B Lab Response to the Questionnaire by the EU High Level Expert Group on Sustainable Finance

Written evidence submitted *by B Lab Europe and B Lab UK, on behalf of the B Lab group of related organizations, which include Sistema B (South America), B Lab Inc. (US), B Lab Australia and New Zealand and B Lab East Africa*

The High Level Expert Group on Sustainable Finance was established up in January 2017 to develop an EU strategy on Sustainable Finance. The questionnaire below was prepared by and under the responsibility of the High-Level Group in relation to their Interim Report, published in July 2017 and presented at a stakeholder event on 18 July 2017. The questionnaire is aimed at gathering targeted feedback on the analysis and reflections in the interim report of the High-Level Expert Group and informing the preparation of the final report.

The answers below reflect the position on the related group of B Lab entities operating around the world, including B Lab Europe and B Lab UK. We have omitted the questions that were not applicable to B Lab's operations.

Questions with respect to these responses should be directed to Rick@bcorporation.net

Question 1. From your constituency point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors)

Fiduciaries and intermediaries through the investing chain (including asset owners, managers, advisors and directors) must manage economic, social and environmental systems, not just individual firms. Companies managed for the primary purpose of creating value for their shareholders (or other specified stakeholders, such as workers or customers) have reason to externalise significant costs to other stakeholders. Over the long-term, such behavior undermines growth and stability, creating risks for the value of all investments. Current legal structures and market norms do not create accountability for this externalization. As the Interim Report notes, "The persistence of external environmental and social costs that are not reflected in market prices and valuations means that sustainability is often not considered to be material now."

Modern Portfolio Theory reinforces this dynamic by encouraging fiduciaries and intermediaries to seek a return that compares favorably with the return of comparable assets or asset classes, *while assuming that market performance as a whole is endogenous to investor activity*. This assumption is a chief cause of the financial system's failure to create a sustainable economy. In fact, economic activity that is driven by pursuit of short term gains, or gains made through externalizing social and environmental costs, has a potentially catastrophic effect on long-term market performance, as well as on essential environmental and social systems.

Develop a classification system for sustainable assets and financial products

Question 2. What do you think such an EU taxonomy for sustainable assets and financial products should include?

We are neutral with respect to particular taxonomies. However any such taxonomy should be broadly applicable to all businesses. The financial system should ultimately ensure that *all* businesses and financial system participants account for their actual costs, including those that are borne by others, whether in the short-term or in the long-term.

Only such broad applicability can address the dual imperatives for sustainability identified in the Interim Report. Broad applicability assures that financial decision making incorporates ESG factors system-wide, so that all businesses account for their true costs. In addition, broad applicability reduces the temptation for asset owners and managers to make capital allocation decisions that ignore sustainability while freeriding on the ESG discipline of other market participants. Reducing this temptation encourages capital to flow to investments that create positive social and environmental impacts.

As we discuss in our answer to Question 6, we believe that the EU can create a path to sustainability across the economy by creating a widely available and easily identifiable corporate structure that mandates (1) a sustainable purpose, (2) accountability for all impacts and (3) transparency with respect to such impacts. Italy has adopted such a model: the Societa Benefit, which is modeled on the Benefit Corporation form adopted in most US jurisdictions.

Establish a European standard and label for green bonds and other sustainable assets

Question 3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high-quality standards and labels that avoid misuse/green-washing?

We believe that corporate form matters, and that any system rating sustainable assets should distinguish between corporate forms that accommodate the view that the primary purpose of a corporation is to provide a return to investors, and those that create entities that are accountable for their impacts on all stakeholders, including impacts on society and the environment. Entities that follow a stakeholder model of governance are more likely to continue green practices in changed circumstances, including changes in ownership and management.

Create "Sustainable Infrastructure Europe" to channel finance into sustainable projects

Question 4. What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

N/A

The report also touches upon areas for further analysis. The following questions focus on a selection of these, which the group would appreciate your feedback on:

Mismatched time horizons and short-termism versus long-term orientation

Question 5. It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

Yes.

Question 5.1. If you agree with this statement, which sectors of the economy and financial system are particularly affected by the 'mismatch of time horizons'? What are possible measures to resolve or attenuate this conflict?

The mismatch depends less on industry and more on the influence of capital. Equity capital is often managed to increase the return by externalizing costs to third parties or future generations. Thus, companies that contribute to environmental degradation in order to increase profit are likely to create negative effects on the long term-value of securities across the market. *See* Intergovernmental Panel on Climate Change, IPCC, 2014: Climate Change 2014: Synthesis Report 64 (2015) (emissions lead to "mostly negative impacts for biodiversity, ecosystem services and economic development and amplify risks for livelihoods and for food and human security."). Similarly, decisions at financial firms prior to the 2008 market break led to the destruction of US$ trillions in stock market value. *See* Int'l Monetary Fund, Global Financial Stability Report—Risk Taking, Liquidity and Shadow Banking: Curbing Excess While Promoting Growth 105 (2014) ("broad consensus that excessive risk taking by banks contributed to [the crisis].").

These challenges can be overcome if equity owners and their representatives, and corporations themselves, invest with an intention to create long term-value throughout the economic system, and account for the true cost of their operations, including externalised costs. Two important measures to address this conflict are (1) clarification that fiduciaries must account for true costs and (2) providing corporate governance tools that facilitate such accountability.

Governance of the investment and analyst community

Question 6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

The Interim Report's recommendation to clarify "that fiduciary duties encompasses sustainability" provides an opportunity to realign the investment and intermediary community fundamentally. Under current law, investment fiduciaries can, and perhaps must, take ESG factors into account. Nevertheless, clarity, especially as to fiduciary responsibility for social, economic and environmental systems, would engender holistic thinking on the by fiduciaries with respect to both purchase and sale decisions, and also with respect to voting and engagement.

More critically perhaps, the EU should provide a tool that allowed all market participants to agree to a sustainable business model at the real economy level by making available a corporate governance structure that establishes (1) a sustainability-infused purpose, (2) accountability at the director level for all stakeholders and (3) ESG transparency.

The Benefit Corporation model adopted in the United States and Italy, and under consideration in a number of other jurisdictions, provides such a tool. An EU directive requiring the availability of such a form would provide a strong scaffolding upon which to build a sustainable economy.

A strong pipeline of sustainable projects for investment

Question 7. How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

The creation of a Benefit Corporation model in member states will add to the viability of sustainable investments. By their nature, Benefit Corporations are designed to create long-term and enduring value, rather than enabling financial system extraction of value from the economy.

Social dimensions

Question 11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

We have no opinion on individual prioritization of positive impact, but we do believe that it is critical to avoid the externalization of costs discussed in our answer to Question 1. Accordingly, investment fiduciaries and companies should prioritise systems and markets, as highlighted in a report co-authored by the UN Global Compact, the UNEP Financial Initiative and PRI:

> Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of ESG factors, *and of the long-term health and stability of the market as a whole.*

United Nations Global Compact et al., Fiduciary Duty in the 21st Century 3 (2015) (emphasis added). The report also notes the link that fiduciaries should draw between ESG performance and their effect on their ultimate beneficiaries:

> Wider social, economic and environmental issues . . . have the potential to seriously affect the investor's ability to deliver on its organisational or investment objectives but that may have limited financial impact within the relevant time period. For example, *these could be issues that affect the stability and health of economic and environmental systems*, or they could be issues that are, or have the potential to be, important to beneficiaries or other stakeholders.

Id. at 19 (emphasis added).

Other

Question 12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

Market forces and legal regimes across the EU permit, and often encourage, companies to operate myopically, seeking to maximise the return they provide to shareholders without focusing on the burden their operations place on society, the environment or future generations.

Creating corporate forms, such as the Benefit Corporation described in our answer to Question 6, would give all participants in the EU economy a tool with which to counter the forces that promote such "shareholder primacy." If each member state had a readily recognizable form of corporation that was sustainable by design, and that provided mechanisms for transparency and accountability, many entrepreneurs and investors would choose it, because it would be consonant with their own desires.

This voluntary process could lead to a virtuous cycle, where workers, customers and communities favour such entities because of their dedication to building shared value. This movement would push more companies to adopt Benefit Corporation governance in order to remain competitive in the labour, capital, product and service markets. This appears to be what is happening in the US, where close to 5,000 companies have been formed under the new Benefit Corporation statutes, which have only recently become available. This virtuous cycle would allow € trillions of private capital to be deployed—with no state intervention—in sustainable fashion.

Question 13. In your view, is there any other area that the expert group should cover in their work?

For the reasons stated in our answers to Questions 6 and 12, we believe that it is critical for the HLEG to address corporate governance, and create a path for all member states to accommodate a widely adoptable and easily recognizable corporate governance structure that counters shareholder primacy and encourages the creation of long-term, durable and sustainable value.

Such legislation authorizing Benefit Corporations has been adopted in 35 US jurisdictions and Italy, and is progressing in a number of other jurisdictions. While aspects of the legislation differ among jurisdictions, all of the laws share three primary features:

- Purpose: An express purpose to positively impact all stakeholders. It is important that this purpose extend to all stakeholders, rather than allowing corporations to pick only certain stakeholders. By requiring broad purpose (and correspondingly broad accountability and transparency), the law requires good corporate citizenship and should preclude the creation of profit by naked externalisation of costs.

- Accountability: Provisions that expand the fiduciary duties of directors to include consideration of the interests of all stakeholders, breaking the cycle of shareholder primacy.

- Transparency: Provisions that require the corporation to regularly report on its impact to avoid greenwashing. These provisions apply without regard to the size of the business, the number of shareholders it has or the company's listed status.