WILLIAM FRY

Asset Management & Investment Funds

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First Concrete Steps Taken To Implement EU Sustainable Finance Action Plan

Publication of Two Out Of Three Core Measures Of EU Sustainable Finance Action Plan

On 9 December 2019, two out of the three core legislative measures which make up the EU's Action Plan for Sustainable Finance (the **Action Plan**) were finalised and published in the Official Journal:

(i) **The EU Climate Transition and EU Paris-aligned Benchmarks Regulation**, which came into effect yesterday (10 December 2019), amends the EU Benchmarks Regulation (**BMR**) and creates a new category of benchmarks aimed at assisting investors in comparing the carbon footprint of their investments and the prevention of greenwashing. While this Regulation is principally facilitative in nature it also includes a welcome two-year extension of the current BMR compliance deadline of 1 January 2020 for critical and third country benchmarks, to 31 December 2021. For a detailed consideration of the impact of this extension, please see our briefing of 13 November 2019 entitled Brexit & UK Benchmarks;

(ii) **The Disclosures Regulation**, which seeks to improve disclosure requirements on how institutional investors integrate sustainability risks, and the consideration of adverse sustainability impacts, in their risk processes.

The final and essential core measure of the Action Plan is the proposed **Taxonomy Regulation.** Once agreed and published, the Taxonomy Regulation will create an EU-wide classification system or 'taxonomy' providing market participants with a 'common language to identify what economic activities can be considered environmentally sustainable'.

On 5 December 2019, EU co-legislators reached "a common understanding on the taxonomy for green economic activities" which will now be subject to the approval of the Parliament and Council. Given the complexities and sensitivities around the establishment of a taxonomy, which will determine whether or not an economic activity is environmentally sustainable, there is some uncertainty as to the timeline to publication. However, the Council has advised that it will be established before the end of 2021, with full application anticipated by the end of 2022.

The Disclosures Regulation

In light of the requirements and obligations imposed by it, this briefing focusses on the Disclosures Regulation and its impact for AIFMs and UCITS management companies (**FMCs**).

Implementation and Application

The Disclosures Regulation enters into force on 30 December 2019 and has a transitional period of 15 months, ending on 10 March 2021; other than in respect of requirements for annual report disclosures which do not apply until the later date of 1 January 2022.

It is unlikely that the Taxonomy Regulation will be in place ahead of the compliance deadline of 10 March 2021 (or 1 January 2022 for annual report disclosure requirements). The difficulties in complying with the obligations (as further detailed below) under the Disclosures Regulation in the absence of an agreed taxonomy identifying what can be considered an environmentally (the current proposed taxonomy does not include social or governance issues) sustainable economic activity have been widely reported. According to ESMA, "[w]hile the Commission is developing the taxonomy, authorised entities shall take a broad approach to assessing potential sustainability risks." The Disclosures Regulation does, however, provide a level of clarification by including the following definition of a 'sustainable investment':

> *"Sustainable investment means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;"*

Who is in-scope of the requirements under the Disclosures Regulation?

The Disclosures Regulation applies to a broad cross-section of EU regulated entities, including AIFMs and UCITS management companies.

What are the obligations for in-scope fund management companies (FMCs)?

The Disclosures Regulation contains obligations for all FMCs, irrespective of the objective of the funds under management, as well as additional obligations for those whose funds have an objective of, or seek to promote, sustainability.

As set out briefly below, the obligations trigger requirements to put in place appropriate policies/procedures and make specified disclosures on the FMCs website, in pre-contractual/fund prospectus documents and, periodically, in annual reports.

<u>All FMCs</u> must integrate sustainability risks into their investment decision making processes

An FMC is required, as part of its investment decision making processes (including the organisational, risk management and governance aspects of such processes) to assess sustainability risk, being the risk of "an environmental (E), social (S) or governance (G) event or condition that, if it occurs, could cause a negative material impact on the value of the investment". While, in the absence of the Taxonomy Regulation, there is no definitive list of which issues or factors are covered by the terms 'ESG', they are, according to the United Nations-supported Principles for Responsible Investment, broadly defined as: (i) Environmental issues related to the quality and functioning of the natural environment and natural systems; (ii) Social issues related to the rights, well-being and interests of people and communities; and (iii) Governance issues related to the governance of companies and other investee entities.

An FMC should have in place policies which provide for the integration of sustainability risk into its investment decision making processes and the assessment of sustainability risk on a continuous basis (alongside the assessment of other financial risks of its investment decisions).

Disclosures:

- **FMC Website:**
    - Concise information on the above-mentioned policies must be published on the FMC's website.
    - Where the sustainability risk assessment leads to the conclusion that there are no sustainability risks, an FMC is required to publish an explanation of the reasons for this conclusion on its website.
    - An FMC which concludes that sustainability risks are relevant must publish on its website the extent to which those sustainability risks might impact the performance of the fund(s) under management, either in qualitative or quantitative terms.
- **Pre-contractual/ fund prospectus disclosures:**
    - an FMC must disclose the manner in which sustainability risks are integrated into their investment decisions, and
    - the results of the assessment of the likely impact of sustainability risks on the fund(s) under management.

The remuneration policies of <u>all FMCs</u> must integrate sustainability risks

An FMC shall include in its remuneration policies information on how such policies are consistent with the integration of sustainability risks and shall publish that information on its website.

<u>All FMCs</u> must disclose any consideration of principal adverse impacts of investment making decisions

An FMC must disclose if it takes account of the impacts of its investment decisions that result in negative effects on sustainability factors ('principal adverse impacts') and, if so, put in place procedures to integrate the consideration of such impacts into their existing investment and risk management processes. Such procedures might include how the FMC discharges its "sustainability-related stewardship responsibilities or other shareholder engagements".

Disclosures:

- **FMC Website:**

  → **if applicable,** information on such procedures should be published on the FMC's website along with descriptions of the principal adverse impacts, or

  → to the extent an FMC does not consider principal adverse impacts, it must disclose the reason for not doing so, including, where relevant, information as to whether and when it intends to consider such adverse impacts.

- **Pre-contractual/fund prospectus disclosures:**

  → a clear and reasoned explanation of whether and, if so how, a fund considers principal adverse impacts on sustainability factors, and

  → if applicable, a statement of where information on the principal adverse impacts on sustainability factors is available.

Additional disclosure obligations for FMCs whose funds which pursue sustainable investment objectives / promote environmental or social characteristics

The Disclosures Regulation includes additional requirements for FMCs with funds which (i) promote environmental or social characteristics, or (ii) have as an objective a positive impact on the environment and society.

Disclosures:

(i) Funds which promote environmental or social characteristics:

- **Pre-contractual/fund prospectus disclosures:** information on how those characteristics are met and if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics and where the index methodology can be found.

- **Periodic reports:** the extent to which environmental or social characteristics are met.

(ii) Funds with a sustainable investment objective:

- **Pre-contractual/fund prospectus disclosures:** if an index has been designated as a reference benchmark, disclosure of how the index is aligned with that objective and if no index is used, information on how the sustainability characteristics of the fund are met. An objective of a reduction in carbon emissions must (unless no such benchmark is available) include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement. If an index is used, an indication of where the methodology used for the calculation of the index can be found.

- **Periodic reports:** The overall sustainability-related impact should be reported regularly by means of indicators relevant for measuring the chosen sustainability objective. Where an appropriate index has been designated as a reference benchmark, that information should also be provided for the designated index as well as for a broad market index to allow for comparison.

Both fund types at (i) and (ii) above:

- **FMC Website:**

  - a description of the environmental or social characteristics or the sustainable investment objective,

  - information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the fund,

  - the precontractual/fund prospectus disclosures above.

Outstanding Level 2 measures necessary for compliance with obligations under Disclosures Regulation

A number of Level 2 measures, which will be necessary for FMCs to achieve compliance with the above-mentioned obligations imposed under the Disclosures Regulation, are outstanding and include:

1. Amendments to the UCITS, AIFMD and MiFID regimes in order to integrate sustainability risks and factors in several policy areas, by amending the relevant legislation.

   ESMA submitted its advice to the Commission in relation to these amendments on 30 April 2019. For investment funds, ESMA recommended amendments requiring all UCITS management companies and AIFMs to: (a) consider sustainability risks in their internal processes, systems and controls; (b) devote sufficient resources to the integration of sustainability risks; and (c) ensure that senior management is responsible for the integration of sustainability risks. ESMA also recommended that UCITS management companies and AIFMs consider sustainability risks in their due diligence processes.

2. The ESA's joint Technical Standards relating to: (i) public disclosure of principal adverse impacts of investment decisions on sustainability factors, such as environmental and social matters, which will apply to market participants on a comply or explain basis (except for companies with more than 500 employees for which the obligation is mandatory) and (ii) product specific disclosure (pre-contractual/ prospectus, public and periodic reporting disclosures) showing how products fulfil environmental or social characteristics or meet sustainable investment objectives.

   ESMA is expected to publish a consultation paper shortly with its proposals for these Technical Standards.

How Can William Fry Help?

William Fry can assist in:

- carrying out a review of existing FMC policies and procedures to identify and address any amendments necessary to comply with the Disclosures Regulation;
- assist in the preparation and drafting of any new FMC policies and procedures required pursuant to the Disclosures Regulation;
- assist in the preparation of FMC website disclosures required pursuant to the Disclosures Regulation;
- advising on the upcoming requirements under the Disclosures Regulation and preparing for compliance; and
- advising on the introduction of the EU Climate transition and EU Paris-aligned Benchmarks Regulation and how FMCs may avail of its facilitative provisions.

Contact Us

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