WORLD FEDERATION OF EXCHANGES

WFE Response to IOSCO's Growth and Emerging Market Committee's (GEMC) Consultation Report

Sustainable Finance in Emerging Markets and the Role of Securities Regulators

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses (CCPs). We represent over 250 market-infrastructure providers, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). Many of our members are located in emerging markets and are highly invested in sustainability issues.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to raise capital and manage financial risk.

We seek outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

Introduction

The WFE would like to commend IOSCO for taking up the issue of sustainable finance, and the recent issuance of its consultation report on "*Sustainable Finance in Emerging Markets and the Role of Securities Regulators*". Given the global nature of many sustainability issues and the importance of a coordinated approach, it is a very positive development to see IOSCO following other standard-setting bodies in acknowledging the relevance of these issues for financial markets and financial market regulators.

The WFE has engaged formally with the topic of sustainability since 2014, when we established the WFE's Sustainability Working Group. The work of this group, and the membership more broadly, culminated at the end of 2018 in the publication of the WFE's Sustainability Principles[1] which identified five key areas in which WFE members would seek to make an impact in promoting a more sustainable financial system. These are: education, promoting the disclosure of investor-relevant ESG information by listed issuers, stakeholder engagement, provision of markets and products that support the scaling-up of sustainable finance and reorientation of financial flows, and the establishment of effective internal governance and operational processes and policies to support their sustainability efforts. Our members are already active in some or all of these areas and will continue to evolve their efforts as local conditions and capacity allow.

While we provide responses to the specific questions below, we wish to make a few general observations.

First, we note the Growth and Emerging Markets Committee (GEMC) statement that the list of recommendations are ones that "GEMC members should consider when issuing regulations or guidance…" While we agree that getting to "international consistency and harmonisation" is highly desirable, we would suggest that narrowing the scope of the recommendations to GEMC member countries, to the exclusion of the rest of the IOSCO community, risks undermining this objective. The issues addressed by the GEMC recommendations are not specific to emerging markets alone. Investment flows often originate in developed

[1] WFE: Sustainability Principles (2018)

countries and many large companies are in developed markets. We therefore suggest that IOSCO acknowledge the global applicability of these matters with the intention of arriving at globally applicable recommendations.

Second, while we are supportive of the role that regulation can play in enhancing the availability of investor-relevant, decision-useful information, and the quality of sustainable finance products, we would caution against a wholesale rush to regulation. On the topic of ESG disclosure (for example) moving too rapidly to a mandatory reporting approach, in the absence of appropriate education of the market, may result in poor-quality reporting that simply increases costs for issuers (thereby undermining the perceived value of listing) and does not meet investor objectives.

Third, we notice the terms “ESG investment”, and “sustainable instruments” are used somewhat interchangeably and that ESG disclosure is sometimes equated with sustainable investment. While it is possible that a company that considers the impact of ESG issues on their ability to generate returns is a “sustainable” company under some definitions, in other instances (where sustainability is defined by reference to impact or activity[2]) the expectation may be that the company does more. We feel it is important to make it clear that these can be separate issues, and that each of the objectives (providing a clear definitional framework for a sustainable investment, and encouraging more effective disclosure of material ESG issues) are valid and important. Tied to this, and our first point around global applicability, we support a move towards greater harmonisation of approaches and standardisation of terminology, where possible, and believe IOSCO has an important role to play in this regard.

Finally, the scope of the recommendations must be tested against their relevance to public markets and the appropriate role of securities regulators. Any regulations should therefore be clearly tied to the objectives of protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk. It is therefore not necessarily the role of securities regulators to redirect financial flows into sustainable investments (depending on the definition) to the exclusion of other investment types. We believe the Governor of the Bank of England, Mark Carney, in his Tragedy of the Horizon speech[3], did an excellent job of explaining the relevance of climate change for prudential regulators. Securities regulators should similarly circumscribe their role in this area to avoid accusations of regulatory over-reach.

The WFE welcomes the opportunity to respond to this consultation paper. If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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[2] See our later comments on the approach of the EU to this topic.
[3] Available here: https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability

Questions relating to the (Recommendation 1)

1. **Do you agree that it is important to include a general recommendation regarding the need for issuers and other regulated entities to integrate ESG-specific issues in the overall risk appetite and governance?**

   YES - The WFE agrees that ESG-specific issues should be included by issuers and regulated entities in their investment strategies and their governance practices, to the extent that they are material. It is by now widely accepted and understood that failure to properly consider and manage ESG risks may impact on the ability of firms to generate returns, and investors to realise returns. In addition, recent WFE research on factors that drive international investor participation in emerging markets has shown that ESG factors are "*important when evaluating investment. In some instances, poor ESG performance would prevent investment*" [4] and therefore halt capital flows into markets that could otherwise develop faster.

2. **Do you have specific comments on the proposed Recommendation 1?**

   YES – Arguably this is not a standalone recommendation but forms part of a broader statement about firm governance. Thus, firms should identify and manage all relevant risks, including those stemming from ESG factors. We agree with IOSCO's point that oversight of this process is appropriately the remit of the Board of Directors.

   IOSCO may wish to include guidance around the concept of materiality. The WFE position is that when creating principles relating to listed entities or users of public markets, material issues are those that are likely to impact on the ability of the firm to generate returns and which, if they were known by an investor, would affect the assessment of the investment proposition. To the extent that there is a relevant materiality standard or guidance already in existence in a market, this is what should be applied. Where there is no such local standard, materiality guidance, such as that provided by the Global Reporting Initiative (GRI), or mapping tools, such as those provided by the Sustainability Accounting Standards Board (SASB) may be a useful reference.

Questions relating to ESG-specific disclosures and reporting, and data quality (Recommendations 2 and 3)

3. **Do you have specific comments on the proposed recommendation for ESG-specific disclosures and reporting?**

   Yes – The WFE membership welcomes global standards and guidance, and agrees that ESG-specific disclosure and reporting requirements should be a key part of global regulatory standards. Disclosure-based frameworks can contribute significantly to the mobilisation and reorientation of sustainable finance. ESG issues pose risks and opportunities in the same way as non-ESG issues and should be treated as such. We therefore agree that their disclosure should also be subject to Principle 16 and 26 of the IOSCO Principles and Methodology to ensure adequate and timely disclosure.

[4] WFE: Attracting International Investors to Emerging Markets (2018) pg 2

Exchanges, sitting as they do at the nexus between issuers and investors, already play an important role in many of the markets in which they operate in promoting effective ESG disclosure. However, experience suggests that getting to this point (where issuers are able to disclose investor-relevant, decision-useful information and investors are able to effectively incorporate this information) is a process that requires education of market participants, and the opportunity to explore how best to achieve this within the relevant firm. As just one example, the Recommendations of the Task Force on Climate-related Financial Disclosures suggests the use of scenario analysis. This may be unfamiliar to some issuers who will need to be educated on how to describe the resilience of their strategies, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Accordingly, local regulators should be cautious about introducing regulatory requirements (as opposed to, for example, issuing guidance and engaging in market education) before their markets are sufficiently developed and educated.

Another point to consider is that the use of guidance, rather than legal tools, enables a greater degree of flexibility and responsiveness. The European Commission's approach with the issuance of Non-Binding Guidelines on Non-Financial Reporting Disclosure (in the process of being updated to include climate-related disclosures) is a good example of this, as are the many disclosure guidances issued by WFE member exchanges.

4. **Do you agree that a separate recommendation on data quality is needed? Do you have specific comments on the proposed recommendation?**

YES – The WFE agrees that high-quality, investor-relevant, decision-useful and, ideally, comparable data is crucial. We would suggest (while noting previous points about different stages of market readiness, and how to address this) that what is very important in achieving data quality is encouraging reporting according to pre-existing reporting standards and frameworks. There is a great deal of work that has already been done around developing disclosure standards and metrics with the emergence of a few global standards. Rather than creating bespoke disclosures (or leaving it to individual companies to determine how they wish to disclose) regulators should encourage use of existing standards and metrics.

Incorporating disclosure in listings rules should only be undertaken when the market is sufficiently mature. In more early-stage markets, the initial focus should be on market education and disclosure guidance.

Questions relating to sustainable instruments (Recommendations 4 to 9)

5. **Do you agree that this set of recommendations should be applicable to all sustainable instruments, and not only debt instruments?**

YES – We agree that arriving at a definition for a sustainable instrument is a desirable outcome. We would suggest, however, that being able to do this requires agreement on what constitutes a sustainable activity (i.e. an instrument is sustainable to the extent that the activity that it finances is sustainable). A great deal of work has already been done on this in the debt space, in relation to defining, for example, a climate bonds taxonomy. This is linked, not to investor preference, but objective questions about whether the activity that is to be financed is positively associated or not with a transition to a low-carbon economy.

More recently, the European Commission has begun work on a taxonomy for defining environmentally sustainable economic activities with the intention of creating a more broadly applicable, objective framework that can provide a basis for standards or labels. [5]

While not in any way disagreeing with the value of moving towards definitions where possible, we wish to highlight that moving from ‘activity’ to ‘instrument’ is likely to be more straightforward for debt instruments (where the instrument is tied to a specific use of proceeds) than for equities. We also want to emphasise again the difference (potentially) between companies that, given what they do, might meet some activity-based definition of a sustainable instrument, and those that are not necessarily engaged in a sustainable activity as defined but are particularly effective at considering ESG issues in their operations, strategy etc. When developing a definition of a sustainable instrument it will be necessary to consider how to deal with all of these, as these ESG-screened companies currently form part of the landscape of ESG investments.

6. **Do you have specific comments on the proposed recommendation relating to the definition and taxonomy of sustainable instruments?**

YES – Overall, the WFE agrees that a definition of sustainable instruments is helpful to create clarity for investors and ensure that instruments that are defined as sustainable actually meet sustainability objectives. Clear definitions will empower stakeholders to make informed decisions and thus will ensure that their market power can be directed towards suitable projects. This will not only lead to greater integrity in the development of instruments but will also help establish trust in the sector.

We would suggest, however, that jurisdictions should not seek to develop entirely new definitions or taxonomies, but rely on emerging global standards, where possible. Ensuring that all sustainable instruments are subject to the same general and global recommendations prevents further fragmentation and confusion over various frameworks. This is true for both jurisdiction-specific and instrument-specific frameworks. The WFE believes that consistency and standardisation can help to scale-up sustainable finance and re-orientate financial flows towards more sustainable outcomes. We recommend therefore that IOSCO steers members to pre-existing standards and frameworks, rather than encouraging them to

5 The European Commission is focused on defining what constitutes a sustainable “activity”. See the “Explanatory Memorandum of the Proposal on Taxonomy” for more detail - COM(2018) 353 final 2018/0178 (COD), 24 May2018 - “This proposal provides the basis to establish the environmental sustainability of economic activities, rather than that of companies or assets. Therefore it does not harmonise the methodology to determine the environmental sustainability of an investment in certain companies or assets. However, the uniform criteria for environmentally sustainable activities will permit to determine the degree of environmental sustainability of a given company, for the purposes of investment. If a company performs only environmentally sustainable activities, the investment in this company is deemed environmentally sustainable. Thus, a share of this company will be an environmentally sustainable asset. Those companies that perform several activities and only some of them are environmentally sustainable, may have different degrees of environmental sustainability, that can be determined, for instance, based on the proportion of turnover that originates from sustainable activities as compared to other activities. The assets that are used to finance only the environmentally sustainable activities of the company (e.g. certain types of bonds) will be considered environmentally sustainable investments, while other assets may have a different degree of environmental sustainability. The degree of environmental sustainability can similarly be determined for investment portfolios consisting of several companies, which will incentivise investments into environmentally sustainable economic activities, without penalising or creating disincentives for investments into other economic activities.” (p. 12)

create their own. In the long run, the ideal outcome would be a move to a global taxonomy that allows for adjustments as necessary for local market specifics.

7. **Do you agree with how eligible projects have been framed in recommendation 5?**

   The WFE believes that more work needs to be done here, particularly in relation to the framework of relevant projects and activities. As noted before, while there will always be jurisdiction-specific issues (and therefore relevant projects) that will need to be captured, these should ideally be framed within the context of a global taxonomy and standard. We refer again to the work of the European Commission on developing a sustainable finance taxonomy and China's NDRC that has just released “the first nationally unified Catalogue for green industries and projects”. There are also several market-led standards which are gaining wide use and acceptance. Examples in this regard include the Climate Bonds Initiative, and ICMA’s Green and Social Bond Principles and Sustainability Bond Guidelines. We would suggest that if IOSCO wishes to facilitate the creation of a reference taxonomy, these would be useful starting points. We would suggest perhaps that rather than proposing a very rough taxonomy, IOSCO should instead refer members to existing standards, such as those highlighted above.

8. **Do you agree that it is useful to have separate recommendations for offering document requirements and for ongoing disclosure requirements, respectively? Do you have specific comments with regard to these recommendations?**

   The WFE agrees that to enable investors to assess the extent to which an instrument meets the relevant definition of sustainable finance, it is necessary to provide for disclosures both in the offer documents as well as ongoing disclosures. We do not feel strongly about whether or not these are separate recommendations as they are intertwined (see for example the listings standards of WFE members like the Luxembourg Green Exchange and the London Stock Exchange’s Green Board). However, if the intention is to highlight the importance of each of these steps (initial disclosure and ongoing disclosure) then having two separate recommendations may help to enforce this point.

   We would support the points covered in the recommendations, but it may be desirable to expand these to include a requirement for the issuer to specify which framework the issuance aligns with, and evidence of external verification (at least at point of issue) of use of proceeds, alignment etc.

9. **Do you agree that regulators should provide for measures to prevent, detect and sanction misuse of funds raised through the issuance of sustainable instruments?**

   It is not clear that this would be possible or desirable at the early stages of a market’s development. However, as the market matures, regulators may wish to introduce measures requiring external verification of use of proceeds. If it emerges that funds are not being used as claimed, then regulators may wish to consider the application of appropriate/adequate sanctions (though we would caution that these should not go beyond the remit of securities regulators to protect investors in the normal course).

10. Do you agree with the recommendation relating to external reviews? Do you think that such external reviews should be mandatory or voluntary?

YES – In general, we believe that external reviews to ensure consistency with the definition of sustainable instruments are beneficial to the system and ensure consistency with agreed guidelines. We would suggest that such reviews should be recommended upon issuance or listing of the instrument. In relation to **ongoing** external reviews of already-listed instruments, we would suggest that these should be encouraged but may have to be phased in over time, to allow for the development of the market. When considering the introduction of reviews, regulators should have regard to both the cost and the availability of external reviews.

On a technical note, we highlight that the definition of sustainable instruments is encapsulated in both Recommendation 4 and 5 and this recommendation should therefore refer to both of these.

Questions relating to institutional investors (Recommendation 10)

11. Do you agree that it is important to have a specific recommendation with regard to institutional investors?

The WFE agrees that it is important for institutional investors to consider ESG factors in their investment decision analysis and decision making (see our response to Question 1). Institutional investors are key drivers of capital flows and core elements in securities markets and it is important that they consider all factors that will impact on the performance of their portfolios. We note that this recommendation is already a requirement in some jurisdictions.

We would stress, however, that markets are at very different levels in this regard and getting institutional investors into a position where they are able to effectively incorporate material ESG issues into their investment decision-making will require market education. Introducing such a requirement, without appropriate market education, may result in a tick-box approach to compliance.

We suggest therefore that IOSCO may wish to amend the recommendation to allow for a moderated approach that takes cognisance of different levels of market development. Thus, the recommendation may read "Consistent with their fiduciary duties, institutional investors, including asset managers and asset owners, should ***be encouraged to*** incorporate ESG-specific issues into their investment analysis, …". This allows for an initial focus on education/capacity-building with the potential for a move to phase the recommendation in over time. This would allow a degree of flexibility and arguably more meaningful adoption of the core principles.

We agree that there is a specific need to educate emerging market investors about the relevance of these issues, but reiterate the point that these issues are relevant to all investors, not just those from emerging markets.[6]

[6] Successive WFE Sustainability Survey responses highlight that while there seems to be increasing investor demand for ESG disclosure, this is not always the case in emerging markets.

12. Do you agree that regulators should consider asking institutional investors to incorporate ESG-specific issues into their investment analysis, strategies and overall governance?

See our response to the question above.

13. Do you agree that regulators should ask the institutional investors to take into account ESG disclosures of the entities in which they invest?

YES – It is not possible for investors to meaningfully assess relevant ESG issues if they do not take account of the disclosures. This may be done by reference to the actual company disclosures, or through using a third party provider who performs relevant analyses on the companies.

Questions relating to capacity building (Recommendation 11)

14. Do you agree that it is important to have a specific recommendation relating to capacity building?

YES – Markets are developing fast; new instruments are constantly released and issuing companies change their strategies. The WFE agrees that constant capacity building, in the form of education and intelligence collection, is relevant to stay ahead of developments and address the issues related to the recommendations in an appropriate manner.

Capacity building (especially education) is a key factor in creating understanding and appreciation amongst all relevant stakeholders of the impact of ESG issues on the resilience and performance of financial markets, and helping to develop a market for sustainable financial instruments. As we have noted throughout our responses, achieving meaningful progress across the areas covered is not possible in the absence of appropriate capacity-building.

We encourage regulators to work with the market, through pre-existing networks of authorities/regulators/market participants (where these exist).

15. Do you also agree that this recommendation should apply both to regulators and market participants?

YES – Capacity building/education around sustainability issues must target all relevant financial market actors in order to be meaningful. This includes regulators, issuers, investors and potentially other market intermediaries. We suggest that regulators collaborate with industry to define the market requirements and to develop programmes to build the necessary capacity. Many WFE members are already doing a great deal of work in their local markets around ESG education and would be a good point of engagement. We would suggest that IOSCO also looks to undertake capacity-building with its membership at the international level.