

Top 10 things asset managers need to know about the EU ESG initiative



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The EU has set in motion an ambitious legislative programme to make environmental, social and governance (“ESG”) concerns a central plank of regulation in the financial services industry.

The EU initiative is relevant to firms which have an express ESG or sustainability focus. In addition, though, key aspects of the new rules will apply to all firms, even those without an express ESG or sustainability focus.

The first set of rules of particular relevance to most asset managers come into force in **Q1 2021** so firms will need to prioritise the ESG initiatives as a key Legal & Compliance project in 2020.

This note summarises the Top 10 things that asset managers need to know about the EU ESG initiative.

“Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors. And with the impact of sustainability on investment returns increasing, we believe that sustainable investing is the strongest foundation for client portfolios going forward.”

Larry Fink, Chairman and CEO, BlackRock
Letter to CEOs, 14 January 2020



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What is the EU's ESG initiative?

01

Responding to the need to move towards a global sustainable development framework, in March 2018, the European Commission (the “**Commission**”) published an Action Plan on Financing Sustainable Growth (the “**Action Plan**”). One of the Action Plan’s core tenets is a belief that financial services firms, particularly those which invest on behalf of clients, can play a key role in the transition to a low-carbon and more sustainable economy.

The Action Plan identifies ten key action points which seek to fulfil this goal in respect of financial services, including

- establishing a taxonomy for sustainable activities
- creating standards for “green” financial products
- incorporating sustainability as part of financial advice
- developing sustainability benchmarks and better integrating sustainability into ratings, and
- strengthening disclosures made by asset managers and financial advisers to their clients.

Various initiatives are also targeted at corporate issuers.

This note focuses on the elements of the ESG initiative relevant to asset managers and financial advisers.

THE COMMISSION’S ACTION POINTS

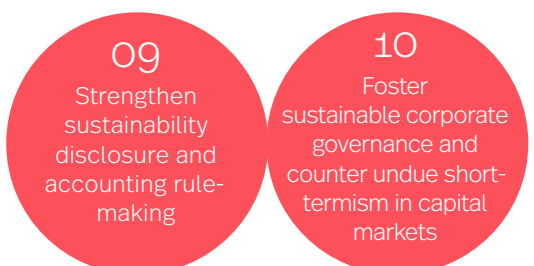
Reorienting capital flows towards sustainable investment



Managing financial risks from environmental and social issues



Fostering transparency and long-termism in financial activity



What are the key elements of the Action Plan relevant to asset managers?

02

Four key legislative initiatives are of particular relevance to asset managers:

(i) Sustainable Finance Disclosure Regulation (SFDR)

The **Sustainable Finance Disclosure Regulation** (the “SFDR”) imposes new disclosure obligations on asset managers and financial advisers in respect of sustainability, to make it easier for end-investors to make informed investment choices.

Although framed as rules about disclosures, there are **significant business and policy decisions** which firms will need to make in relation to how sustainability impacts on their investment processes, which will be relevant to **all** in-scope asset managers.

So, in some respects, it may better to think of this as the “sustainable investments” regulation, rather than the “disclosures” regulation.

(ii) Framework (or Taxonomy) Regulation

The regulation on the establishment of a framework to facilitate sustainable investment (the “**Framework Regulation**”) creates a new common taxonomy to be used in determining the degree to which an economic activity can be described as being ‘environmentally sustainable’. This then allows asset managers and investors to establish how environmentally sustainable a given investment is.

In effect, the taxonomy is seeking to define what “good” looks like, when it comes to environmental sustainability.

For the most part, the Framework Regulation will be relevant only to asset managers which make available a financial product which either (a) has an objective of environmentally sustainable investment, or (b) promotes environmental characteristics.

However, **all** managers will at least need to make a negative disclosure to confirm that all out-of-scope financial products are out of scope.

(iii) Suitability Delegated Regulation

The Commission’s **draft delegated regulation under MiFID 2**, (the “**Suitability Delegated Regulation**”) would amend the **MiFID 2 Delegated Regulation** to clarify that ESG considerations and preferences should be taken into account in the investment and advisory process as part of an investment firm’s duties towards its clients when performing the “suitability” assessment for portfolio management and investment advice.

(iv) Integration of sustainability into a firm’s systems and controls

Finally, the Commission has proposed additional Level 2 delegated acts (the “**Delegated Acts**”) which would make amendments to the existing Level 2 measures under (a) the **UCITS Directive** and **AIFMD** and (b) **MiFID 2** respectively, to ensure that sustainability risks and sustainability factors are integrated within a manager’s organisational, operating and risk management processes.

What is the status of the new rules and when do they come into force?



As at May 2020, only the SFDR has so far been passed into law while the other initiatives in the Action Plan (below) are at varying degrees of finalisation and will come into force at different times.

SFDR

This was published in the EU's Official Journal in December 2019.

The European Supervisory Authorities (ESAs) have now started work on developing Level 2 measures to give greater clarity as to exactly what information has to be disclosed and how. The ESAs have already published one consultation paper, which closes on 1 September 2020, and at least one other public consultation can be expected. The ESAs must submit their advice in respect of most of these measures to the Commission by the end of December 2020 so they are ready to apply from 10 March 2021.

The Level 2 measures currently under consultation propose detailed requirements that are dramatically more onerous than had been expected by the industry and would represent a very significant undertaking for in-scope asset managers. Our summary of these proposals is here – we will be keeping a careful eye on how these develop.

The Framework Regulation also makes a number of amendments to the text of the SFDR including some additional Level 2 measures, which the ESAs will now develop.

Framework Regulation

This was **published** in the Official Journal on 22 June 2020.

The Regulation provides for a phased implementation with certain of the rules applicable as from **31 December 2021**, and the remainder applicable as from **31 December 2022**.

Suitability Delegated Regulation

Now that the SFDR has been published, the Commission has put forward a proposal to amend the MiFID 2 Delegated Regulation as to the considerations and preferences an investment firm should take into account when performing its "suitability" assessment.

Delegated Acts

The Commission has published its proposals for new Level 2 measures in respect of (a) the UCITS Directive and AIFMD and (b) MiFID 2.

These proposals are subject to consultation until 6 July 2020 and subsequent review by the Council of the EU and the European Parliament. When agreed, the final texts will be published in the OJ.

⋮ The outstanding legislation will take the form of EU regulations, which will be directly applicable in the EU and EEA without the need for national regulators to implement them.

⋮ We expect, though, that national regulators may need to make some minor consequential changes to their existing rules which implement the MiFID, AIFMD and UCITS regimes in their jurisdiction.

Which firms and products are in scope?



The **SFDR** and the **Framework Regulation**

These both apply as follows:

Financial market participant

The core obligations apply to the new concept of a “**financial market participant**”. In the context of the asset management industry, this includes:

- AIFMs
- UCITS ManCos
- MiFID investment firms or credit institutions which provide portfolio management services and
- managers of certain venture capital and social entrepreneurship funds.

In this note, for shorthand, we refer generally to these categories of financial market participant as “**asset managers**”. (The concept, though, also includes certain insurance and pensions entities, which are beyond the scope of this note.)

Financial adviser

In addition, certain aspects of the SFDR apply to a “**financial adviser**”, which includes MiFID investment firms, credit institutions, AIFMs and UCITS managers when providing investment advice.

Financial products

The two regulations both also apply in relation to the new concept of “**financial products**”.

These include AIFs, UCITS funds, and a portfolio management service (as well as certain pensions and insurance products). However, other financial instruments such as shares, bonds, and derivatives are not covered by the SFDR.

Other MiFID services (such as order execution, reception and transmission of orders, own account trading, etc) are not covered by these regimes.

In practice, this means that firms that are in scope will include alternative and institutional fund managers, other asset managers, investment firms, banks, private banks, wealth managers and financial advisers, whether these firms are “buy side” or “sell side”.

The **Suitability Delegated Regulation** and the **Delegated Acts**

These will apply to MiFID firms, AIFMs and UCITS managers, as specified.

What are the key requirements of the Sustainable Finance Disclosure Regulation (SFDR)?

The **SFDR** is framed as a series of sustainability-related disclosures which must be made in the documentation for a financial product or on an asset manager's website, relating to:

- the (internal) integration of sustainability risks in the asset manager's investment process; and
- the (external) consideration of the adverse impact that investments may have on sustainability factors.

There are seven key new rules which flesh out these themes. We summarise these below but first summarise scoping issues. There are two critical initial points which we would emphasise

First, many important aspects of the SFDR apply to **all asset managers**, whether or not they have an express ESG-focus or sustainability-focus.

Some further aspects of the SFDR, though, apply only to financial products with a specific ESG-focus.

Second, while framed as rules about disclosures, the SFDR effectively requires firms to make strategic business and policy decisions (which must then be disclosed).

We recommend that firms focus first on these key strategic decisions, before moving on to consider the medium of disclosure.

Level 1 of the SFDR introduces three new concepts relating to and defining aspects of sustainability (which feed into the seven key new rules summarised below).

“Sustainable investment”

In summary, this is an investment in an economic activity which

- contributes either to an environmental or a social objective
- does not significantly harm any economic or social objectives and
- the investee company follows good governance practices.

“Sustainability risk”

This is an environmental, social or governance event or condition which, if it occurs, could cause a material negative impact on the value of an investment.

“Sustainability factors”

This means environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

There are seven key new rules, which fall into three categories

Rules which impose manager-level obligations

- 01 An asset manager must formulate a policy on the integration of sustainability risks in its investment decision-making process.
- 02 An asset manager must make a business decision to either
 - implement a due diligence policy with respect to the principal adverse impacts of its investment decisions on sustainability factors or
 - explain the reasons why it does not consider such adverse impacts.

From **30 June 2021**, publishing a statement on its website on its due diligence policy will be mandatory where the asset manager has (or is the parent undertaking of a group which has) an average of over 500 employees during the financial year.

- 03 An asset manager must update its existing remuneration policy to include information on how the policy is consistent with the integration of sustainability risks.

Rules which impose obligations applicable to all financial products (whether or not they have an ESG or sustainability focus)

- 04 An asset manager must make a business decision, for each financial product that it makes available, whether to either
 - assess the likely impacts of sustainability risks on the returns of each financial product or
 - explain why the asset manager does not consider sustainability risks to be relevant to a particular financial product.

(Note that certain of the manager-level information under rules 1 to 3 would also need to be disclosed for all financial products).

Rules which impose obligations applicable only to financial products with a specific sustainability-focus

Additional disclosures will be required where a financial product:

- 05 promotes environmental or social characteristics
- 06 has sustainable investment as its objective or
- 07 has a reduction in carbon emissions as its objective.

(In this note we refer to these collectively as **“ESG-focused products”**).

On 23 April 2020, the European Supervisory Authorities (ESAs) jointly published a consultation paper, putting forward a number of draft Level 2 measures in the form of regulatory technical standards (RTS). The draft RTS set out granular specifications for the content, methodology and presentation of certain disclosures required under the Level 1 text, while the associated Annex, which was published at the same time, provides a set of indicators and metrics to be used in assessing adverse impact across a range of ESG issues.

The draft RTS (which would supplement the rules referred to at points 2, 5, 6 and 7 above) cover:

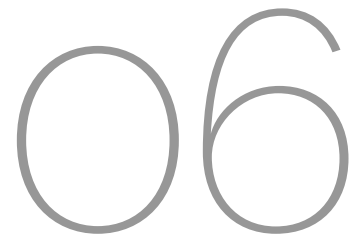
- **Entity-level “adverse impact” website disclosure** – details of an asset manager’s/financial adviser’s policy for assessing the adverse impacts of its investment decisions/recommendations on sustainability factors, at the level of the asset manager/adviser as an entity (adverse sustainability impacts statement)
- **Product-level disclosures for ESG focused products** – pre-contractual, website and periodic disclosures in respect of products which promote environmental or social characteristics (Article 8 of the Level 1 text) and products with sustainable investment or a reduction in carbon emissions as their objective (Article 9 of the Level 1 text).

The proposals have proved to be significantly more onerous than industry had expected - the Annex alone, for example, contains 50 quantitative disclosures, 32 of which are mandatory – and, if accepted in their current form, the RTS would represent a very significant undertaking for in-scope firms.

Our detailed summary of the ESAs’ proposed RTS can be found [here](#).

Our detailed summary of the key requirements under the SFDR can be found [here](#).

What are the key requirements of the Framework Regulation?



The **Framework Regulation** establishes a taxonomy for determining whether an economic activity is environmentally sustainable. This determination can in turn be used to establish how environmentally sustainable an investment is.

The vast majority of the Framework Regulation will be relevant only to asset managers who make available financial products with an express environmental sustainability focus.

However, all asset managers will need to include a short negative disclosure in financial products which do not follow the taxonomy.

In overview, the aim of the taxonomy is to establish whether an investment can properly be characterised as environmentally sustainable. For these purposes, an economic activity will be considered “environmentally sustainable” where it

- contributes substantially to any of a series of defined environmental objectives
- does not significantly harm any of the environmental objectives
- complies with a series of minimum social safeguards and
- complies with performance thresholds (known as “technical screening criteria”) - these will be developed as Level 2 measures in due course.

The environmental objectives referred to in the first two bullets above are:

- climate change mitigation
- climate change adaptation
- sustainable use and protection of water and marine resources
- transition to a circular economy
- pollution prevention and control
- protection and restoration of biodiversity and ecosystems.

(The Framework Regulation focuses exclusively on environmental, not social, sustainability).

Asset managers will need to ensure that the pre-contractual documentation and periodic reports for ESG-focused products which relate to environmental objectives or promote environmental characteristics contain additional disclosures to explain how the product’s investments comply with the taxonomy.

Practical points

Asset managers with in-scope products will need to engage during 2020 with the developing taxonomy and technical screening criteria, with a view to preparing the initial disclosures during 2021.

In addition, all financial products (other than ESG-focused products) must include in their pre-contractual disclosures and in their periodic reports a prescribed disclaimer:

“The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments”.

As such, **all** financial products will need to have their documentation updated during 2020 or 2021 to include this disclaimer. Firms may wish to consolidate this update along with those required under the SFDR.

What are the key requirements of the Suitability Delegated Regulation?



The **Suitability Delegated Regulation** will alter how a MiFID firm assesses the suitability of its products and services for its clients by ensuring that the client's ESG preferences are taken into account at various stages, for example:

- when providing a client with information about the factors which the MiFID firm has taken into account when recommending a financial instrument, this information will need to include a description of ESG considerations
- information about the client's investment objectives will need to include the client's ESG preferences, if any
- information about the client which the MiFID firm must obtain in order for it to determine that a specific transaction meets the client's investment objectives will also have to include the client's ESG preferences – in practice, this is likely to entail actively asking the client what these ESG preferences are
- policies and procedures which the MiFID firm must have in place to ensure that it adequately understands the features of services and instruments selected for its clients must include ESG considerations
- when providing investment advice to a retail client, the MiFID firm must state in its report whether the client's investment objectives are achieved by taking into account the client's expressed ESG preferences.

FACTS AND FIGURES

84%

Millennials who focus on ESG impact as a central goal

(Source: Bloomberg Intelligence and Simmons & Simmons' Asset Management Outlook to 2025)

23.3%

increase in ESG mandates for 500 largest asset managers globally in 2018

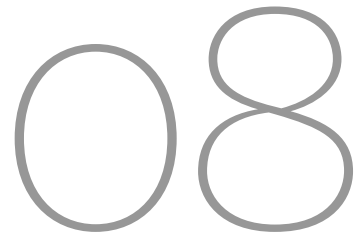
(Source: Institutional Asset Manager, 28 October 2019)

\$137bn

AuM held in 300 sustainability-focused investment funds

(Source: Morningstar research, 10 January 2020)

What are the key requirements of the Delegated Acts?



If, as expected, the Commission accepts the advice which ESMA has submitted, the **Delegated Acts** would amend the relevant Level 2 measures under the UCITS Directive, AIFMD and MiFID 2 in the areas of organisational requirements, operating conditions, risk management policy and product governance.

ESMA has stressed, though, that firms should apply the new requirements proportionately, taking into account the size, nature, scale and complexity of their activities.

Looking at ESMA's proposals in more detail:

(a) Under the UCITS Directive and AIFMD

Briefly, an AIFM or UCITS ManCo would have to take steps to, among other things

- take sustainability risks into account when complying with its obligation to establish, implement and maintain adequate decision-making procedures and organisational structures
- ensure it has the necessary resources and expertise to effectively integrate sustainability risks and monitor third party activities carried out on the basis of an arrangement with the manager
- ensure that its senior management is responsible for the integration of sustainability risks
- when identifying conflicts of interest, include those that may arise in relation to the integration of sustainability risks
- take sustainability risks into account when
 - selecting and monitoring investments
 - ensuring the manager has adequate knowledge and understanding of the assets in which the fund is invested
 - establishing written due diligence policies and procedures and
 - implementing effective arrangements to ensure that investment decisions are carried out in compliance with the fund's objectives, investment strategy and risk
- ensure that its risk management policy includes sustainability as a type of exposure which it must assess on behalf of the fund.

(b) Under MiFID 2

Similarly, ESMA's advice to the Commission makes a number of changes to the organisational and product governance measures supporting MiFID 2.

These changes would require an investment firm to take ESG considerations, preferences and characteristics into account, where relevant

- in establishing and implementing risk management policies and procedures, and, where appropriate, in setting the level of risk that the firm tolerates
- in identifying the potential target market for each financial instrument and specifying the type of client for whom the financial instrument is compatible
- in determining whether a financial instrument meets the target market's identified needs, characteristics and objectives
- in assessing whether the investment products the firm offers or recommends and the services it provides on a regular basis, remain consistent with the needs, characteristics and objectives of the intended target market

How does Brexit impact UK firms?



The UK left the EU on 31 January 2020 under a Withdrawal Agreement that provides for a transitional period to 31 December 2020.

Even allowing for an extension, it seems highly unlikely that any of the new rules mentioned above will come into force until the transition period has ended (though any in force during that time would automatically apply to the UK).

Mindful of how important the sustainability initiative is as part of the EU's response to the Paris Climate Agreement and of its own commitment to supporting the growth of the UK's financial services industry, HM Government listed the Framework Regulation, SFDR and the associated Low Carbon Benchmarks Regulation as EU legislation which will be 'onshored'. This means that these regulations would be part of the EU financial services legislation implemented for a period of two years after the UK leaves the EU, in the event of a no-deal Brexit (for example, if the transition period ends on 31 December 2020 with no agreement having been reached on the future trading relationship between the UK and the EU).

The Financial Services (Implementation of Legislation) Bill, which would have implemented the onshoring, automatically fell when Parliament was prorogued ahead of the UK general election in December 2019. And while the Queen's Speech to the new Parliament confirmed HM Government's intention to introduce a Financial Services Bill, whether or not this includes a provision for onshoring

of the EU's ESG legislation will only become clear when the new Bill is put before the House of Commons in due course.

In the meantime, though, on 6 May 2020, HM Government published a draft of its Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020, Regulation 22 of which states that the articles of the SFDR which require Level 2 measures to be developed and adopted "are omitted".

As a result, unless the transition period is extended beyond 10 March 2021, when the SFDR applies, the Level 2 measures made under it will not apply to UK firms. Even so, it remains highly likely that HM Government will introduce domestic measures that align closely with the Level 2 provisions. Any material divergence would not only create dual-compliance requirements for many UK asset managers marketing into Europe but could impede the negotiation of mutual EU-UK "equivalence" determinations.

In terms of UK firms wishing to do business in the EU following Brexit, the UK would, after 31 December 2020, be a third country and firms' ability to manage or market funds, or provide investment services in the remaining EU Member States will depend on any agreement reached between now and then.

FACTS AND FIGURES

78

of the UK's 154 public universities have committed to divest from fossil fuels

(Source: [ft.com](https://www.ft.com/content/11-jan-2020), 11 January 2020)

€37bn

net flows into European sustainable funds H1 2019

(Source: **Morningstar**, 19 September 2019).

67%

increase in assets in sustainable mutual funds and exchange-traded funds in Europe and the United States 2013 to 2019 according to BlackRock

(Source: **McKinsey**, August 2019)

What should firms be doing now?

10

Given that the different pieces of legislation referred to above are at different stages of finalisation, firms will likely have to adopt a staggered approach to their compliance. The immediate priority in 2020 will need to be compliance with the SFDR and, to the extent relevant, the Framework Regulation.

SFDR

Firms will need to begin to consider

- what approach they will take to the “comply or explain” decisions
- how they will implement the required policies
- which products (if any) have an express sustainability-focus and
- the process for making the required disclosures.

Firms will also need to assess each fund and managed account which they make available, to determine if it is in scope of the enhanced disclosures for products with an ESG-focus.

In practice, the documentation for **all** financial products made available by asset managers (funds, managed accounts, advisory services) will require at least some formal updates for these ESG regulations.

Firms should make an early assessment of the likely scale of that exercise.

Framework Regulation

The scoping exercise noted opposite should also include an assessment of which funds and accounts will be in scope for the environmental sustainability disclosures under the taxonomy.

As noted, all funds not in scope will need to include an express negative disclosure in their documentation.

Firms will need to consider the internal processes to work towards implementation, including project plans, team leads, internal resource and budget allocation. Firms may also wish to consider which external service providers may need to be engaged.

Simmons & Simmons would be pleased to assist with scoping, advising on decision-making, advising on application, project plans, preparing policies, and drafting disclosures. We are preparing templates for our clients to use.

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