EU ESG INITIATIVE

DISCLOSURES REGULATION – KEY REQUIREMENTS

The EU's **Regulation on sustainability-related disclosures in the financial services sector** (the "**Disclosures Reg**") was published in December 2019 and forms part of the EU's package of measures relating to Environmental, Social and Governance (ESG) issues.

This document summarises the aspects of the Disclosures Reg which will be of most relevance to asset management firms. It also summarises those elements of the draft Framework (or Taxonomy) Regulation which are directly relevant to the Disclosures Reg.

Although the large majority of the Disclosures Reg will not be implemented until March 2021, we strongly recommend that firms prioritise during 2020 to ensure that they will be ready to comply with its provisions.

Please see our **note summarising the wider EU ESG initiatives** and our **Sustainable Finance and ESG microsite**.

Introduction

The Disclosures Reg is framed as a series of **sustainability-related disclosures** which must be made

- in the **documentation for a financial product** such as a fund or managed account and
- on an **asset manager's website**.

Two critical points should be emphasised from the outset.

- many important aspects of the Disclosures Reg will apply to **all** asset managers, even those which do not have an express ESG-focus or sustainability-focus (although some aspects of the Disclosures Reg will apply only to those financial products which have a specific ESG-focus).
- while the Disclosures Reg is framed as setting out rules on disclosures, it effectively requires firms to make strategic business and policy decisions, which the firm must then disclose. In some ways, then, it may be better to think about this as the 'Sustainable Investments' Reg, rather than the Disclosures Reg. We believe that firms should focus first on the key strategic decisions that they will need to take, before moving on to consider how and what they disclose.

As a result, we have divided this note into three key themes according to the likely commercial impact of the Disclosures Reg, looking in turn at the rules which:

(a) apply at the level of the asset management firm

(b) apply to **all** financial products made available by an asset management firm, whether or not the product has an express ESG focus, and

(c) apply only to financial products which have an express ESG focus.

A sub-set of the rules in the Disclosures Reg applies to **financial advisers** and we show which rules are relevant to these in the tables below.

The Framework Regulation proposes certain additional disclosures which need to be made for the purposes of the Disclosures Reg, and we summarise these where relevant. This document assumes that the Framework Regulation will become law in line with the **text agreed by the Council of the EU and the European Parliament** on 17 December 2019.

Key new rules

The tables on page 4 of this document identify nine key new rules, under these headings:

A. Manager-level obligations

1. An asset manager must formulate a policy on the integration of sustainability risks in the manager's investment decision-making process.
2. An asset manager must make a business decision to either:

   (a) implement a due diligence policy with respect to the principal adverse impacts of its investment decisions on sustainability factors, **at the level of the manager as an entity** (a "**sustainability DD policy**") or

(b) explain the reasons why it does not consider such adverse impacts. **[See item 5, below, for a similar obligation in respect of financial products.]**

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

B. Obligations applicable to all financial products (whether or not they have an ESG or sustainability focus)

4. An asset manager must make a business decision for each financial product that it makes available, whether to either:

(a) assess the likely impacts of sustainability risks on the returns of each financial product; or

(b) explain why it does not consider sustainability risks to be relevant to a particular financial product.

5. Depending on whether it has implemented a sustainability DD policy (see point 2 above), an asset manager must either:

(a) if it **has** implemented a sustainability DD policy - make a further decision whether and how each financial product considers principal adverse impacts on sustainability factors

(b) if it has **not** implemented a sustainability DD policy - explain for each financial product the reasons why it does not consider such adverse impacts.

6. An asset manager must review its marketing documentation generally, to ensure that the marketing documents do not contradict the mandatory disclosures under the Disclosures Reg.

[Note that certain of the manager-level information above under heading A would also need to be disclosed for all financial products.]

C. Obligations which apply only where a financial product has a specific sustainability-focus

Additional disclosures will be needed where a financial product:

7. promotes environmental or social characteristics;

8. has sustainable investment as its objective; or

9. has a reduction in carbon emissions as its objective.

Scope – which firms and products does the Disclosures Reg cover?

a) Firms

The Disclosures Reg applies to the defined concept of "**financial market participant**", or **FMP**. The definition of FMP includes:

- MiFID firms providing the service of portfolio management
- AIFMs and
- UCITS Managers.

In this note, we refer to such firms as "**asset managers**".

In addition, a sub-set of the rules applies to **financial advisers** (including MiFID firms, AIFMs, and UCITS Managers which provide standalone investment advice). The tables below distinguish which rules apply to financial advisers (in the column marked "Does this apply to FAs?"), by reference to the equivalent rule which applies to asset managers. However, the remainder of this document refers generally only to the broader set of rules which is applicable to asset managers.

The Disclosures Reg also has a wider application to other firms operating in the insurance and pensions sector, which is beyond the scope of this note.

b) Products

The Disclosures Reg applies in respect of **financial products** made available by asset managers - these include

- AIFs
- UCITS funds and
- portfolio management services / managed accounts.

What does sustainability mean for these purposes?

The Disclosures Reg introduces three new concepts of "**sustainable investment**", "**sustainability risk**" and "**sustainability factors**". These are all defined terms in the Disclosures Reg - defined terms are indicated in bold underlining in the summary table below.

- "**Sustainable investment**":
  In summary, this is an investment in an economic activity which:
  - contributes **either** to an environmental objective or a social objective
  - does not significantly harm[1] any environmental 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.

What disclosures are relevant?

The Disclosures Reg requires an asset manager to disclose specified information on its website, in the pre-contractual information for a financial product, and (in some cases) in the periodic information provided to investors. For these purposes:

"**pre-contractual disclosure**" means

- the prospectus for a UCITS fund
- the AIFMD Article 23 disclosures for an AIF (typically in or attached to the prospectus) and
- the MiFID-required regulatory disclosures or T&Cs for a portfolio management or advisory service.

"**periodic disclosure**" means

- the annual report for a UCITS fund
- the annual report for an AIF or
- the periodic reports on a service under MiFID.

The summary tables below confirm the medium of disclosure as applicable.

Certain of the disclosures remain to be explained in further Level 2 technical standards – these should be published by the end of 2020. The tables below indicate where the Disclosures Reg requires further technical standards to be developed.

What is the timing requirement?

Most of the obligations in the Disclosures Reg will come into force on **10 March 2021**. This means that firms should use 2020 to update their policies and documentation in anticipation of this.

Some obligations come into force at a later date and the tables below provide details of when each rule applies.

When working towards the regulatory deadline, as with any change which may impact a mandate and/or disclosure provided in fund documentation, firms will need to consider whether issues of investor consent arise and the extent to which, for example, it is appropriate to give investors (and in some circumstances regulators) advance notice of any changes.

What is the impact of Brexit on UK firms?

The UK left the EU on 31 January 2020 under a Withdrawal Agreement that allows 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 (although, if any are in force during that time, they would automatically apply to the UK).

Mindful of the importance of the sustainability initiative as part of the EU's response to the Paris Climate Agreement and its own commitment to supporti ng the growth of the UK's financial services industry, HM Government listed the Framework Regulation, Disclosures Regulation and the associated Low C arbon Benchmarks Regulation as EU legislation which will be 'onshored' – i.e., these regulations would be part of the EU financial services legislation impl emented 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 2 020 with no agreement on the trading relationship between the UK and the EU).

However, the Financial Services (Implementation of Legislation) Bill, which would have implemented the onshoring, automatically fell on the prorogation of Parliament ahead of the December 2019 general election. The Queen's Speech to the new Parliament noted HM Government's intention to introduce a Financial Services Bill, which may (or may not) include a provision for onshoring of the EU's ESG legislation – this will only become clearer in due course, when the new Bill is put before the House of Commons.

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.

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(1) Article 16c of the draft Framework Regulation will amend the Disclosures Reg to include additional detail on what "do not significantly harm" means in practice.

A. MANAGER-LEVEL OBLIGATIONS							
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**

1	**New sustainability risk policy**
	
	The asset manager must formulate a policy on the integration of <u>sustainability risks</u> in its investment decision-making process.
		Yes	**Website**	3(1)
				
				3(2)
					No	**10 March 2021**	• Review whether and to what extent the firm integrates (or wishes to integrate) <u>sustainability risks</u> into its investment decision making process.
							
							• Make formal decision (Board level?) on this issue.
							
							• Update internal investment and risk management policies.
							
							• Make changes to systems and processes necessary to reflect changes in the policies.
							
							• Draft required external disclosures –
							
							  • for the firm's website and
							
							  • for each financial product the firm offers.

		Yes	**Pre-contractual disclosure**	6(1)(a) 6(2)(a)	No	**10 March 2021**	
2	**Business decision (comply or explain) on adverse sustainability impact (entity level – i.e. manager level transparency)** An asset manager must decide whether to **either**: (a) **comply** - implement a due diligence policy with respect to the principal adverse impacts of its investment decisions on <u>sustainability factors</u> at manager level (a "**sustainability DD policy**") – see 2a below; or (b) **explain** - formulate reasons why the asset manager does not consider such adverse impacts – see 2b below. As from 30 June 2021, the "comply or explain" obligation becomes mandatory to comply for FMPs with more than 500 employees (or FMPs which are the parent undertaking of a group with more than 500 employees). In other words, it will then be mandatory for asset managers with more than 500 employees to implement the due diligence policy. **[See also point 5 below, for the equivalent rule at financial product level.]**						
2a	**If complying with (a)** Publish a statement on the due diligence policy. This must include information on the identification and prioritisation of adverse impacts, summaries of engagement	Yes	**Website**	4(1)(a) 4(2) 4(5)(a)	Yes	**10 March 2021** [2]	• Review whether and to what extent it wishes to implement a sustainability DD policy. • Make formal decision (Board level?) on this issue.

(2) Note that there is a phased implementation for the Level 2 technical standards. A first set dealing with adverse impacts on climate and other environmental impacts is due by **30 December 2020**. A second set dealing with adverse impacts on social and employee matters, respect for human rights, anti-corruption and anti-bribery is not required until **30 December 2021**. This is after the implementation date for this rule. We assume – although this will need to be confirmed by applicable regulators – that this would in practice mean that the due diligence policy would be required to address only climate and other environmental impacts as at 10 March 2021, with no requirement to address the additional impacts until the remaining Level 2 measures are published.

	A. MANAGER-LEVEL OBLIGATIONS						
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**
	policies, and adherence to responsible business codes and other internationally recognised standards.						• If the decision is to comply: • draft internal sustainability DD policy • make changes to systems and processes necessary to reflect the policy. • Draft required external disclosures.
2b	**If explaining non-compliance under (b)** Publish the reasons for not considering the adverse impact of investment decisions on sustainability factors (the explanation should include information on whether and when the firm does intend to consider such impacts)	Yes	**Website**	4(1)(b) 4(5)(b)	No	**10 March 2021**	
3	**Update remuneration policy** Update existing remuneration policy to include information on how the policy is consistent with the integration of sustainability risks.	Yes	**Website**	5(1)	No	**10 March 2021**	• Consider to what extent it will update remuneration policy. • Draft required updates to policy document.

	B. OBLIGATIONS RELEVANT FOR ALL FINANCIAL PRODUCTS (EVEN THOSE WITHOUT AN ESG-FOCUS)						
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**
4	**Business decision (comply or explain) on assessing the impact of sustainability risks on returns** An asset manager must decide, for **each** financial product that it "makes available"[3], whether to either: (a) **comply** - assess the likely impacts of sustainability risks on the returns of **each** financial product – see 4a below; **or** (b) **explain** - formulate an explanation for why the asset manager does not consider sustainability risks to be relevant to a particular financial product – see 4b below.						
4a	If complying with (a) Publish the results of the assessment of the likely impact of sustainability risks on the return of the financial product	Yes	**Pre-contractual disclosure**	6(1)(b) 6(2)(b)	No	**10 March 2021**	• Review, for each financial product, whether the firm will assess the impacts of sustainability risks on the return of that financial product.

[3] There is no formal definition in the Disclosures Reg as to the meaning of "make available". Further clarification will be required from applicable regulators, including as to whether it is limited to active marketing by the FMP, or whether it also includes distribution of a FMP's products through third parties, or products sold exclusively in response to reverse enquiries.

<table>
<tr><th colspan="8">B. OBLIGATIONS RELEVANT FOR ALL FINANCIAL PRODUCTS (EVEN THOSE WITHOUT AN ESG-FOCUS)</th></tr>
<tr><th></th><th>What must the asset manager do?</th><th>Does this apply to FAs?</th><th>What type of disclosure?</th><th>What Article covers this?</th><th>Will there be Level 2 measures?</th><th>What's the deadline?</th><th>Next steps the firm should take</th></tr>
<tr><td>4b</td><td>If explaining non-compliance under (b)

Publish clear and concise reasons why <u>sustainability risks</u> are not relevant for returns of the financial product</td><td>Yes</td><td>Pre-contractual disclosure</td><td>6(1)(b)

6(2)(b)</td><td>No</td><td>10 March 2021</td><td>• Make formal decision (Board level? Product committee level?) on this issue.

• For any product where the firm is carrying out this assessment establish methodology for performing and publishing the calculation.

• For any product where the firm is not carrying on the assessment prepare the express negative disclosures</td></tr>
<tr><td>5</td><td colspan="7">Refer to the decision made at item 2 on whether to implement a sustainability DD policy
(a) where the asset manager has implemented a sustainability DD policy
• it must further decide whether and how each financial product considers principal adverse impacts on <u>sustainability factors</u> at a product level – see 5a below; or
(b) where the asset manager has not implemented a sustainability DD policy
• it must explain for each financial product the reasons why it does not consider such adverse impacts – see 5b below.</td></tr>
<tr><td rowspan="2">5a</td><td rowspan="2">If implementing a sustainability DD policy

Disclose whether and how each financial product considers the principal adverse impacts on <u>sustainability factors</u>.</td><td>No</td><td>Pre-contractual disclosure</td><td>7(1)(a)</td><td>No</td><td>30 December 2022</td><td rowspan="2">• Review, for each financial product, whether and how the financial product considers the principal adverse impact on <u>sustainability factors</u>.

• Make formal decision (Board level? Product committee level?) on this issue.

• For any product where the firm is considering <u>sustainability factors</u>: prepare relevant disclosures.

• For any product where the firm is not considering <u>sustainability factors</u>: prepare the express negative disclosures.</td></tr>
<tr><td>No</td><td>Periodic disclosure[4]</td><td>7(1)(b)</td><td>No[5]</td><td>30 December 2022</td></tr>
<tr><td>5b</td><td>If <u>not</u> implementing a sustainability DD policy

Disclose for each financial product an express negative statement that the asset manager does not consider adverse impacts, and the reasons for not doing so.</td><td>No</td><td>Pre-contractual disclosure</td><td>7(2)</td><td>No</td><td>10 March 2021[6]</td><td>• Prepare express negative disclosures for each financial product.</td></tr>
</table>

[4] Article 7(1)(b) is in some respects confusingly drafted. It requires that if a FMP considers adverse sustainability impacts, it must include in pre-contractual disclosures [ie the "**article 6(3) disclosures**"] a statement that information on adverse sustainability impacts will be included in the periodic reports for the product [ie the "**article 11(2) disclosures**"]. However, there is no express provision which switches-on an obligation to include such information in the periodic disclosures. We assume that article 7(1)(b) implicitly creates that obligation, although this may be subject to further clarification by applicable regulators.

[5] No specific Level 2 measures are set to be published for this rule, but article 7(1) second sub-paragraph cross-refers to the RTS to be published under article 4 - so presumably the intention is that such RTS would also be used for the purposes of the periodic disclosures.

[6] Note that article 7(2) disclosure of non-compliance with article 4(1)(b) does <u>not</u> benefit from the delayed implementation date under article 7(1).

B. OBLIGATIONS RELEVANT FOR ALL FINANCIAL PRODUCTS (EVEN THOSE WITHOUT AN ESG-FOCUS)							
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**
6	**Review all marketing communications** The asset manager must review of all its marketing materials for all in-scope products and services, to ensure that those marketing documents **do not contradict** any information disclosed under the Disclosures Reg	Yes	**All marketing materials**	13(1)	Yes	**10 March 2021 (and ongoing)**	• Determine which team(s) within the firm will be responsible for this exercise – for example Compliance, IR / Marketing, Product, and/or consider use of external legal counsel for this exercise. • Establish a complete list of current and future marketing materials issued by the firm which will be in use as at 10 March 2021. This might include, for example, presentations, pitch books, DDQs, teasers, website etc. • Formulate a project plan for reviewing all such marketing materials and ensuring that any references to ESG or sustainability are consistent with policy decisions made or formal disclosures formulated in accordance with the Disclosures Reg. • Update marketing materials as necessary, and communicate those updates internally to IR / Marketing teams, and externally to any third party distribution network.

C. OBLIGATIONS ONLY RELEVANT FOR FINANCIAL PRODUCTS WITH AN ESG-FOCUS							
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**
7	**Financial product promotes environmental or social characteristics** Where a financial product promotes, among other characteristics, environmental or social characteristics (and investments follow good governance practices), the asset manager must disclose certain prescribed information • on how those characteristics are met and • on any index designated as a reference benchmark.	No	**Website**	10(1)	Yes	**10 March 2021**	• Assess whether each financial product is in or out of scope, depending on the investment objectives and wider focus of the product. • In addition, assess specifically if the product promotes environmental characteristics (which will then trigger compliance with the Taxonomy). • For any product **in scope**, implement project to track development of level 2 measures and prepare required additional disclosures. In addition, for any product in scope of
		No	**Pre-contractual disclosure**	8(1) 8(2)	Yes	**10 March 2021**	
		No	**Periodic disclosure**	11(1)	Yes	**1 January 2022**	

C. OBLIGATIONS ONLY RELEVANT FOR FINANCIAL PRODUCTS WITH AN ESG-FOCUS

	What must the asset manager do?	Does this apply to FAs?	What type of disclosure?	What Article covers this?	Will there be Level 2 measures?	What's the deadline?	Next steps the firm should take
	In addition, **if** the product promotes **environmental** characteristics, additional disclosures will be required under the Framework Regulation, relating to compliance with the taxonomy and an explanation of the "do no harm" principle.[7] For out-of-scope products, an express negative disclosure will be required.[8]						the Taxonomy, further workstreams will be required on adherence to the Taxonomy. • For any product **out of scope**, include the mandatory express negative disclosure.
8	**Financial product with objective of <u>sustainable investments</u>** Where a financial product has <u>sustainable investment</u> as its objective, the asset manager must disclose certain prescribed information depending on whether or not an index has been designated as a reference benchmark. In addition, <u>if</u> the product invests in an economic activity that contributes to an **environmental** objective, additional disclosures will be required under the Framework Regulation, relating to compliance with the taxonomy.[9] For out-of-scope products, an express negative disclosure will be required.[10]	No	**Website**	10(1)	Yes	**10 March 2021**	• Assess whether each financial product is in or out of scope, depending on the investment objectives and wider focus of the product. • In addition, assess specifically if the product contributes to an environmental objective (which will then trigger compliance with the Taxonomy). • For any product **in scope,** implement project to track development of level 2 measures and prepare required additional disclosures. In addition, for any product in scope of the Taxonomy, further workstreams will be required on adherence to the Taxonomy. • For any product **out of scope**, include the mandatory express negative disclosure.
		No	**Pre-contractual disclosure**	9(1) 9(2) 9(4)	Yes	**10 March 2021**	
		No	**Periodic disclosure**	11(1)	Yes	**1 January 2022**	
9	**Financial product with objective of reducing carbon emissions** Where a financial product has a reduction in carbon emissions as its objective, the asset manager must disclose certain prescribed information in relation to the Paris Agreement. In addition, **if** the product invests in an economic activity that contributes to an environmental objective, additional disclosures will be required under the Framework Regulation, relating to compliance with the taxonomy.[11] For out-of-	No	**Website**	10(1)	Yes	**10 March 2021**	• Assess whether each financial product is in or out of scope, depending on the investment objectives and wider focus of the product. • In addition, assess specifically if the product contributes to an environmental objective (which will then trigger compliance with the Taxonomy). • For any product **in scope**, implement project to track development of level 2 measures and prepare required additional disclosures. In addition, for any product in scope of
		No	**Pre-contractual disclosure**	9(3) 9(4)	Yes	**10 March 2021**	
		No	**Periodic disclosure**	11(1)	Yes	**1 January 2022**	

[7] Article 4-beta and Article 16 of the draft Framework Regulation, which inserts a new Article 8(2a) into the Disclosures Reg.
[8] Article 4-gamma of the draft Framework Regulation.
[9] Article 4-alpha and Article 16 of the draft Framework Regulation, which inserts a new Article 9(2a) into the Disclosures Reg.
[10] Article 4-gamma of the draft Framework Regulation.
[11] Article 4-alpha and Article 16 of the draft Framework Regulation, which inserts a new Article 9(2a) into the Disclosures Reg.

	C. OBLIGATIONS ONLY RELEVANT FOR FINANCIAL PRODUCTS WITH AN ESG-FOCUS						
	What must the asset manager do?	**Does this apply to FAs?**	**What type of disclosure?**	**What Article covers this?**	**Will there be Level 2 measures?**	**What's the deadline?**	**Next steps the firm should take**
	scope products, an express negative disclosure will be required. [12]						the Taxonomy, further workstreams will be required on adherence to the Taxonomy. • For any product **out of scope**, include the mandatory express negative disclosure.

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[12] Article 4-gamma of the draft Framework Regulation.