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Sustainable Finance Unit

Climate and Energy Division

The Treasury

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Via email: SustainableFinanceConsultation@treasury.gov.au

Sustainable Finance Strategy

Zenith Investment Partners (Zenith) welcomes Treasury's consultation paper regarding Australia's Sustainable Finance Strategy. Zenith is broadly supportive of Treasury's proposals outlined in this paper as well as the proposals made in Treasury's Climate-related financial disclosure consultations.

We believe Treasury's proposals will help provide a strong foundation for sustainable finance in Australia and align capital markets with emerging international standards. We also look forward to working with the government and the Australian Accounting Standards Board (AASB) on the draft legislation and standards being proposed in the Australian Sustainability Report Standards (ASRS).

Please note that Zenith seeks to raise several issues in relation to not just this consultation, but also proposals made in Treasury's Climate-related financial disclosure consultations and the AASB Sustainability Reporting Exposure Draft (ED SR1), which we believe are important to recognise in the broader context. Please note we have not sought to submit answers to all questions in the consultation.

Key points in our submission are as follows:

- To support the investment management industry in making climate disclosures, we believe the implementation of threshold rules for Managed Investments Schemes under the proposed ASRS should be reviewed to maximise effectiveness and efficiency.
- Critical to sustainable investment product labelling is separating investment process from product outcomes. Consideration should also be given to the interaction between preventing greenwashing, fund disclosures, fund naming and the scope for 'investment products' captured.
- We believe additional guidance regarding 'sustainability' claims would be useful. We understand that there is a fine line between broad directives that fail to instil a sense of urgency or lack robustness versus too prescriptive an approach that handcuffs utility.
- Priorities in addressing greenwashing should consider more specific guidance to provide heightened focus. We believe implementing key aspects from other local and international approaches may be helpful.

- We support regulating ESG ratings as financial services. There should however be recognition that issues such as internally derived programs should remain out of scope, and that licensing exemptions for foreign financial services providers may also be a consideration.
- There are several issues relating to data and analytical challenges as well as ensuring fit for purpose regulatory frameworks we believe may require additional review. This particularly relates to the potential mis-match of data availability between large and small entities.

Priority 1: Establish a framework for sustainability-related financial disclosures

Q1. What are the opportunities for Government, regulators and industry to support companies to develop the required skills, resources and capabilities to make climate disclosures under the proposed new obligations?

Opportunities

Zenith believes that broadly, focus should be given to driving education across market constituents about the proposed changes, the context by which these changes are important and how to determine what's material.

We note the development of the government's Net Zero Economy Agency to manage Australia's net zero transition. In particular, we note the intention to [emphasis added]:

- *<u>Help investors and companies engage</u> with net zero transformation opportunities.*
- *<u>Coordinate programs and policies across government</u> to support regions and communities to attract and take advantage of new clean energy industries and set those industries up for success.*
- *<u>Support workers</u> in emissions-intensive sectors <u>to access new employment, skills</u> and support as the net zero transformation continues.*

In order to support the industry to implement climate disclosures, a similar approach will be needed. Programs to accelerate knowledge transfer between market participants, coordination of policies to increase efficiency and support to develop skills will all be essential. Programs to accelerate knowledge to bridge the gaps between sustainability practitioners and the finance and accounting industry will be critical, especially given the audit requirements.

Challenges

We also believe a necessary element will be greater clarity to some areas of the market. While the issues are largely well articulated for companies, there are a number of issues that remain unclear or insufficiently addressed for asset managers, issues which we believe hamper the markets ability to develop the required skills, resources and capabilities to make climate disclosures.

We agree that climate disclosure reporting should be standardised across the proposed entities required to report under ASRS, those under Chapter 2M of the Corporations Act, including private and public companies as well as Managed Investment Schemes (MIS). However, we believe that standardisation in the proposed threshold tests across all entities runs the risk of leading to unintended consequences.

Under ED SR1 (and noted in earlier Treasury consultations), entities under ASRS need to fulfill two of three thresholds, relating to employee numbers, value of consolidated gross assets and amount of consolidated revenue. As a MIS does not have employees, the test relies on asset and revenue thresholds only.

Using 'revenue' for MISs is problematic. Due to a combination of differences in accounting policies between companies and MISs as well as the fact that most schemes exhibit high variability in annual 'income' depending on their asset class, market movements and strategy, standardisation of this threshold is in our view, impractical. We believe using gross consolidated assets as a single threshold for MISs is probably more appropriate for these entities as a more consistent measure. We also believe consideration should be given to 'buffer rules' to ensure the volatility in gross assets because of market performance and fund flows limits whipsaw in MISs falling in and out of scope year on year for ASRS reporting purposes. A buffer rule might be using a two or three years 'average assets' figure. Alternatively, a 'window' could be used where once a MIS is in scope, it has to report for at least two to three years even if its assets have fallen below the minimum threshold before falling out of scope completely.

It is important that the regulatory settings for all entities achieves the right balance of transparency and efficiency. We believe additional consultation with the asset management industry is warranted to ensure maximum utility for both users and producers of climate disclosures.

Q2. How should the Government, regulators and industry prepare for global developments in sustainability-related financial disclosure frameworks and standards, including the TNFD?

While global disclosures have increased harmonisation in recent years, continuing evolution is also continuing to create regional regulatory gaps. For example, the International Sustainability Standards Board (ISSB) on which ASRS is largely based, only accounts for the impact of climate change on an entity's financials i.e. 'single materiality'. Conversely, the European Sustainability Reporting Standards (ESRS) considers 'double materiality', i.e. it includes the impact of climate change on an entity's financials as well as the impact that the entity has on the environment and society.

Given globalisation, regulators can't lose sight of the implications of jurisdictional incompatibly in regulations, let alone the implications as other issues such as TNFD are added. While much of the industry is aware of the implications of global developments, anecdotal evidence suggests that materials gaps remain, especially outside Group 1 & 2 entities under ED SR1.

Priority 4: Develop a labelling system for investment products marketed as sustainable

Q3. What should be the key considerations for the design of a sustainable investment product labelling regime?

We note Treasury's use of the phrase "products labelled as 'green', 'sustainable', 'ESG' or similar". One of the major problem facing the industry globally is a general lack of standard consensus, definitions, and sophistication, which combined with a lack of inoperability, is materially holding back progress.

A primary consideration should be the separation between the underlying concepts. As ESG and sustainability have no universal meaning, we find it easier to consider in the context of single and double materiality (see Question 2 above).

For example, is a fund only considering the external impacts of issues on a company's financials, or are they considering the impact that company has on the environment and society? Another way to consider this question: Is a fund considering and integrating 'ESG' factors along with other non-ESG factors in their investment decisions as part of the investment process only? Or is the fund seeking to achieve specific 'ESG' or 'sustainability' aligned outcomes or impacts as part of the product's design?

While these two outcomes form part of a spectrum, they tend to underpin development of fund labelling/disclosure regimes in other jurisdictions such as the US, UK, EU and others. We believe demarcation between investment process versus product is integral to a workable system. Increasingly, global regulations are recognising integrating ESG into an investment process is not 'sustainability' and marking products accordingly, an approach we believe to be instructive. For example, in the UK, FCA Policy Statement PS23/16 on Sustainability Disclosure Requirements (SDR) notes a key feature of their proposed labelling regime are that sustainable labels are for products seeking to achieve positive sustainability outcomes only, products using strategies such as ESG integration or basic ESG tilts alone would not qualify.

Critical to developing an effective regime will be recognising that there are different sustainability objectives and different investment approaches to achieve them. They should also cater for the fact that depending on the asset class and strategy, some strategies may seek to invest only in sustainable companies, others may seek to support companies focussed on improving their sustainability. Actual outcomes may also be direct or indirect. Regardless of approach however, there also needs to be a focus on intentionality. Funds seeking to claim sustainability objectives should have those objectives clearly linked to in investment policies and disclosures.

Also, consideration needs to be given to threshold levels i.e. what proportion of the product's assets must be invested in accordance with its sustainability objective, e.g. 70%. Observed thresholds across jurisdictions appear to vary from 66% to 80%.

Developing an effective labelling regime will also rely on finalising other critical programs, including delivery of a Sustainable Finance Taxonomy and guidelines on credible transition plans. Given the timeframes involved in finalisation of these programs, a provisional approach to product labelling may be required.

Operability of labels also needs to be assessed across the intersection of different asset classes, strategies, responsible investment strategies (i.e. positive and negative screening, active ownership, impact investing etc) and implementation methodologies. Actively managed fundamental strategies may have different issues to combat versus index tracking strategies. Lack of standardisation in defining responsible investment strategies is also a hinderance, although we note the launch in November 2023 of 'Definitions for responsible investment approaches' from CFA, PRI and the Global Sustainable Investment Alliance. The authors have indicated they encourage the global industry and regulators to adopt these definitions, particularly for developing labelling and disclosure standards to reduce confusion and provide greater clarity, consistency, and certainty.

Care needs to be taken that the pursuit of a meaningful and challenging 'sustainable' fund label does not result in one which is too prescriptive, resulting in too few funds being able to achieve it. A successful outcome will be one which is challenging yet achievable, comprehensive and yet clear to end investors. Consideration also needs to be given as to how such labels will interact or operate in the context of:

- Greenwashing – how will funds articulate their own specific approach against a broader label?
- Disclosure – where would labels be placed and how often should they be reviewed?
- Fund naming conventions – will labels prohibit use of some terms on fund names?
- Scope – how will 'investment products' be defined? Will it align with ASRS?

Pillar 2: Financial system capabilities

Priority 5: Enhancing market supervision and enforcement

Q4. Are Australia's existing corporations and financial services laws sufficiently flexible to address greenwashing? What are the priorities for addressing greenwashing?

Rather than creating specific anti-greenwash rules, ASIC currently points to existing legislation prohibiting statements, information or conduct that is false, misleading or deceptive in relation to a financial product or service.

We believe this is broadly consistent with approaches already being made in the EU, UK and US, although we note that other jurisdictions can be more proscriptive.

While broadly supportive of ASICs approach and recognising the high level of flexibility and broad utility, we believe additional guidance regarding sustainable claims would be useful. We understand that there is a fine line between broad directives that fail to instil a sense of urgency or lack robustness versus too prescriptive an approach that handcuffs utility.

While recognising the value of ASIC Information Note 271 'How to avoid greenwashing when offering or promoting sustainability-related products', we believe that more specific guidance such those proposed by the Australian Competition and Consumer Commission (ACCC), the UK Green Claims Code, the UK Anti-Greenwashing Rule and the EU Directive on Green Claims, may provide additional focus. While recognising that some of the following are touched on by INFO 271, major points from these publications can be summarised as:

- Claims must be truthful, accurate and substantiated by evidence
- Broad claims should be avoided and conditions or qualifications must be explained
- Claims must be clear and unambiguous, in easy to understand language
- Visual elements in promotions should not give a false impression
- Claims must not omit or hide important relevant information
- Comparisons must be fair and meaningful

We do note locally that the result of the ACCC guidelines and the inquiry into greenwash by the Senate may result in additional guidance and/or legalisation. We also note ASICs recent announcements that future areas of interest in pursuing greenwash are likely to include use of terms such as ‘carbon neutral’, ‘clean’ or ‘green’. We feel there is merit in scrutinising approaches in other jurisdictions which look to ban use of similar terms under certain circumstances, a move we believe has merit here.

Zenith believes that fund labelling remains a problematic issue. While we recognise that ASIC have recently made a review of the MIS sector and acted on some MIS issuers, we believe more work is required. We also recognise that implementation of a ‘sustainable labelling’ system for products, as noted in this consultation, is required before greater proscription becomes more practical on these aspects of greenwashing. Consideration as to how approaches to controlling greenwashing interact with sustainability labelling (as noted in Question 3) will be a key issue.

Q5. Is there a case for regulating ESG ratings as financial services?

We believe so. It is currently a requirement for Credit Ratings Agencies (CRAs) and Research Houses to hold an Australian Financial Services License (AFSL). Given the reliance of investors, corporates and other market players on ESG ratings and data, we believe it appropriate to include providers of ESG ratings under licencing requirements.

We note that in November 2021, the International Organization of Security Commissions (IOSCO), in its final report on ESG Ratings and Data Product Providers, set out 10 recommendations across key areas regarding transparency, governance, systems and controls, and management of conflicts of interest. Following the IOSCO report, several jurisdictions have engaged in developing codes of conduct and/or legislative proposals addressing the recommendations.

We feel consideration should be given to the application of such regulation. We note that in the EU, draft legislation is being considered regarding the transparency and integrity of ESG rating activities. We believe it notable that amongst other issues, the EU legislation would not apply to:

- private ESG ratings which are not intended for public disclosure or for distribution;
- ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in house financial services products;
- the provision of raw ESG data that does not contain an element of rating or scoring and that is not subject to any modelling or analysis resulting in the development of an ESG rating;
- ESG ratings from an authorised ESG rating provider that are made available to users by a third party.

We believe that in order to balance the need to instil greater transparency and management of conflict of interests against pragmatism against capturing too many usage cases unnecessarily, the EU’s draft proposals may be instructive.

Finally, we note Treasury’s industry consultations regarding ‘Licensing exemptions for foreign financial services providers’, particularly on “comparable regulator exemptions”. Given many of the large ESG ratings and data companies operate globally, this may also be a consideration.

Priority 7: Addressing data and analytical challenges

Q6. What are the priorities for ensuring that data-related initiatives already underway are tailored to meet the needs of firms and investors?

While mandating data disclosure (i.e. GHG emissions) in a phased approach is logical, it creates unintended consequences. Under the proposed ASRS, entities will be divided into three 'Groups' based on size and scale. However, for large asset managers, this creates a problem. For example, a large Group 1 entity required to report Scope 3 emissions from FY26 may have considerable holdings in Group 2 entities (reporting from FY28) or Group 3 entities (reporting from FY29). This creates challenges in data availability and integrity which must be considered.

Zenith believes that where MIS issuers find structural data gaps challenging under these circumstances, mandating a 'comply or explain' disclosure may be appropriate, where issuers explain any limitations in their ability to disclose in accordance with the ASRS and their plans and timeline for addressing those limitations.

Priority 8: Ensuring fit for purpose regulatory frameworks

Q7. Do you agree that existing regulatory and governance frameworks and practices have adapted well to support better integration of sustainability-related issues in financial decision making? Are there barriers or challenges that require further consideration? This may include:

- **Corporate governance obligations, including directors' duties**
- **Prudential frameworks and oversight, including in relation to banks and insurers**
- **Regulation of the superannuation system and managed investment schemes**

Location of disclosures

It needs to be recognised that while the needs of companies and investors are inter-connected, the landscape and its requirements are highly nuanced. While standardisation of disclosures across entities under ASRS is desirable, where those disclosures are made needs consideration.

The most pertinent and commonly used source of information for retail investors in a company is the annual/semi-annual reports, along with market announcements for listed entities. However, this is not the case for MISs. For example, annual reports are rarely considered in investment decisions as they often do not contain the most relevant information for investors on a funds aims, strategy of performance. In addition, they are often not easily available to the average investor.

Simply moving the disclosure mandate to an entity's offer documents (Prospectuses, PDSs etc) is also unhelpful as company prospectuses can be decades old and MIS PDSs would require either annual rolling or Supplementary PDSs to be issued. This would also raise the question of forward-looking statements in offer documents which could be challenging.

We suggest that additional consideration be given to the nuances between companies and investment vehicles regarding the most effective location for climate disclosures for the investment community.

Reporting for MISs

As per our response to Question 1 in this document, we take the view that use of a 'revenue' threshold for MISs as a measure determining inclusion under ASRS reporting is problematic as most MISs exhibit high variability in annual income, potentially resulting in ineffective scope capture. We believe using a single assets-based threshold test will have greater utility.

Registered vs Unregistered Schemes

We note that ED SR1 currently appears to capture registered, but not unregistered MIS (which are not required to report under Chapter 2M of the Corporations Act). Zenith believes this could create untended consequences via regulatory arbitrage, in some schemes, particularly in unlisted investments involving heavy emitting assets. While recognising that some unregistered MIS may exist for structural reasons such as feeders or interposed funds, the amount of capital directed by unregistered is considerable, estimated at approximately $0.9 trillion (ASIC 2022).

Zenith believes consideration should be given as to whether unregistered schemes would undertake ASRS reporting, although the location of any such reporting may differ as inclusion in annual reports may not be appropriate.

Managed Accounts

We also note that other issues such as the treatment of managed accounts under ASRS remains unclear. As per our response to Question 6 in this document, the phased approach may challenge large managed accounts who must report earlier but who themselves may have material exposure to investments who report later, creating data challenges.

We also highlight that Managed Accounts may hold exposure to a number of individual model managers. While the managed account in itself may be quite large (i.e. Group 1 under ASRS timeline for reporting), the size of the portfolios provided by the individual model managers to the managed account provider may be quite small. This also potentially creates data challenges in meeting GHG emissions reporting.

Q8. What are the key priorities for Australia when considering international alignment in sustainable finance?

Broadly, we believe there needs to be recognition of the fine balance between harmonisation and localisation. Interoperability is a crucial principle for issues like taxonomy development. It ensures that taxonomies can align with other global taxonomies, facilitating cross-border sustainable investment flows. Finding the right balance between harmonisation and localisation is a key challenge.

Any queries or comments in relation to the content of our submission can be directed to the undersigned.

Sincerely,

Dugald Higgins

Head of Responsible Investment & Sustainability

Zenith Investment Partners

Zenith Investment Partners is one of Australia's most respected research and investment consultancies, with a 20-year track record of delivering premium investment research, fund ratings and investment portfolio solutions for financial advisers. Commencing as a high conviction fund research and ratings business in 2002, today we support a rapidly growing number of advisers nationally with research ratings on over 900 investment products, and the management of more than 100 investment portfolio solutions for their clients. The broader Zenith Group was acquired by global fund data and technology leader, FE fundinfo, at the end of 2021. Our international reach provides us with access to an extensive network of investment specialists and empowers us with unique data and insights from across the globe to better inform and empower our clients.