ISLA™ INTERNATIONAL SECURITIES LENDING ASSOCIATION

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Dear Gwil Mason

Please see below responses to Questions 2 and 12 of the Discussion Paper 21/4 on Sustainability Disclosure Requirements and Investment Labels, on behalf of the International Securities Lending Association (ISLA), which represents the common interests of securities lending and financing market participants across Europe, Middle East, and Africa, with a geographically diverse membership of over 170 firms that includes institutional investors, asset managers, custodial banks, prime brokers, and service providers.
ISLA would like to note that with regards to question 12, we endorse the responses of both the International Swaps and Derivatives Association (ISDA) and the Alternative Investment Management Association (AIMA) for their respective comments on sustainable investing for derivatives and short selling. ISLA remain at your disposal should you wish to discuss any of the below in further detail.

Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.

ISLA support the approach outlined in 2.6 of the discussion paper, to align the scope of firms that will abide by the proposed entity- and product-level disclosure requirements, with the same scope of the Global TCFD disclosure requirements, i.e., they would be applicable to 'Asset Managers, Asset Owners, including public- and private-sector pension plans, endowments, and foundations.' ISLA believe that it is important to try, where possible, to maintain alignment with other global Initiatives such as the TCFD disclosure recommendations and avoid creating diverging regional disclosures that would increase the operational burden to firms.

When it comes to labels, ISLA agree with the FCA's approach as outlined in 3.10 of the discussion paper, to develop a classification system that covers a full range of investment products available to retail consumers, in order to help them form a view of the sustainability characteristics of their entire investment portfolio and not just limited to products that make sustainability claims or are marketed as being sustainable. However, there should be a distinction made between investment funds, that make sustainability claims of their direct investments to attract retail investors, and investment 'tools' such as lending and short selling, whose purpose it is to assist investment managers with their investment strategies, as securities lending activity is not categorised as a 'direct investment'.

ISLA support the classification system outlined in Figure 3 of the discussion paper, so long as each category is supported by clear definitions and criteria, and a distinction made between direct investments and

investment tools. ISLA would also recommend sub-categorisation to differentiate between investment tools that consider sustainability and others that do not.

It is not clear whether products, such as securities lending, that can facilitate sustainability objectives of the investor/asset owner but is not marketed as a sustainable product and cannot contribute to a sustainable outcome in itself, should be categorised in a different manner.

Securities Lending, although available to retail investors, is normally conducted between institutional investors or beneficial owners, Agent Lenders and Broker Dealers. Securities Lending, if considered as a labelled product under the FCA's proposal, would fall into the first category, as outlined in Figure 3 – '*Not Promoted as sustainable*'. However, it is important to remember that the activity of securities lending, can still consider sustainability factors and therefore, it is fair to say, that you can integrate sustainability considerations into the category 'Not promoted as Sustainable'. ISLA feel it would be necessary for this to be reviewed, when defining the criteria for this particular category.

In contrast, it is ISLA's interpretation that securities lending (as a product) has been de-scoped from the EU's Sustainable Finance Disclosure Regulation (SFDR) No. 2019/2088 for example, as it is limited to apply to *'financial market participants'*, which for the purposes of the regulation, are defined as;

1(b) an investment firm which provides portfolio management….

1(j) a credit institution which provides portfolio management.

'Portfolio Management' is as defined in point (8) of Article 4(1) of Directive 2014/65/EU; (MiFID)

(8) 'portfolio management' means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments;

Under the Markets in Financial Instruments Directive, it is ISLA's interpretation that Securities Lending activity is not defined as 'portfolio management' and therefore, it does also not directly fall within the immediate scope of the SFDR requirements.

ISLA would welcome guidance from the FCA on the treatment of products that are not considered sustainable and do not 'promote' sustainability characteristics, but can incorporate sustainability factors, such as securities lending.

In the absence of regulatory guidance on the classification of these types of products, investors are increasingly discussing whether they should engage in securities lending altogether, as it could be deemed as a product that is not compatible with a responsible investment objective, if not classified/ labelled at all, and this could be detrimental to the smooth functioning of capital markets, potentially impacting liquidity.

In summary, ISLA would like the regulator to acknowledge that there are some products, such as securities lending, that do not fall within the traditional 5 classifications, as outlined in Figure 3. However, ISLA would like to seek guidance on how businesses, that engage in this activity, can convey their incorporation of sustainability factors.

See further explanation in response to Question 12.

Q12: What do you consider the role of derivatives, short-selling, and securities lending to be in sustainable investing? Please explain your views.

ISLA believe that securities lending plays a fundamental role in today's global capital markets and has long been used as a means of meeting settlement and collateral requirements, as well as providing vital liquidity and efficiency to secondary markets. It also helps to promote price discovery, as well as facilitate important

hedging and investment strategies, such as short selling. In fact, many central banks across the globe use securities lending as part of their implementation of monetary policy.

Securities lending is also used as a valuable tool in the mobilisation of collateral, including High Quality Liquid Assets (HQLA), within the financial ecosystem. The efficient mobilisation of collateral is important, not only in the context of the smooth running of traditionally collateralised markets such as securities lending and repo, but collateral increasingly underpins many derivatives markets.

ISLA believe that securities lending as a product, should not be considered comparable to short selling and derivatives in the context of ESG. The use of derivatives and short selling as an investment strategy that can achieve a sustainable outcome, for example, short selling to create an economic impact to influence the nature of capital flows towards a sustainable outcome, or trading a sustainability-linked derivative, should not be considered in the same light as securities lending, which is considered to be an ancillary service.

ISLA believe that securities lending can instead act as a capital facilitator that will be required for the transition to net zero and other sustainability objectives.

When looking at integrating sustainability factors into securities lending, investors and asset owners consider three core areas must be addressed:

1) **Stewardship and Voting**
2) **Transparency**
3) **Collateral**

In November 2021, the newly formed Global Alliance of Securities Lending Associations (GASLA), that includes founding members; International Securities Lending Association and sister associations across the globe in Asia, Canada, North America and South Africa, jointly published a Voting Best Practice Guide. This guide explains the significance of shareholder engagement and advocates that the decision to exercise ones right to vote, is an important way for active investors to influence corporate behaviour on ESG and sustainability issues.

ISLA reference our support for the Bank of England's Money Market Code that stipulates 'It is accepted good practice in the market that securities should not be borrowed solely for the purpose of exercising the voting rights'.

ISLA acknowledge that the role of voting to drive long-term considerations is evolving. In the short-term securities lending agreements and internal governance processes can be adapted to ensure that, where necessary, securities can be recalled for key shareholder meetings. Where those lenders need to vote, there should be sufficient time for all parties in the chain to accommodate the request. This is also relevant in the context of transparency.

It is important for investors to understand that when their securities are lent, they have the right to recall for voting purposes. The GASLA guide states *'when conducting a thorough assessment, lenders should consider whether the voting outcome would result in financial or non-financial impact which is material to the lender, as defined in the lenders stewardship and engagement policy. Lenders may choose not to recall securities for voting purposes, in respect of corporate events that are not considered by the lender to have material economic consequence, as defined by their policy. Alternatively, lenders may, depending on their ESG strategy, choose to recall securities due to an ESG-related vote, which is material under their policy, irrespective of potential lending revenue.'* In summary, a lenders ability to fulfil their stewardship responsibilities over their underlying investments, should not be impeded by their participation in securities lending.

Another issue to consider is the purpose for which securities are borrowed where the borrowing of

shares to vote is undertaken purely for short-termist or non-ESG aligned strategies. However, this can be mitigated through regulation and guidance. For example, as stated above, this behaviour would violate the UK Money Markets Code, that's enforceable under the FCA's Senior Mangers Regime. The EU's Shareholders Rights Directive II (SRD II), implemented in the UK through various existing regulations, which gives an issuer the right to identify its shareholders at a given time, as well as the reporting to regulators of securities lending positions, under the Securities Financing Transaction Regulation (SFTR) which provides a great level of transparency of securities lending activity.

In addition to the above, collateral management is another topic that often arises when investors and asset owners consider the integration of sustainability factors into the securities lending chain. They have, to date, been mandated through the EU's SFDR to implement policies to their direct investments. However, in the absence of regulatory guidance around products such as securities lending, there remains a lack of clarity and consistency on the extent to which ESG policies should apply to collateral.

It has been common practice for some asset managers to apply negative exclusions to their acceptable collateral guidelines, in relation to certain types of industry sectors, such as fossil fuels and tobacco, whilst others apply threshold acceptable limits to various sectors. Given the current lack of regulatory certainty on treatment of collateral under ESG-related regulations globally, asset managers are increasingly taking a risk-based approach to align their eligible collateral guidelines with the ESG parameters in respect of their long holdings, which can be problematic.

ISLA seeks clarity from the FCA on whether collateral, as a risk management tool, should integrate the same level of ESG screening as the long portfolio of the fund or, alternatively, whether eligible collateral guidelines should intentionally constitute broader and more liquid parameters, in order to effectively manage risk. Whilst it is recognised that all fund assets must embed ESG criteria, it should be noted that collateral does not form part of the funds' assets, to the full extent of the portfolio assets. Equally, it is recognised that, irrespective of whether the fund's long portfolio ESG policies are applied to collateral, it will nevertheless be essential to embed sustainability into the acceptability framework for collateral, as a matter of good risk management, under emerging prudential requirements, for example embedding the financial risks of climate change, in line with the ECB climate guidelines and PRA guidelines (with similar requirements evolving globally).

By adopting a broader acceptable collateral schedule, lenders are able to effectively diversify their risk. If lenders were to limit acceptable collateral to the parameters of their long holdings, this could have an adverse impact(s) on their ability to manage risk, as collateral would be less diversified, and liquidity could be impacted.

In summary, for collateral to continue to serve as an effective risk management tool for the market, the risk analysis for collateral acceptability must consider all relevant risks, which should include sustainability/ESG risks but, at the same time, collateral guidelines should also be adequately diversified with a key aim of properly mitigating credit risk and also ensure collateral is liquid and can be realised in the event of default, thereby providing the lender with effective protection against counterparty exposure.

Narrowing of collateral schedules will reduce diversification of risk, will negatively impact the risk mitigation which collateral is intended to provide, and will have negative impacts to secondary market liquidity. Ultimately a liquid secondary market is crucial for overall market stability and the issuance of ESG securities in the primary market. Unintended consequences could include:

1) The risk of stranded assets at an accelerated pace, leading to credit issues and potential corporate defaults and market disruption and
2) Disrupting an orderly transition process to a sustainable economy, through engagement, before well-balanced decisions on divestment are evaluated and
3) Creating a lack of liquidity of collateral in the market, at a time when collateral velocity is crucial.

ISLA would welcome the FCA's guidance, to assist investors and asset owners, in setting pragmatic best practices to lend their securities whilst achieving appropriate standards of ESG integration. Lenders can engage in securities lending to generate additional alpha, to cover their operational costs and provide incremental revenue to long term investors, such as pensioners.

As is currently recognised by regulators that securities lending is an important investment tool in the capital markets infrastructure, essential for liquidity, market integrity and efficient markets, necessary to support the vital sustainable finance agenda and, in particular, to scale the vast climate finance needs to achieve the ambitions of the Paris Treaty.

With regards to the EU's SFDR, the ESA's published guidance earlier in 2021 concerning Article 8 & 9 products, in which they stated: *'A financial product, in order to meet requirements in accordance with prudential, product-related sector specific rules may, next to 'sustainable investments'*, **also include investments for certain specific purposes such as hedging or liquidity** which, in order to fit the overall financial product's sustainable investments' objective, have to meet minimum environmental or social safeguards, i.e. investments or techniques for specific purposes must be in line with the sustainable investment objective.'

ISLA was encouraged by the fact that EU supervisors have acknowledged the need for other investments to be used for 'liquidity and hedging purposes', alongside investments with sustainable objectives, although the guidance from the ESA's is still unclear. ISLA would welcome similar guidance from the FCA, that the securities lending product can be treated as an investment tool for liquidity and hedging purposes and not a sustainable investment in its own right. It can however, successfully integrate the sustainability preferences of an investor/ asset owner.

Extracts taken from ISLA and Allen & Overy Whitepaper – Framing Securities Lending for the Sustainability Era

Yours Sincerely

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