# ESG: Special Briefing on the Disclosures Regulation

Briefing for AIMA members

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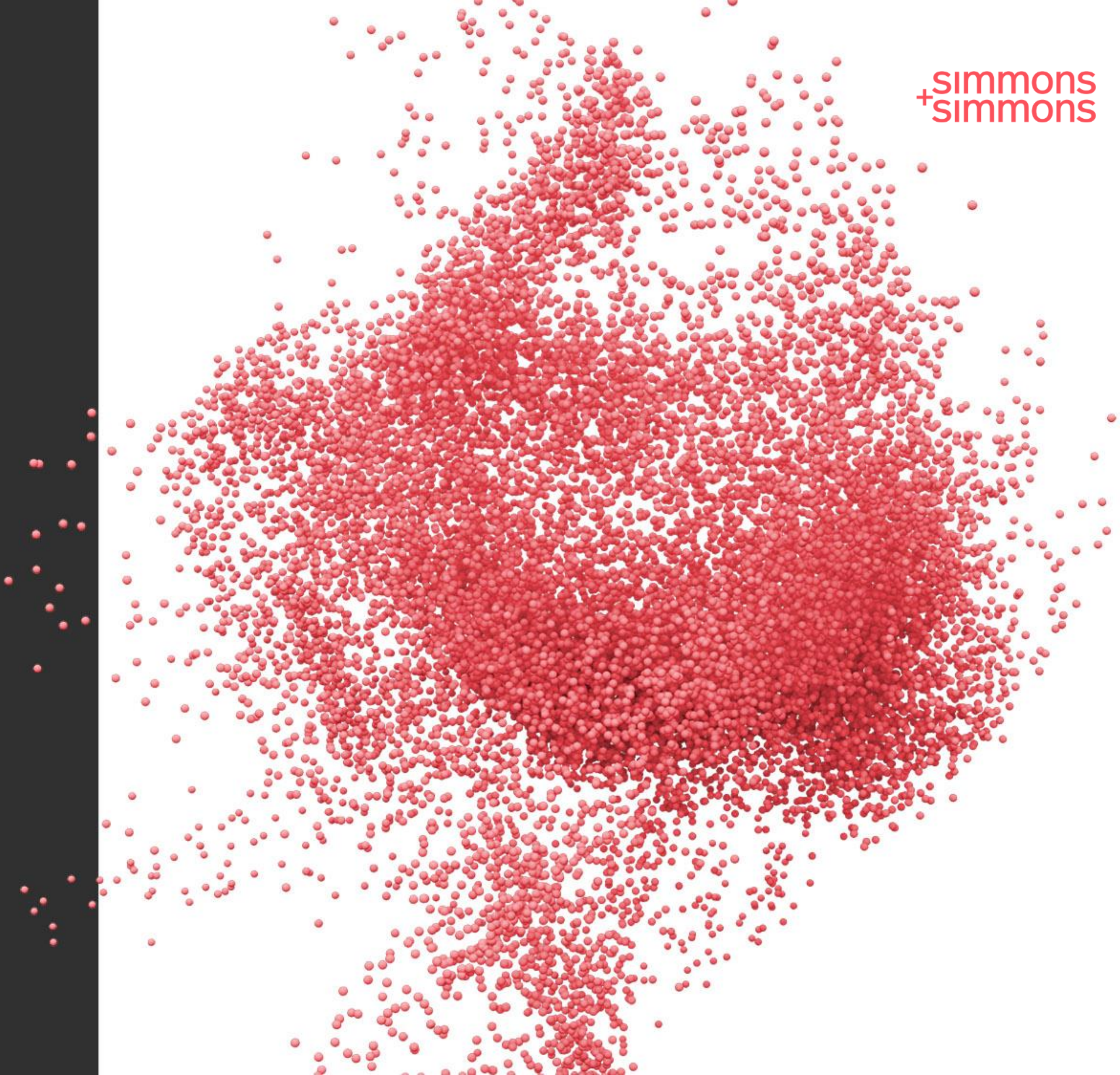


# Today's agenda

1. Background
2. Disclosures Regulation: initial scoping and key concepts
3. Disclosures Regulation: key new rules – manager level
4. Disclosures Regulation: key new rules – fund level
5. Framework Regulation (aka Taxonomy)

# Part 1
Background

# ESG regulation

## Where is this coming from?



**Global initiatives:**

- 2015 Paris Agreement on climate change
- United Nations 2030 Agenda for Sustainable Development

**European Commission High-Level Expert Group (January 2018) imperatives:**

- improving the contribution of finance to sustainable and inclusive growth
- strengthening financial stability by incorporating ESG factors into investment decision-making

**Commission's Action Plan on Financing Sustainable Growth (March 2018):**

- Proposals for mutually reinforcing legislative acts aimed at integrating ESG considerations into the investment and advisory process

Not just Europe: e.g. HK SFC April 2019 Circular on Green or ESG funds

# The Commission's Action Points



**Reorienting capital flows towards sustainable investment**

01 Establish an EU taxonomy for sustainable activities

02 Create standards and labels for green financial products

03 Foster investment in sustainable projects

04 Incorporate sustainability when providing financial advice

05 Develop sustainability benchmarks

**Managing financial risks from environmental and social issues**

06 Better integrate sustainability in ratings and market research

07 Clarify institutional investors' and asset managers' duties

08 Incorporate sustainability in prudential requirements

**Fostering transparency and long-termism in financial activity**

09 Strengthen sustainability disclosure and accounting rule-making

10 Foster sustainable corporate governance and counter undue short-termism in capital markets

# Key regulations – EU Action Plan



| EU Regulation | Focus | Status | In force... |
|---|---|---|---|
| **Disclosures Regulation** | Requirement to disclose new policies relating to integration of sustainability within firm, and external impact of firm's investing on sustainability factors | Finalised and published in OJ in Q4 2019 | 10 March 2021 |
| **Framework Regulation** | Establishes a taxonomy for determining whether an economic activity is environmentally sustainable, and imposes certain additional disclosures on asset managers | Near-final draft in Q4 2019 | 31 December 2021 then phase-in? [TBC] |
| **Delegated Acts for MiFID 2, UCITS Directive and AIFMD** | Amendments to organisational / systems and controls rules to require integration of sustainability across a firm | ESMA consultation in Q2 2019 | Aligned with Disclosures Reg? [TBC] |
| **Suitability Delegated Regulation** | Changes to the MiFID suitability test to include a mandatory focus on the client's ESG preferences | Commission proposal in Q1 2019 | Aligned with Disclosures Reg? [TBC] |
| **Amendments to Benchmarks Regulation** | Requires operators of ESG-focused benchmarks to publish certain data | Finalised and published in OJ in Q4 2019 | 30 April 2020 |
| **SRD2** | Requires asset managers to publish shareholder engagement policy and annual report, on "comply or explain" basis | Already in force from Q2 2019 | Since Q2 2019 |

# The B-word....



**What's the impact of Brexit for UK firms?**

- UK left the EU on 31 January 2020, subject to the Withdrawal Agreement
- Transitional period in Withdrawal Agreement due to end on 31 December 2020 (unless extended)
- Disclosures Regulation comes into force as from 10 March 2021 – i.e. after end of transitional period
- But... UK government has said that it will onshore the Disclosures Regulation and the Framework Regulation into UK law, even after a hard Brexit
- UK firms should therefore assume that these rules will become law in the UK
- In addition, any EU-27 asset management entity in a UK firm's wider group will be directly subject to these rules (e.g. a Lux or Irish Manco)

# Part 2

Disclosures
Regulation:
initial scoping
and
key concepts

# Key themes



**Two key sustainability themes**

1. Internal within a firm: integration of sustainability risks in **investment decision-making** processes
2. External to the markets: consideration of **potential adverse impacts** of investment decisions on sustainability factors
   - Commercial decisions will need to be made on both points, before thinking about any disclosures
   - Relevant to <u>all</u> firms and funds (even those without an express ESG focus)

**And also…**

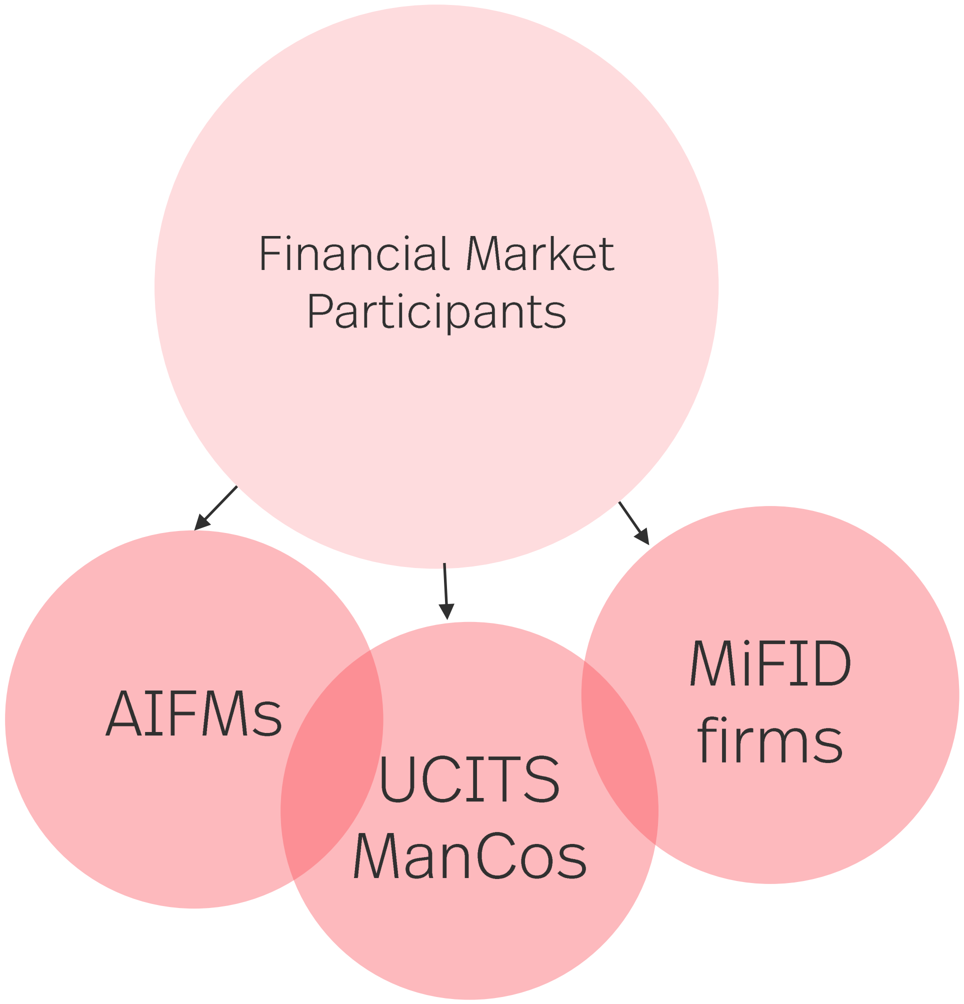
- An additional set of disclosure rules for financial products with an express ESG focus

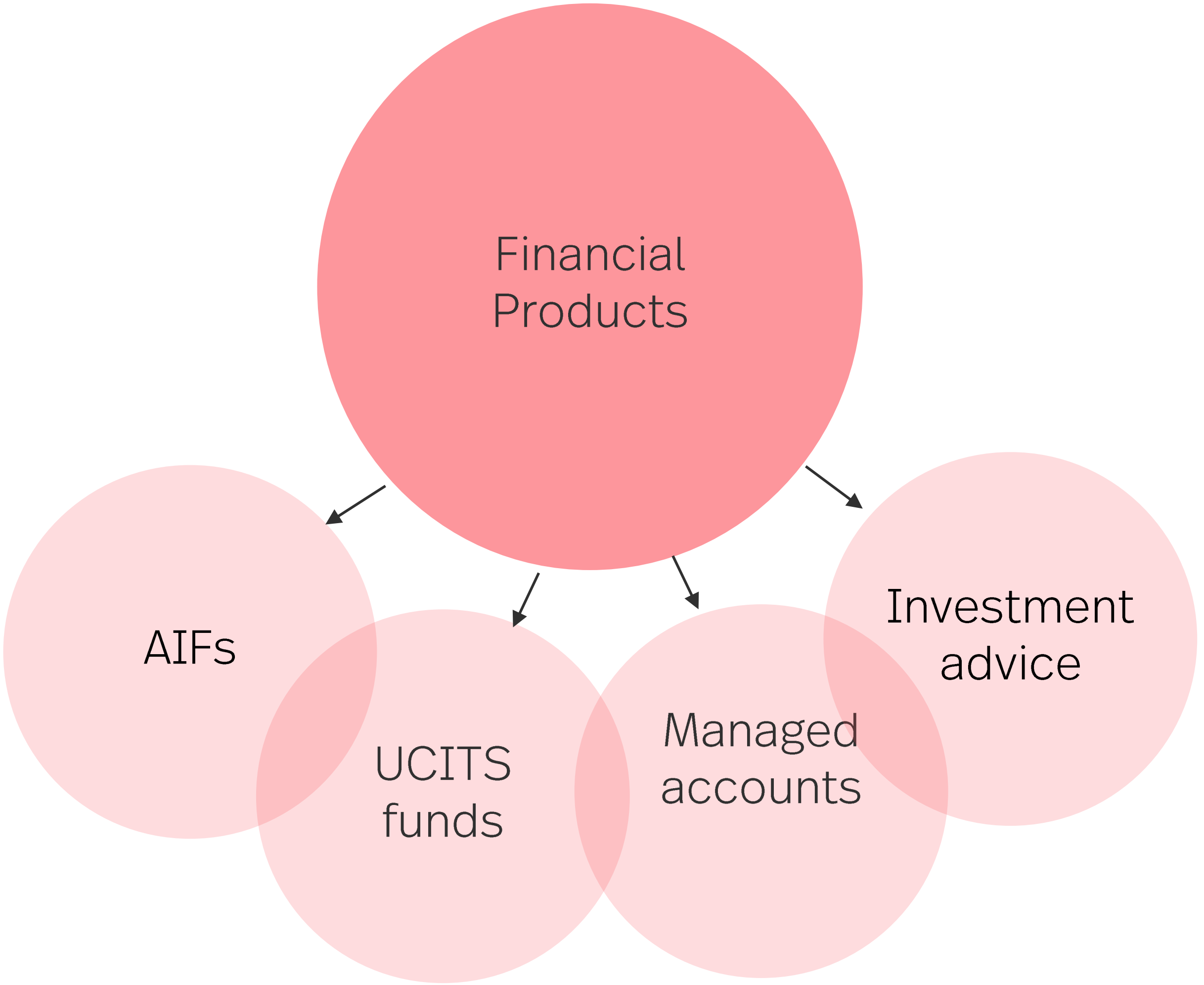
**These rules are <u>not</u>….**

- Mandatory restrictions on what firms can or cannot invest in (i.e. <u>not</u> a "whitelist" or a "blacklist")
- Concerned about a firm's own ESG initiatives as a business (e.g. a firm's own diversity policy is <u>not</u> in scope)

# Who is subject to the Disclosures Reg?





# What type of "ESG" is in scope?

**Framework Regulation (taxonomy) focuses only on environmental:**

- 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

**Disclosures Regulation has broader focus on "sustainability":**

- Environmental: energy, raw materials, water and land, waste, emissions, biodiversity, circular economy
- Social: inequality, cohesion, labour relations, human capital, disadvantaged communities
- Governance: management structures, employee relations, remuneration of staff and tax compliance

# Key definitions

**Disclosures Reg introduces three new concepts with formal definitions**

- Sustainable investment: In summary, an investment in an economic activity which:
  - contributes either to an environmental objective or a social objective *[as summarised on slide 11]*
  - does not significantly harm any environmental or social objectives and
  - the investee company follows good governance practices

- Sustainability risk: 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: environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters

# Practical considerations



**Disclosures Regulation will require new policies to be implemented and amendments to fund documentation (including prospectus / formal offer document) and managed account agreements**

**ESG as a project:**

- Who in your organisation is responsible for the Disclosures Regulation (and ESG regulation generally)?
- What working group / project plan do you require?
- What budget do you have?
- How are you engaging senior management and other stakeholders internally?
- What involvement will be needed from external service providers?

**Updates to fund documentation/managed account agreements:**

- Will investor notification / consent be required?
- Will regulatory notification / consent be required?
- What process will you need to follow?
- How much time will you need to build in, ahead of March 2021, to circulate documents and obtain consents?

# **Part 3**
# Disclosures Regulation: key new rules – manager

# Manager-level rules (1)

## Sustainability Risks Policy:

- Firms must have policy on integration of *sustainability risks* into investment decision-making processes
- Internal impact
- What does this mean in practice?

## Practical issues:

- Decide whether/how sustainability risks are integrated into investment process
- At what level in the firm is the decision made?
- Update internal investment/risk management policies, systems and processes
- Draft external disclosure for website and each financial product
- Process for updating documentation (timing, notice, consent, etc?)

# Manager-level rules (2)

**Sustainability due diligence policy:**

- Comply or explain requirement initially, but will become mandatory for firms or groups with > 500 employees
- If complying: must implement investment due diligence policies to consider principal adverse impacts of your investment decisions on *sustainability factors* at level of investment manager
- External impact
- What does this mean in practice?

**Practical issues:**

- Decide whether to comply: decision to implement a sustainability DD policy (or confirm if automatically caught by >500 employees rules)
- At what level in the firm is the decision made?
- *If complying:* draft internal policy, change systems and processes and external disclosures
- *If not complying:* publish reasons for not considering adverse impact
- In either case: process for updating documentation (timing, notice, consent, etc?)

# Manager-level rules (3)



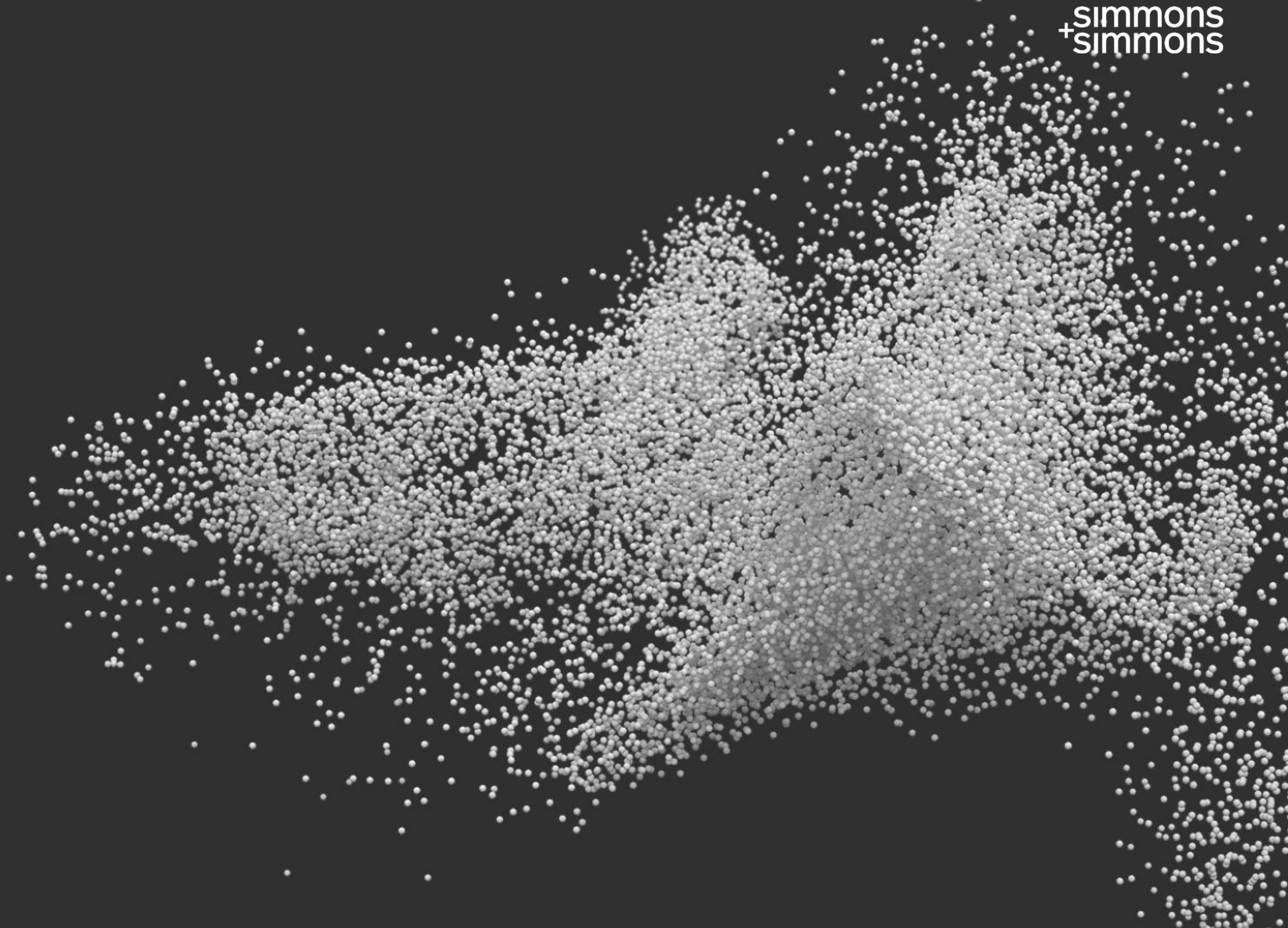
**Remuneration policy:**

- Update remuneration policy to include information on how remuneration in firm is consistent with integration of sustainability risks
- Internal impact

**Practical issues:**

- Consider to what extent to update remuneration policy
- Draft required updates to policy document

# **Part 4**
# Disclosures Regulation: key new rules - fund



# Product-level rules (for all products) (1)



**Assess impact of sustainability risks on returns:**

- Comply or explain requirement
- If complying: must assess impact that *sustainability risks* would have on the returns of each financial product
- Internal impact
- What does this mean in practice?

**Practical issues:**

- Decide whether to either:
  1. perform the impact assessment (product by product) or
  2. formulate an explanation for why the asset manager does not consider sustainability risks to be relevant to a particular financial product
- At what level in the firm is the decision made?
- *If complying:* for each product where the firm is carrying out the assessment:
  - establish methodology for performing and publishing calculation
  - prepare disclosure
- *If not complying:* publish clear and concise reasons why sustainability risks are not relevant for returns of the financial product
- Process for updating documentation (timing, notice, consent, etc?)

# Product-level rules (for <u>all</u> products) (2)



**Product-level consideration of principal adverse impacts:**

- Conditional requirement: <u>If</u> the manager has implemented a sustainability DD policy at manager level *(see slide 16)*, must disclose whether and how each financial product considers the principal adverse impacts on sustainability factors
- External impacts
- What does this mean in practice?

**Practical issues:**

- If implementing a sustainability DD policy at manager:
  - review each product and determine whether/how it considers adverse impacts
  - prepare positive or negative disclosures
- Otherwise: publish for each financial product that the manager does not consider adverse impacts, and the reasons for not doing so
- Process for updating documentation (timing, notice, consent, etc?)

# Product-level rules (sustainability only) (3)



Certain additional disclosures required only for products with an express sustainability focus

- Scope: any product which:
  - promotes environmental or social characteristics
  - has sustainable investment as its objective or
  - has a reduction in carbon emissions as its objective
- Disclosures depend on whether or not an index is designated as a reference benchmark
- If the product invests in an economic activity that contributes to an environmental objective, additional disclosures will be required under the Framework Regulation

**NOTE: For out-of-scope products, an express negative disclosure may be required**

# What and how to disclose



**Manager's public website:**

- Policy on integration of sustainability risks
- Sustainability DD policy – manager level (or explanation of why not implemented)
- Information on remuneration policy

**Prospectus for fund (or T&Cs for managed account):**

- Policy on integration of sustainability risks
- Results of impact assessments on investment returns (or explanation of why not relevant)
- Sustainability DD policy – fund level (or explanation of why not implemented)
- Express negative disclosure on environmental sustainability *[unless expressly in-scope – see below]*

**Funds with an express sustainability focus:**

- Additional pre-contractual, public and periodic disclosures

# **Part 5**
# Framework Regulation (aka Taxonomy)

# Framework Regulation (Taxonomy)



**Policy:**

- establishes a taxonomy for determining whether an economic activity is environmentally sustainable

An economic activity will be considered "environmentally sustainable" where it:

- "contributes substantially" to one or more of the 6 environmental objectives *(see slide 11)*
- "does not significantly harm" any of the others
- complies with minimum social safeguards (OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights)
- complies with performance thresholds (known as "technical screening criteria") - these will be developed as Level 2 measures in due course

# Framework Regulation (Taxonomy)



**Application of taxonomy:**

- Vast majority relevant only to asset managers who make available financial products with an express environmental sustainability focus, but
- All asset managers need to include a short negative disclosure in products which do not follow taxonomy

Managers of in-scope products will need to ensure that the pre-contractual documentation and periodic reports for in-scope products contain additional disclosures to:

- Identify the relevant environmental objective(s)
- explain how, and to what extent, the product's investments comply with the taxonomy (substantial contribution, DNSH, minimum safeguards, technical screening)

# Framework Regulation (Taxonomy)

**Practical issues:**

- Determine which funds/products are in-scope
  - Has sustainable investment as an objective and invests in an activity that contributes to an environmental objective OR
  - Promotes environmental characteristics
- 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

# Q&A

# Key contacts



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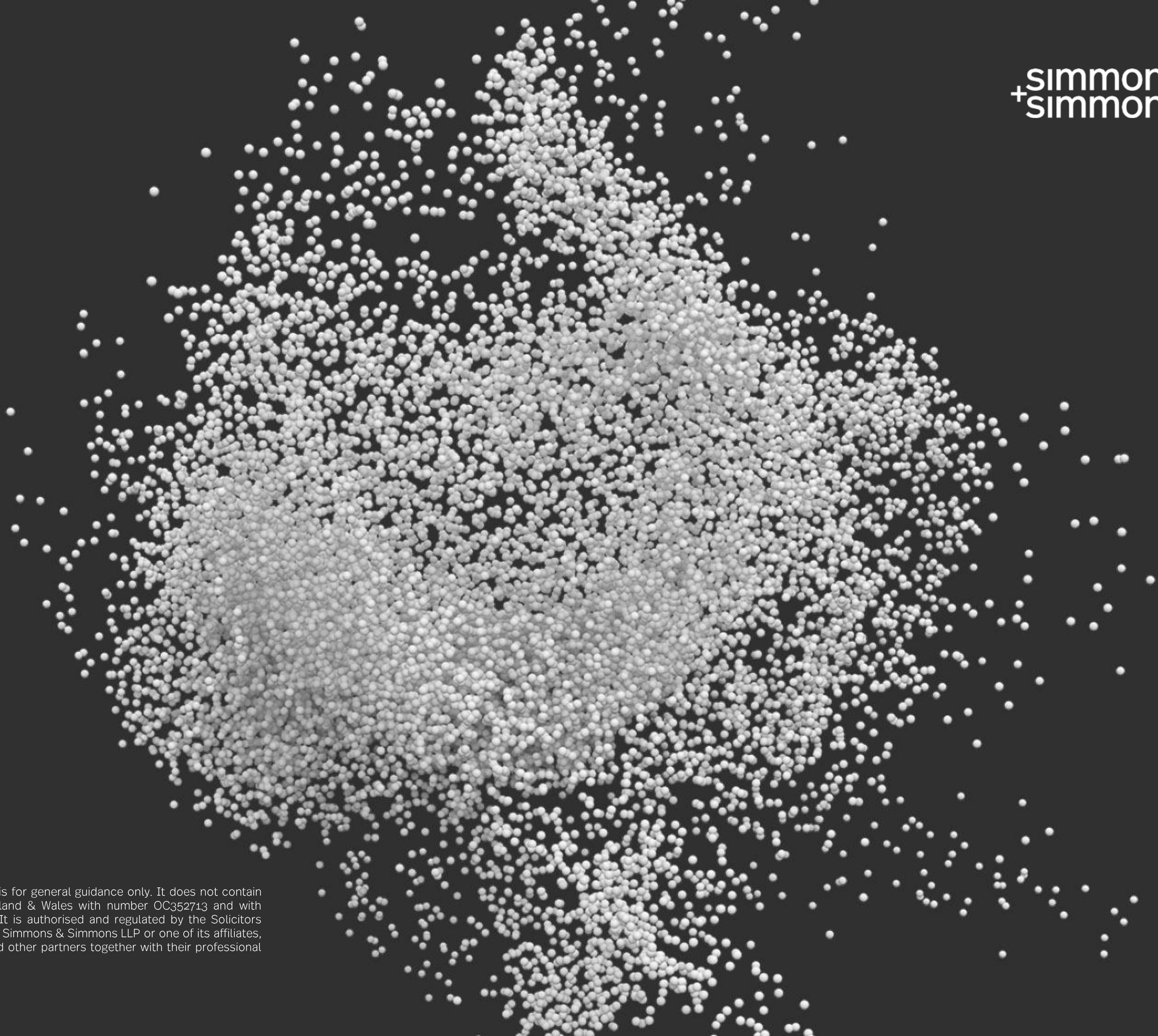

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