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GREAT FUND INSIGHTS

Environmental, Social and Governance (ESG) Regulatory Developments

What fund and asset managers need to know

Up to date as of 25 November 2019

Sustainable investing and ESG have become "buzz" words in the fund and asset management industry, with a vast array of new industry bodies and initiatives both in the EU and globally. New regulations are also emerging as the EU Commission seeks to reorient private capital flows towards sustainable investments, to meet its climate and energy targets. A brief update on what fund and asset managers need to know in this space is set out below, including an update on timing. Separate briefings will shortly be published giving a "deep dive" on the new Disclosure Regulation and information for UK firms on new engagement and stewardship requirements.

Update on new EU regulations on ESG

Disclosure Regulation (2018/0179)

The EU Council adopted this on 8 November 2019 (for a copy see here).[1] It is still to be finalised when the new requirements will come into effect, but the current expectation is that it will apply in a staged way from **c.Q1 2021**. The regulation will impose new transparency and disclosure requirements on firms including fund and asset managers. In this way, firms must publish certain policies on their websites about the integration of sustainability risks into their investment and decision-making processes. Pre-contractual disclosures will be required on the manner in which sustainability risks are integrated into firms' investment decisions and on the likely impact of sustainability risks on returns. Firms will be subject to ongoing reporting obligations and certain other requirements, including pre-contractual disclosures and reporting, will apply where products are badged as sustainable.

Low Carbon Benchmarks Regulation (2018/0180)

Similarly, this was adopted on 8 November 2019 (for a copy see here).[2] It will come into effect the day after publication in the Official Journal, currently expected at the end of November, but the substantive obligations in the regulation will come into force in a staged way. The regulation will amend the Benchmarks Regulation (**BMR**) to address various concerns, including "greenwashing", with a view to providing investors with better information on the carbon footprint of their investments. The phrase "greenwashing" refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact this may not be the case – and is a key driver of some of the new regulatory requirements on ESG.

By way of example, the regulation will prescribe minimum standards for an "EU climate transition" benchmark (**CTB**) and an "EU Paris-aligned" benchmark (**PAB**) to avoid "greenwashing", to be met by 30 April 2020. Transparency requirements will also apply as regards their methodologies. By 1 January 2022, EU administrators that provide significant benchmarks determined on the basis of the value of one or more underlying assets or prices "shall endeavour to provide" one or more EU climate transition benchmarks. By 30 April 2020, subject to limited exceptions, an administrator's benchmark statement must explain if ESG factors are reflected in each benchmark it publishes (and if so, how) or say this is not done. Further requirements will apply for administrators of significant equity and bond benchmarks.

Taxonomy Regulation (2018/0178)

The EU is working to establish a common EU-wide classification system or taxonomy for environmentally sustainable economic activities – basically to agree "what's green and what's not". The Council's latest position is that the taxonomy should be established by the end of 2021, to ensure its full application by the end of 2022 – although this timing is considered ambitious.

When finalised, the Taxonomy Regulation will require firms such as fund and asset managers to consider certain criteria when offering or manufacturing products and services badged as environmentally sustainable – ie to ensure a robust and consistent approach and avoid "greenwashing". For a copy of the latest draft of the regulation, see here.[3] A lot of work has been done in support of this, and to develop an agreed taxonomy. For example, the EU Technical Expert Group on Sustainable Finance (TEG) issued its "Taxonomy: Technical Report" in June 2019 (for a copy see here).[4] This was a vast endeavour, looking at the development of an EU classification system for environmentally sustainable economy activities, covering 67 activities across 8 sectors. It was accompanied by a call for feedback that closed on 16 September 2019. The TEG is now analysing the responses and will advise the Commission on how to take the feedback forward.

1 https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf
2 https://data.consilium.europa.eu/doc/document/PE-90-2019-INIT/en/pdf
3 https://data.consilium.europa.eu/doc/document/ST-12360-2019-ADD-1/en/pdf
4 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf

ESG updates to MiFID II, AIFMD and UCITS Directive

Regulations on this front are yet to be published in final form, but what is proposed has two strands:

- First, delegated regulations are proposed in relation to MiFID II and the Insurance Distribution Directive (**IDD**). The last versions were published in January 2019 – they can be found here and here.[5] The new regime will require firms to ask clients about their ESG preferences and take them into account when providing advice or portfolio management services. Enhanced ESG disclosures and reports will also be required. The new regime would come into force c.12 months after the text is published in the Official Journal – current expectations are **c.Q1 or Q2 2021**.
- Secondly, changes are proposed to MiFID II, the UCITS Directive and AIFMD, in support of the Commission's Sustainability Action Plan, to integrate sustainability risks and factors. ESMA published its final reports on this front in May 2019 (see here and here),[6] although timing and next steps are unclear.

In relation to MiFID II, ESMA's proposals require firms to: take into account (i) ESG considerations when complying with the existing organisational requirements and (ii) sustainability risks in their risk management policies and procedures; consider conflicts that may stem from the distribution of sustainable investments; implement arrangements to ensure that inclusion of ESG considerations in the advisory process and portfolio management does not lead to mis-selling; and ensure the compliance and internal audit functions, management body and senior management consider sustainability risk in their respective duties. ESMA also proposes that firms integrate ESG due diligence and preferences into their product governance arrangements.

In relation to AIFMD and the UCITS Directive, ESMA has proposed that management companies: take into account sustainability risks when complying with the requirements on procedures and organisation and have the necessary resources and expertise for the effective integration of sustainability risks; ensure senior management is responsible for the integration of sustainability risks; include sustainability risks when identifying conflicts; factor sustainability risks into due diligence decisions; and include sustainability in risk management policies.

As a final point, the current UK government has clarified that, even if there is a "hard" Brexit, the Taxonomy Regulation, the Disclosure Regulation and the Low Carbon Benchmarks Regulation will be onshored, and current expectations are that any new government will carry forward this position. The position as regards the other regulatory changes mentioned above is likely to be dealt with on a case by case basis.

Recommendations

In terms of what firms should be doing now:

- Get up to speed on the new disclosure and benchmarks requirements and establish an internal team to consider both the risks and potential opportunities for your business.
- Ensure you are "plugged in" to industry work on ESG.

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.

5 https://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf and https://ec.europa.eu/finance/docs/level-2-measures/idd-delegated-act-2018_en.pdf
6 https://www.esma.europa.eu/sites/default/files/library/esma34-45-688_final_report_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_the_aifmd.pdf and https://www.esma.europa.eu/sites/default/files/library/esma35-43-1737_final_report_on_integrating_sustainability_risks_and_factors_in_the_mifid_ii.pdf