination of both**

- **whether sustainability related incentives should be considered for senior management only, or a wider cohort of employees**
- **how firms could consider remuneration and incentive plans in the design and delivery of their transition plans**
- **remuneration adjustments where sustainability related targets (at either the firm level or individual level) have not been met.**

Please explain your views.

The IA has for many years set out expectations on how remuneration should be structured for the executives of UK listed companies. Our members are significant investors of these companies, generating sustainable and long-term returns on behalf of their clients. Since the pandemic, there has been a growing focus on how the management of sustainability issues should be incorporated into remuneration structures.

The impact of material sustainability risks on the long-term value of companies is increasingly evident. As a result, a greater number of companies are incorporating the management of material sustainability risks and opportunities into their long-term strategy. In these cases, remuneration committees should consider the management of these material sustainability risks as performance conditions in the company's variable remuneration (including annual bonus or any long-term incentive plans). As with other performance measures, we would expect sustainability metrics to be linked to the strategy, be quantifiable and to avoid unnecessary complexity, with firms setting out how progress against these metrics is measured and for performance against these goals to be disclosed. Firms should also disclose these targets at the start of the performance period and an explanation should be provided on how these targets map onto the longer-term commitments made by the company (such as any commitments to be net zero).

We consider that a similar approach should also be taken for regulated firms. They should be able to choose those material sustainability issues which impact their business strategy and align with their clients objectives, and set out how they are seeking to measure those issues. If appropriate, remuneration should be used to incentivise the management of those sustainability risks. Remuneration Committees or executives should have the flexibility to decide:

- Which risks are most material to the business;
- How the management of these sustainability risks should be undertaken and whether the assessment of these risks should be captured over the short or long term (for example incentivisation through either the annual bonus or long-term incentives); and
- What population of the workforce should be incentivised to manage these risks (i.e. whether this should extend below board level).

We do not believe that prescriptive requirements should be set, but the regulators could ask regulated firms to disclose how the management of sustainability issues are remunerated in the context of the company's business model and strategy.

Based on the way that question 8 has been drafted, some members are concerned that the FCA is leading with a prescriptive approach which could lead to 'tick-box' and formulaic responses from firms that do not allow for discretion as to when and how it is appropriate to incentivise progress towards sustainability objectives. For some firms, the incorporation of sustainability targets in pay may not be relevant. Some members have also noted that as with SFDR, it should be sufficient for firms to disclose, as part of SDR, how remuneration policies are consistent with the integration of sustainability objectives.

Some members further note that the approach to remuneration and incentives will be cascaded from group strategy and dependent on delivering on elements of that strategy. As such, it would not be appropriate to set targets for individuals on sustainability where they are not derived from group strategy and are not based on individual decisions. Therefore, members reiterate the need for creating the right culture for sustainability which accounts for risk and opportunity and is embedded throughout the organisation and could help avoid some of the outlined challenges.

It is also important to note that the MiFID PRU Remuneration Code already requires a MiFID PRU investment firm to take into account financial as well as non-financial criteria when determining the amount of variable remuneration to be paid to an individual. Examples of non-financial criteria include achieving targets relating to sustainability factors, such as diversity and inclusion.

Our members have provided the following examples of approaches they take to incorporating sustainability factors into remuneration:

- Sustainability considerations are included in the remuneration process for sustainability-related roles (e.g. credit analyst);
- For employees that have less clear ties with sustainability (e.g. portfolio managers), some firms will link compensation to the goal of enhancing risk-adjusted returns[2] for example, the coverage or portfolio that is linked to sustainability research or engagement;
- Sustainability factors are included in the CEO's performance score-card but some firms are unlikely to extend beyond this as it could impact on an investment manager's fiduciary duty to their clients;
- While sustainability is not specifically singled out as an incentive, it is integrated into the overall contribution to company success;
- Remuneration is linked to each team's performance, which under some firms' business models necessarily requires a level of sustainability integration consistent with the expectations of each team's clients.

Linking sustainability to executive pay has become a signalling mechanism and way to bridge the gap between short-term actions and long-term goals. Although, as Tom Gosling notes, linking these targets to pay needs to be in the context of wider cultural change within the organisation that aligns with long-term, sustainable value creation. In the broader corporate sector, some members as investors in these companies are concerned that with boards lacking the knowledge and time to adequately scrutinise sustainability target metrics, the risk is that firms could end up setting softer targets with vague metrics that could lead to higher-pay-outs. In this instance, executives would be paid more, but there would be very little benefit to wider society or the environment. In addition, members have also noted concern around hitting a target, but missing the point, which again reinforces that linking pay to sustainability targets on their own will not result in firms doing more on sustainability.

Q9: Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.

[2] For instance, some members note that this will need consideration of input-based considerations (proof they did the analysis and considered financially material sustainability factors) vs output-based (eg the sustainability score of the portfolio was better than the benchmark or they reduced the carbon footprint of their portfolio by a certain percentage). Members note that the former is more likely to impact risk-adjusted returns.

We believe that the current regulatory expectations are sufficient and that the FCA handbook already contains a robust and comprehensive set of rules and guidance on remuneration.

If the FCA did decide to introduce regulation in this space for regulated firms, we suggest that this be limited to disclosure of their approach to managing sustainability issues through their remuneration structures, without prescribing a set approach or requirement. We believe this flexibility is necessary as the approach will differ greatly, depending on such factors as the issue being managed and the business strategy of the company.

Q10: Should we consider additional regulatory measures to encourage effective stewardship, particularly in relation to firms' governance and resourcing of stewardship, and associated incentive mechanisms and conflict of interest policies? Are there regulatory barriers that we should consider? Please explain your views.

Our members believe that the Stewardship Code has made a significant impact in improving disclosures on the governance and resourcing of stewardship, as well as management of conflicts of interest. At this time, we do not believe that any additional measures to encourage effective stewardship are required.

The investment management industry's purpose is to deliver long-term returns to clients aligned with their investment objectives. Investment managers' stewardship activities will be conducted to be consistent with this objective. Stewardship is normally used by managers to address financially material risks and opportunities that could impact a company's long-term value. These issues increasingly include sustainability concerns and the impact of investee companies' activities on the environment and society and how in turn events in society, the environment and the economy impact the value of the company. Stewardship plays a role in helping to mitigate the various material risks and realising the opportunities by encouraging investee companies to disclose whether and how material risks and opportunities are integrated into the company's strategy.

While stewardship can encourage companies to consider the management of material risks and opportunities, it is also important to note that investors are not responsible for the management of the companies in which they invest. The board of a company is responsible for governance and oversight of the strategy while the Executive Directors run the company. Boards are responsible for determining the appropriate approach to material drivers of risk and value within the business model and strategy as well as fulfilling their directors' duties to shareholders and taking account of their impact on wider stakeholders such as employees, communities, the environment, and suppliers.

Boards are also accountable to their shareholders, and through their stewardship obligations it is the responsibility of those shareholders to hold the board to account for its actions and the way the company is managed, especially where there is a risk to long-term value. However, the board and company management must also be willing to respond to these investor concerns, where appropriate. In this context, stewardship can help a company to improve its prospects if the underlying business is viable and if the company is receptive to constructive engagement with investors.

Governance and Resourcing of Stewardship

At the time of introduction of the 2020 Stewardship Code, we supported the new expectation that institutional investors coordinate their approach to stewardship with the overarching objectives and governance of their firms. We did highlight concerns that this governance could be put in place just to meet the requirements of the Code, as a 'box-ticking' exercise without real benefits to the management of the firm. Whilst it was a helpful opportunity for investment managers and owners to set out how their approach to stewardship ties in with their overall organisational approach, we were concerned that these should not be 'developed' solely for the purpose of becoming signatories to the Code. Organisations should be disclosing their purpose, objectives and governance arrangements independently of the Code, which should focus on how these relate to stewardship. We thought it would be helpful for organisations to set out how this process informs (and where relevant is informed by) their approach to stewardship – this will help both asset owners and investment managers to identify who they want to work with during the selection process.

Our members, as signatories to the Stewardship Code, have generally been supportive of the impact of the Code and the way in which it has led to material changes of practice including on governance and resourcing of stewardship. Almost all of the respondents to the IA's survey of our members noted that they had governance arrangements in place to provide oversight and accountability for stewardship, and that these arrangements had been strengthened through the introduction of the Stewardship Code.

Members generally agree that robust governance arrangements can help to provide greater transparency and accountability on a firm's approach to stewardship. Principle 2 of the Stewardship Code requires organisations to assess how they have governed and resourced stewardship. Members note that outcomes-based reporting as required under the Stewardship Code has helped to facilitate improvements in investment managers' governance structures and in how they will seek to mitigate differences in views within firms. Our members have identified the following as improvements to their governance processes:

- The establishment of oversight committees (comprising the CIO of each investment class, the Global Head of Sustainable Investing, Global Head of Investment Stewardship and heads of controls functions);
- Developing dedicated stewardship and sustainability teams;
- Improving the integration between these teams and the core investment process;
- Initiating improvements to reporting and transparency; and
- Making senior appointments to provide leadership for responsible investment.

Some members note that regulation has also helped to establish better governance practices, with SFDR requiring additional governance processes to oversee sustainability integration work. Given the global nature of investment firms, it is also necessary to take account of the geographical dispersion of teams and recognise that in these instances local governance practices may take precedence over international practices.

On resourcing, members generally agree that they have had to increase resourcing to stewardship functions in part due to meeting firm-specific stewardship goals but also as a result of increased regulation and sustainability integration. Some of this resourcing may exist at a global level given the nature of global firms.

One of the challenges that members are consistently managing on the governance of stewardship is reconciling the views of investment teams and stewardship functions. On the whole, members note that there has been better integration between stewardship and investment teams, with input from the stewardship team increasingly being used by the investment team to inform their policies and achieve a more integrated approach. Members have noted that stewardship teams have become much more embedded into the investment process. They are not just a consultative function working on voting or engagement, their remit also extends, for example, to capital allocation through the application of sanctions where engagement has failed. In some instances, member firms also noted that the stewardship view would form the baseline for any final decision taken on areas of disagreement.

Members note that such disagreements could arise in relation to exclusions, voting, engagement or escalation. A formalisation of internal knowledge sharing, with clear escalation routes (outside of the CIO) could help with providing greater transparency around the role that each function plays. Teams should also document any discussions and conclusions for audit purposes. Some members noted that those firms which create an organisational culture that focuses on sustainability as a material risk are less likely to face internal conflicts.

At this stage, members believe that reporting on the Stewardship Code has led to better outcomes for the governance of stewardship and resourcing, and that further regulatory intervention is unnecessary. Reporting against the Code continues to mature and members feel that a prescriptive, rules based approach could inhibit firms' approach to stewardship.

In our joint report with the PLSA, 'Investment Relationships for Sustainable Value Creation', we set out the importance of stewardship being a defining feature in the relationship between asset owners and investment managers. This includes ensuring that asset owners were content that the governance, purpose and resourcing of investment managers is aligned with the needs of clients over the course of the relationship. We therefore believe that it will be important for the asset owners to be content that governance and resourcing of stewardship is appropriate for their client's needs. These market pressures may have more lasting and meaningful change than a new regulatory approach.

Incentives

Under the Stewardship Code, members have to report on their approach to incentivising stewardship - however the extent to which stewardship is a core determinant of remuneration outcomes for employees will differ depending on how this is incentivised in the context of the company's business model and strategy. There is now a general recognition that stewardship is integral to the investment process and ultimately, long-term performance. As such, active stewardship is seen as something which helps to improve and enhance investment performance, and inversely where a firm is unsuccessful in meeting its stewardship objectives, this could negatively impact investment performance. As part of the IA survey, some firms noted that incentive-based pay for relevant roles within the organisation (e.g. sustainability specialists or portfolio managers) was linked to investment performance and as a consequence the delivery of stewardship objectives.

Conflicts of Interest

Investment managers are accustomed to managing conflicts of interest. Stewardship-related conflicts are not unique - they have always existed, and the industry has responded through minimising and mitigating risk. The FCA notes that there are currently weaknesses in the way in which regulated firms report on their conflicts of interest, especially as they relate to stewardship. Under the Stewardship Code, the FRC currently expects firms to disclose examples of specific or actual conflicts of interest that have arisen during the previous 12 months, and how they have been mitigated. This is further underpinned by the FCA's Conduct of Business Sourcebook (COBs) which requires firms to annually disclose their engagement policy and how it has been implemented during the year. Firms are required to describe how they manage actual and potential conflicts of interest in relation to the firm's engagement. Some members have queried why two separate disclosures on conflicts of interest are required, and that generally the COBs rule will take precedence. However, overall, members feel that the existing regulatory requirements are sufficient in capturing how conflicts of interest will be managed and mitigated against by investment managers.

To this end, most members operate a conflicts of interest policy. Members generally set out the potential or actual conflict, mechanisms for the management of this conflict and also the control mechanism. There are challenges of explicitly naming clients within examples of actual conflicts of interest - some members have stated that disclosing actual conflicts of interest is difficult as it requires extra permissions from clients or that they may be subject to confidentiality restrictions. In many cases, members would seek to address conflicts before they arise so there may be no actual conflicts to manage. Not every conflict of interest will be able to be foreseen, therefore drafting conflicts policies to address the broad points allows members to address the individual circumstances of the conflict rather than rely on the specific circumstances.

Q11: What additional measures would encourage firms to identify and respond to market wide and systemic risks to promote a well functioning financial system? How can the collective stewardship efforts of asset owners and asset managers best be directed towards the most pressing systemic issues? And how can remaining barriers best be reduced? Please explain your views.

Identifying and responding to market-wide and systemic risk is already required as part of the Stewardship Code, and as set out below members have already demonstrated how collective engagement can contribute towards tackling these issues. We welcome that the forthcoming review of the regulatory landscape for stewardship will consider this further, however, we believe that the existing measures are currently sufficient.

As we note in response to question 10, the purpose of stewardship is to support the creation of long-term financial returns for clients. Stewardship in this context will be used by managers to address financially material risks and opportunities that could impact a company's long-term value, including sustainability. While stewardship plays an important role in encouraging investee companies to disclose whether and how material risks and opportunities are integrated into a company's business model and operations, it is ultimately the role of the board and company management to determine the most appropriate approach to sustainability-related risk and opportunity.

Shareholders have a responsibility to hold boards to account, particularly on how the company is being managed, and especially if there are risks to long-term value, and will use certain rights and obligations to ensure they manage their investments responsibly. However, the effectiveness of engagement activities relies on the responsiveness of boards who must be willing to respond to shareholder concerns, where appropriate.

To this end, stewardship (through engagement with portfolio companies) can help with the management of systemic risks by supporting strong governance practices that support long-term value creation. However, it is important for public policy teams within regulated firms to supplement this with policy engagement which frames and shapes the economic environment and investment landscape, by pushing for real changes to the ecosystem within which companies operate.

Responding to Market-wide and Systemic Risks

The Stewardship Code expects asset owners, investment managers, and service providers that support them to play an important role in responding to market-wide and systemic risks, as well as responsibly allocating, managing and overseeing the capital held in their portfolios. Seeking to address systemic issues through stewardship rests on the premise that market participants have a responsibility to help preserve the integrity of the whole financial system, and to help service society and the planet. This should be done by engaging with regulators, policymakers and other stakeholders. Examples of the most significant systemic threats facing the stability of the financial market may include: (i) macroeconomic risk (including political, legal and regulatory changes), (ii) environmental risk (including climate change, water scarcity and pollution); and social risks (such as human rights abuses and income inequality).

Climate change is arguably the most pressing of many market-wide and systemic risks facing us today. Facilitating the transition to net-zero in the real economy has involved a mobilisation of capital to finance the transition as well as many investors supporting decarbonisation efforts through their engagement with companies and stakeholders. Some members note that it should be the role of investors to tackle the management of systemic risks within investee companies, particularly where they impact the long-term value of client's assets. This is all the more important where these risks cannot be diversified out of. However, others have expressed concern around what the remit of responsibility should be for investors in terms of seeking outcomes related to addressing systemic challenges, noting that this overstates the role of investors and should be determined by policy interventions which require a multi-stakeholder approach. There is a view that corporate engagement with individual companies in and of itself cannot achieve the change required for real-world decarbonisation, or bring about improvements to a particular sector. This is particularly the case in harder-to-abate sectors where it may not be technologically or economically feasible for companies to currently meet investor requests. Some members have further noted that in order to make a long-standing impact on a company, it is crucial to change the ecosystem and environment in which it operates, particularly through engagement with policymakers and regulators (as set out below).

To this end, some members have called for an expansion of engagement to focus on sector specific engagement, undertaken in collaboration with other investors, that will allow for tangible real-world decarbonisation across a specific sector. This also allows for scalability of engagement, which addresses concerns around the level of resource required for significant engagement at a company specific level. For example, collaborative engagement through the Investor Mining and Tailings Safety Initiative has helped to improve sector specific disclosure on the management of tailings storage facilities, through the establishment of a global standard on tailings dam management. Equally, some members note that differing views on systemic risk and focuses on different aspects of materiality can make collaboration at a sector-specific level difficult.

We welcome that the FCA is seeking to align as far as possible with existing disclosure standards such as the Transition Plan Taskforce (TPT), which also seeks disclosures from regulated firms as corporate entities on engagement within the value chain and industry. Such engagement should make it easier for regulated firms to collaborate with their peers and stakeholders within the value chain, develop new technologies to decarbonise, as well as effectively share costs and execute projects more efficiently. Some members argue that such engagement is still within its infancy but we note that this may improve as corporates start to disclose against the TPT framework.

Policy engagement is also another lever through which investors can help to tackle market-wide and systemic risk. Some members have noted that investors' interests in the long-term health of the economic system can help to counter against the short-term views of companies. In particular, investor engagement in shaping the regulatory environment in which companies operate (through direct engagement with sovereigns and regulators) can help provide greater clarity on the sector-specific pathways needed to achieve net zero. This is arguably the greatest influence that investment managers can have and ensures that the industry has the right information and tools to hold companies to account on their sustainability commitments. As an example, positive investor engagement with policymakers and standard setters has helped to deliver a global baseline for consistent and comparable sustainability-related information, ensuring that investors have a sound basis from which to make effective capital allocation decisions. This would not have been possible without a whole-of-ecosystem approach to encouraging international harmonisation and interoperability in disclosure standards, given the global nature of financial systems.

As the IA noted in its response to the TPT, firms and companies may also demonstrate their commitment to responding to system-wide risks through their involvement in professional associations. Investors have a role here in calling out or seeking change if investee companies (as members of trade bodies) have conflicting policy positions which are at odds with investor views. Some members have noted that investors should not be afraid to call out behaviour from investee companies that may be seeking to hinder rather than progress the management of material risk, including that related to sustainability.

The Stewardship Code already encourages reporting on the identification of and response to market-wide and systemic risk, and most firms have made significant progress on reporting on these issues. Members note that identifying and addressing these risks will largely remain unchanged from year to year, with success at times being difficult to measure. Nonetheless, we do not think any additional intervention is needed at this time. The FRC may want to consider working with stakeholders to issue guidance on the importance of sectoral engagement, which is likely to become a much more useful tool in addressing systemic risks. We further recognise that the FRC may set out clearer expectations on reporting following the regulatory review of the landscape for stewardship in Q4 2023.

Barriers to Collective Engagement
Collaborative engagement has led to a number of successes. For example, in the IA survey to members, the majority of members that responded noted that they deployed collaborative engagement as a way to respond to market and systemic wide risks. Members provided the following as examples of initiatives they were involved in:

- Climate Action 100+ is an example of collaborative engagement that has helped to speed up climate action from companies. Investors can further use tools like the Net-Zero Company Benchmark to shine a light on the lack of progress from company in response to their public commitments on climate.
- Engagement through the Investor Forum as a model for collaborative engagement with UK companies which meets UK regulatory requirements.
- Participation through industry specific trade bodies (such as the Investment Association) and relevant committees (e.g. the Stewardship Committee, or Sustainability & Responsible Investment Committee).
- Policy engagement through lobbying policymakers and responding to specific consultations.

Members recognise that systemic risks can result in market failure and as such require a collective response to address them. One of the barriers which the FCA suggests could be inhibiting collaborative engagement are competition rules in the UK, such as the Market Abuse Regulations (MAR). Whilst the explicit MAR requirements might not act as a barrier to collective engagement with individual companies, there are perception issues with the operation of MAR and existing competition rules in certain circumstances which put some investors off collective or collaborative engagement, so as not to be seen to be in breach of MAR. Through engagement with our membership, we have not yet identified concrete examples of problems that investors have had while trying to operate within the bounds of the Regulation, but there was a general sense from members that existing competition rules could be inhibiting engagement.

The Investor Forum offers a 'safe and secure' Collective Engagement Framework which provides clarity on concert party and MAR and it has noted that it does not believe that competition rules are proving to be a substantial barrier to engagement in the UK. However, there are concerns that have been raised in other markets, and given the global nature of investment firms and stewardship functions, as well as sensitivity of UK investors to norms and rules in other jurisdictions, some members have suggested that this issue should be escalated to IOSCO to address.

Collective engagement is a powerful tool that can help investors to amplify their messaging through critical mass support and therefore increase the potential for change at investee companies. We note that collaborative approaches taken with due regard to existing competition rules have had a record of delivering successful outcomes (e.g. diversity within the boardroom). As we have set out in our response to the FCA's Consultation Paper 22/20 on the Sustainability Disclosure Requirements and Investment Labels, we are concerned that the increase in a firm's individual activities and how they contribute to sustainable outcomes risks funds pursuing individual activist behaviour where they can take credit for their individual contribution, rather than stewardship which is conducted collaboratively. Given these forthcoming regulatory developments, we would not want collective engagement to be deemed less important than individual engagement - this could be exacerbated by a lack of understanding of how MAR operates in the context of such engagement.

Given that different investors have varying perspectives of what can be achieved under MAR, the FCA may want to issue further guidance on how investors can exercise collective engagement without falling foul of the Rules.

We note that the Competition and Markets Authority (CMA) is also consulting on the extent to which competition law applies to environmental sustainability agreements between firms and seeks to help businesses take action on climate change and environmental sustainability generally, without unduly breaching competition rules. We would encourage the FCA to consider the CMA's guidance as it updates its own guidance on MAR.

CHAPTER 4 – TRAINING AND COMPETENCE IN REGULATED FIRMS

Q12: What do you consider to be the main sustainability related knowledge gaps across the financial sector and how can these best be addressed? What do you consider to be the potential harms to market integrity, consumer protection or competition arising from these knowledge gaps?

The investment management industry recognises that knowledge gaps across the financial sector can harm consumers and undermine credibility in the financial services sector. Therefore, training and upskilling employees in order to address sustainability-related knowledge gaps is a key priority for investment managers. 90% of respondents to our survey stated that they provided training to the wider workforce on sustainability/climate risks and opportunities and two-thirds of respondents stated that they provide training to their board. Members are conscious that sustainability training should not exist in a silo and instead focuses on the interconnectedness of sustainability with other key topics, risks and opportunities.

Members undertake a wide variety of training exercises, including, but not limited to: compliance modules; ad-hoc training sessions organised for specific business units; specific training to control functions and investment teams; requirements for the front office to have completed PRI training; regular in-house training by responsible investment teams; and external training from sustainability education professionals. Member firms also seek to keep their employees updated on various areas of focus within sustainability, via such channels as regular updates from legal counsel, semi-annual business wide updates provided by heads of sustainability, and regular board updates.

A case study from one member showed that in 2021, they embarked on a campaign to upskill their colleagues' sustainability knowledge and expertise. By early 2023, over 90% of their client-facing distribution personnel across the US, EMEA, and Asia obtained an external sustainability certification. All investment personnel associated with an SFDR Article 8 or 9 fund undertook over four hours of mandatory sustainability subject matter training. This included teach-ins on sustainability data and third-party vendors, climate data, climate scenario analysis, financial materiality, DEI, and human capital management, delivered by their Sustainability Strategy and Development team. All employees across the firm – including those for whom sustainability is not a part of their core role – continue to be offered 4-5 hours of general sustainability online training. They are also invited to upskill by taking an external certification - paid for by the firm - and to undertake any of the more specialised sustainability trainings offered to investment teams.

Clearly, there is still work being done by investment managers to identify and address sustainability-related knowledge gaps within the industry and given the rapidly evolving nature of sustainable investment, it is likely that there will be numerous knowledge gaps at any one time. The breadth of issues alongside the limitations of data in some areas makes this challenging to upskill teams across the organisation. As just one example, the Taskforce on Nature-related Financial Disclosures framework for biodiversity is due to be finalised later in 2023. Among the many implications will be an organisational challenge to understand the requirements both for the responsible investment team and the wider upskilling required across the business. Collaboration between firms and their strategic partners as well as by the sector in terms of sharing understanding and best practice, will be critical as this fast-moving area continues to develop.

Q13: Do you think there is a need for additional training and competence expectations within our existing rules or guidance? If so, in which specific areas do you consider further rules and/or guidance are required? Please explain your views.

The IA and its members greatly value the importance of training and competence in ensuring a well-quipped workforce within the investment management industry. At this time, we do not consider it necessary to introduce new rules and guidance around training and competency expectations and we would caution against a one-size-fits-all approach. As stated previously, we do not view sustainability as a standalone strategy but as a fundamental consideration that should be embedded within existing training and competence structures. Given firms adopt a range of strategies and approaches relating to sustainability, there is unlikely to be a uniform proportionate approach to training.

Training and competence levels have been a key issue for members for a number of years and sustainability-related training and competence building is already well underway in the investment management industry.

Furthermore, sustainability is an evolving area of growth for the financial sector. Training and competence needs can vary based on members' business strategies and sustainability commitments. As such, it is our belief that firms should have the discretion to decide what would be most suitable for their people and business to achieve the best outcomes for clients. If additional training and competence expectations were introduced, they would need to be sufficiently flexible, given roles in this area vary significantly and sustainability itself continues to develop.

As mentioned in response to question 12, members undertake a wide variety of training exercises. There has been considerable investment across the investment management industry on both internal and external training for executives as well as on company-wide training for staff at all levels.

The FCA references in paragraph 4.10 the twelve technical skills and competencies needed for professionals to perform various roles in sustainable finance set out by the Monetary Authority of Singapore, as an example of an initiative in this area. We would argue that such an initiative would not be suitable for the investment management industry in the UK, as the needs of firms and their clients are varied. Individual firms need to assess their own requirements and would also need to have the flexibility within their training models to be able to adapt.

We believe that prescriptive rules at this stage could lead to 'box-ticking' and formulaic responses from firms. It is also important to emphasise that knowledge and competence are a combination of an appropriate qualification and appropriate experience. Striking the right balance between theoretical and practical knowledge is key. Pursuant to SYSC 5.1, firms are already required to employ personnel with skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. The existing rules are non-topic specific to allow for changing competence needs over time. We believe firms are best placed to identify the appropriate balance of skills, knowledge and expertise required based on their size and business model.

We fully support FCA's commitment to consider proportionality when deciding the most appropriate course of action and would encourage this same approach with training and competencies to avoid a one-size-fits-all approach.

Q14: Which aspects of the training and capability building initiatives discussed above, or any others, would be particularly useful to consider (for example in identifying which skills and/or training is needed) and how best should we engage with them?

The IA and its members believe that strong training and capability-building initiatives are vital to the success of a firm's sustainability-related objectives. Investment managers have taken varied approaches to training and capability-building within their firms based on their business model and sustainability commitments. As previously mentioned, a one-size-fits-all approach to training and capability-building initiatives would not be suitable for our members.

Sustainability is an emerging area, and it continues to grow and evolve at a rapid pace. Being too prescriptive as to sustainability-related training and capability-building may potentially have a negative impact on embedding climate and sustainability-related considerations across a firm's operations. Allowing for flexibility would likely create the best results.

Q15: Have you seen misrepresentation of ESG credentials among ESG professionals and, if so, what are the potential harms? Have you seen any consistent training metrics that can help compare firms' knowledge/capabilities? Please describe.

No, we have not observed a misrepresentation of sustainability credentials among industry sustainability professionals, but we fully agree with the FCA's assertion that the breadth and complexity of sustainability often requires specialist expertise and technical knowledge. We also support the need for genuine capability-building across the financial sector, including staff training on climate change and net zero, and sustainability more broadly. We are aware that where the appropriate skills, knowledge or expertise are missing, potential harms may occur. Our members make significant efforts to seek to ensure that this is avoided.

Under SYSC 5.1, firms are already required to employ personnel with skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. We consider that firms are best placed to identify the appropriate balance of skills, knowledge and expertise required based on their size and business model. One commonly used qualification used by our members to ensure that their employees have appropriate knowledge and capabilities is the CFA Institute's Certificate in ESG Investing.

However, ultimately, in such a rapidly evolving area, it would be very difficult for a regulator to define a specific set of skills or expectations without these fast becoming obsolete. Firms are constantly innovating to keep up with client demand and developing and hiring new staff in order to do so. A static formula or set of expectations would quickly become dated and as such, we would not recommend regulatory intervention in this area. It is also important to recognise that the recent rise in job titles using sustainability related terms is more likely to be a reflection of the growing sustainable investing market than an indication of competence washing.

Finally, we note that knowledge and competence are a combination of appropriate qualifications as well as appropriate experience. Striking the right balance between theoretical and practical knowledge is key.