



ESG Duties and Disclosures for Asset Managers and Advisers

European legislative proposals to improve the integration, classification and transparency of sustainable finance

Overview

On 24 May 2018, the European Commission published a package of legislative proposals which seek to help investors identify, classify and compare sustainable investments and to integrate environmental, social and governance (“**ESG**”) considerations within the investment process.

The **Commission’s proposals** build on its Action Plan on Financing Sustainable Growth, which was published in March 2018 and highlighted in **this note**.

As a follow-up to those proposals, in a **letter** published on 1 August 2018, the Commission mandated the European Securities and Markets Association (“**ESMA**”) to prepare technical advice on how to require asset managers and advisers to integrate ESG risks in their investment decisions or advisory processes, as part of their duties towards investors and/or clients.

Key Impacts

The key impacts of these measures for asset managers and advisers are:

- > integration of ESG factors and risks in the legal duties they owe to investors and/or clients;
- > formal obligations to disclose how sustainability risks are integrated in their organisations and the services they provide to clients; and
- > where firms market themselves as pursuing a low carbon emission objective, they may need to designate and comply with methodologies for “low carbon” or “positive carbon impact” benchmarks.

Firms may also need to capture and reflect clients’ ESG preferences where suitability assessments are required under MiFID II.



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Who is caught by the proposals?

The proposals are aimed at firms involved in investment decision-making processes and firms providing investment advice. Firms in the former category are referred to as “**Financial Market Participants**”, and include:

- > management companies of undertakings for collective investment in transferrable securities (“**UCITS**”);
- > alternative investment fund managers (“**AIFMs**”) under the Alternative Investment Fund Managers Directive (“**AIFMD**”);
- > managers of European venture capital funds and European social entrepreneurship funds;
- > investment firms which provide portfolio management under the Markets in Financial Instruments Directive II (“**MiFID II**”); and
- > providers of pension products and providers of certain insurance-based investment products.

The latter category encompasses investment firms providing investment advice under MiFID II and certain insurance intermediaries providing insurance advice.

This note focusses on the impact of the proposals on asset managers and investment advisers.

Please see our separate [note](#) for more information on how the proposals apply to the insurance sector.



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The Commission intends to use its powers under MiFID II, the UCITS Directive and AIFMD to amend existing regulations to explicitly require the integration of “sustainability risks” (i.e., ESG risks) in the duties owed by asset managers and investment advisers to their investors and/or clients. To that end, it has asked ESMA to provide technical advice recommending how and where firms should integrate relevant sustainability risks within their business models and relevant procedures in the following areas (in each case, taking into account the size, nature, scale and complexity of their activities):

- > Organisational requirements and governance
- > Operating conditions, investment strategy and asset allocation
- > Risk management

In relation to investment advisers, the technical advice must also specify how and where sustainability risks and other sustainability factors are to be integrated within the target market assessments required under the MiFID II product governance regime.

ESMA, together with the European Insurance and Occupational Pensions Authority (“**EIOPA**”), is required to provide this technical advice by 30 April 2019.

How significant would this be?

Although many asset managers and investment advisers are already in the process of more fully integrating ESG factors into both their investment decision-making and their wider operational architecture, being placed under a legal duty to do so would represent a significant step. In the short term, it may serve to exacerbate some of the existing challenges created by attempting to incorporate ESG factors. For example, a lack of high quality data, particularly in relation to social factors, means that many asset managers have found it difficult to integrate ESG factors into their investment methodology in a robust, consistent way, which goes beyond negative screening (whereby certain investments are excluded from consideration altogether based on ESG factors). However, it is important to note that any proposals as to the form these rules may take will not be published until ESMA has provided its technical advice to the Commission.



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ESG disclosures to investors and clients

The Commission considers that there is a lack of consistent, systematic transparency regarding whether, and if so how, asset managers, investment advisers and institutional investors consider ESG factors in their investment and advisory processes. A proposed “**ESG Disclosure Regulation**” seeks to address these deficiencies by requiring Financial Market Participants and investment advisers to make a range of disclosures relating to “sustainability risks” and “sustainable investments”.

> Sustainability risks: firms must:

- publish and maintain written policies on their websites, describing the integration of sustainability risks in their investment decision-making or advice; and
- include in their pre-contractual disclosures descriptions of the procedures and conditions applied for such integration, how their remuneration policies are consistent with such integration (and, where relevant, with sustainable investment targets), and the extent to which sustainability risks are expected to have a relevant impact on the returns of financial products.

> Sustainable investments: In relation to a sub-set of financial products which have as their target “sustainable investments” (i.e., investments in an economic activity that contributes to an environmental or social objective, or in companies following good governance practices) or investments with similar characteristics, firms must:

- publish and maintain on their websites descriptions of these sustainable investment targets and related methodologies;

- include in their pre-contractual disclosures and on their websites information about how such sustainable investment targets are reached (by reference to a benchmark, where relevant); and
- include in their periodical reports and on their websites the overall sustainability-related impact of these financial products (by reference to relevant sustainability indicators and a reference benchmark, where applicable).

The European Supervisory Authorities will be required to develop, and the Commission will adopt, regulatory technical standards further specifying the presentation and content of certain of these disclosures, up to 18 months after the framework regulation enters into force.

How significant would this be?

Institutional investors are already placing increasing weight on ESG factors and have been demanding more comprehensive ESG information from asset managers and advisers. Supporting this trend are organisations such as the **UN Principles for Responsible Investment (PRI)**, which has a wealth of resources, including the recently published guide to **ESG Monitoring, Reporting and Dialogue in Private Equity**. The extent to which the new EU disclosure requirements actually place an increased burden on asset managers and investment advisers will, therefore, largely depend upon the detailed requirements of the regulatory technical standards to be adopted by the Commission in due course. The fact that these disclosure requirements will not apply until twelve months after the ESG Disclosure Regulation is published in the Official Journal of the EU will provide firms with more time to align their existing disclosure practices with the incoming regime.



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Territorial scope for AIFMs

The proposals simply refer to AIFMs as defined in the definitions article of AIFMD, which captures all types of AIFM, whether they are EEA or non-EEA. To determine which types of AIFMs will be captured by each of the proposals, therefore, it is useful to track through and identify which provisions of AIFMD they will amend or supplement.

- > Duties: The Commission intends to implement its proposals relating to duties by supplementing certain specified articles under AIFMD which currently apply only to EEA authorised AIFMs. However, by the time these provisions come into effect (see “What’s next?” below for more details), the third country passport under AIFMD may well have been switched on for certain non-EEA countries, and so any non-EEA AIFMs utilising this passport would have to comply with these new rules as well.
- > Disclosures: Some of the disclosure proposals supplement Article 23 AIFMD (Disclosure to Investors) and Article 22 AIFMD (Annual Report). Those AIFMD articles apply to all AIFMs marketing or having marketed funds in the EEA, so would capture both EEA authorised AIFMs and non-EEA AIFMs if they have European investors. However, some other provisions do not refer back to specific articles of AIFMD, so their scope remains unclear. It would therefore be useful if greater clarity were provided in the final versions of these rules.

In any event, many non-EEA AIFMs may have a EEA authorised investment firm providing investment advice or portfolio management services in their structures. In these cases, the duties and disclosure requirements will apply directly to the investment firm itself.



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Taxonomy

The second overarching objective of the Commission's legislative proposals is to provide investors and other stakeholders with an improved range of tools with which to identify, classify and compare sustainable economic activities and investments.

A proposed “**ESG Taxonomy Regulation**” will establish a framework for the development of uniform criteria to identify whether a particular economic activity can be considered “environmentally sustainable”. To be environmentally sustainable, an economic activity must:

- > contribute substantially to one or more of six specified environmental objectives, namely: (i) climate change mitigation; (ii) climate change adaptation; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control; and (vi) protection of healthy ecosystems;
- > not significantly harm any of these six environmental objectives;
- > be carried out in compliance with certain minimum social and governance safeguards; and
- > comply with additional qualitative and quantitative technical screening criteria, to be developed by the Commission through delegated acts.

The purpose of the ESG Taxonomy Regulation is to create an EU-wide ‘taxonomy’, by specifying criteria which must be applied by Member States when developing labelling systems for environmentally sustainable financial products, and

also by Financial Market Participants when marketing such products. In particular, Financial Market Participants offering financial products as environmentally sustainable investments (or investments with similar characteristics) would be required to disclose how and to what extent the criteria set out in the ESG Taxonomy Regulation have been used to determine the environmental sustainability of those products.

Like the ESG Disclosure Regulation, the ESG Taxonomy Regulation empowers the Commission to adopt further rules which will specify additional technical screening criteria for each of the six environmental objectives. The Commission will establish a platform on sustainable finance, comprising stakeholders from the public and private sectors, to advise it in relation to the development of these criteria.

Furthermore, in order to ensure that the environmental taxonomy is appropriately developed and stable before Member States and Financial Market Participants are required to implement it, the provisions in relation to each of the taxonomy's six environmental objectives will only become applicable six months after the relevant technical screening criteria for contributing to a particular environmental objective or harming other environmental objectives are established.

In its present form, the ESG Taxonomy Regulation deliberately addresses environmental criteria only. However, it also contains a review mechanism providing that, by 31 December 2021 and every three years thereafter, the Commission will publish a report evaluating the appropriateness of extending the scope of the taxonomy to cover other sustainability objectives (in particular, social objectives).



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Benchmarks

A proposed “**ESG Benchmark Regulation**” will amend the current EU Benchmark Regulation to create two new categories of benchmark:

- > Low-carbon benchmark: This is a ‘decarbonised’ version of a standard benchmark (e.g., the S&P 500), in which the underlying assets are selected so that the resulting portfolio has lower carbon emissions than the ‘parent’ standard benchmark
- > Positive carbon impact benchmark: This is a more ambitious sustainability-focused benchmark, in which the underlying assets are selected on the basis that their carbon emissions savings exceed their carbon footprint

It will also require benchmark administrators to publish their methodologies for the assessment, selection and weighting of the underlying assets comprising their individual versions of these benchmarks, and explain how such benchmarks reflect ESG objectives.

Much of the detail relating to these benchmark categories remains to be clarified by the Commission in future acts, through which it intends to specify both the base methodologies that benchmark administrators must apply when constructing these benchmarks, and the minimum content of the disclosures required from benchmark administrators.

It is notable, however, that the Commission considered and rejected the creation of a fully harmonised methodology for the selection and weighting of the underlying assets constituting these benchmarks. Instead, the Commission’s favoured ‘minimum harmonisation’ approach will leave benchmark administrators with significant flexibility in the construction of individual benchmarks, and will also permit the development of new benchmarks in response to shifting demand from asset managers and investors over time.



A proposed “ESG Benchmark Regulation” will amend the current EU Benchmark Regulation to create two new categories of benchmark.



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MiFID II suitability assessment – clarifying ESG preferences

Under the existing MiFID II suitability framework, firms providing investment advice and portfolio management services are required to obtain information from clients about their knowledge and experience, ability to bear losses and their investment objectives (including risk tolerance) to ensure that such firms recommend and/or trade products that are suitable for the client.

In practice, the information gathered by firms as part of this suitability assessment tends to focus primarily on the client's financial objectives rather than non-financial considerations, and the Commission considers that investment firms consistently fail to appropriately factor ESG preferences into their investment recommendation and selection processes.

To address this, the Commission has published a draft regulation to incorporate ESG considerations in the suitability framework. Portfolio managers and investment advisers will have to take steps to ensure that their clients' ESG considerations are captured and embedded in their investment decision and recommendations framework.

From an operational perspective, given the diversity of subjective ESG preferences that could be put forward by clients, as well as the likelihood of fluctuations in the ESG profile of investments, we expect that asset managers will face significant difficulties in coding ESG preferences within their systems. The proposed framework particularly poses challenges for portfolio managers with model portfolios or portfolio strategies that run concurrently across multiple client accounts, in the event that clients invested in those portfolios and strategies communicate very different ESG preferences. Thought would also have to be given on how best to ascertain and capture clients' ESG preferences. Clients do not "have" to provide particular ESG preferences, but the draft regulation indicates that firms have an obligation to prompt clients for this information (including pre-existing clients).



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The ESG Disclosure Regulation, ESG Taxonomy Regulation and ESG Benchmark Regulation will need to follow the EU's 'ordinary legislative procedure' before being enacted into law.

The Council and the Parliament separately discuss their respective positions on the Commission's proposals, before entering 'trilogue' negotiations with the Commission to agree a common legislative text. The Commission expects agreement on the proposals to be reached before the European Parliament elections scheduled for May 2019. Each regulation will then become binding upon its publication in the Official Journal of the EU, and will enter into force, in the case of the ESG Benchmark Regulation, the day following publication, and in the case of the ESG Disclosure Regulation and the ESG Taxonomy Regulation, the twentieth day following publication.

However, as we have previously noted, the key operative provisions of both the ESG Disclosure Regulation and the ESG Taxonomy Regulation will have delayed application, which affords Financial Market Participants and other affected stakeholders additional time to fully get to grips with these new regimes. We also don't know how the proposals will emerge from the legislative procedure.



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The Commission's proposals to clarify ESG considerations in the context of MiFID II suitability assessments are still pending. The final regulation will be subject to a transition period and will apply 18 months after its entry into force.

At a national level, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* - "BaFin") has not expressly given its opinion on the Commission's proposals. BaFin stated its own approach in an expert article (*'Sustainable Finance: Environmental and societal changes - How BaFin deals with risks'*, p.15-17, published in BaFin Journal on 15 May 2018) regarding sustainable finance and how it will deal with risks relating to environmental and societal changes, citing the Commission's proposals as a starting point for the development of a harmonised European strategy.

BaFin's approach includes:

- > Developing a harmonized and efficient international reporting standard to measure environmental and climate risks;
- > Increasing awareness among undertakings supervised by BaFin for sustainability and encouraging them to integrate sustainability in their risk management processes; and
- > Continued analysis and identification of how sustainable finance can be implemented into BaFin's regulation practice and active engagement in corresponding political processes.



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