THE EU'S SUSTAINABLE FINANCE ACTION PLAN

CLARIFYING DUTIES – WHAT ASSET MANAGERS NEED TO KNOW

The Sustainable Finance Action Plan was adopted by the European Commission in March 2018 as part of the EU's efforts to connect finance with the specific needs of the European and global economy for the benefit of the planet and society. Several of the 10 high-level Action Points are particularly relevant to asset managers. This briefing will focus on Action Point 7: clarifying institutional investors' and asset managers' duties.

SPOTLIGHT ON IMPLEMENTATION OF ACTION POINT 7:

- Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations (the "Disclosure Regulation").
- Consultation on integrating sustainability risks and factors into AIFMD, UCITS, MiFID 2, Solvency 2 and IDD.

KEY CONCEPT: WHAT IS THE AIM OF THE DISCLOSURE REGULATION?

- Explicitly requires institutional investors and asset managers to integrate sustainability considerations in their investment decision-making process.
- Increase transparency towards end-investors on how they integrate such sustainability factors in their investment decisions, particularly their exposure to sustainability risks.

Key Dates

May 2018
Commission proposal for Disclosure Regulation

July 2018
Commission requests technical advice from ESMA re integrating sustainability risks and factors

December 2018
ESMA consults on integrating sustainability risks and factors in MiFID 2, AIFMD and UCITS

March 2019
Political agreement reached on text of Disclosure Regulation

April 2019
ESMA publishes technical advice to Commission on integrating sustainability risks and factors

Q3/4 2019
Potential publication in Official Journal and entry into force of Disclosure Regulation

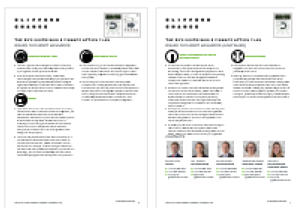
Q4 2020/Q1 2021
Potential application of Disclosure Regulation

What are the new requirements, what does the technical advice say, and what are the issues?

Disclosure Regulation

ESMA'S Technical Advice

Issues for Asset Managers



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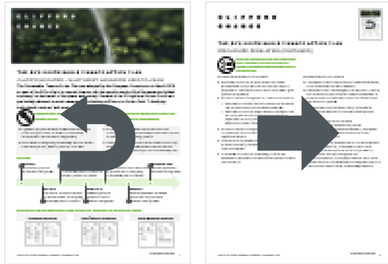

THE EU'S SUSTAINABLE FINANCE ACTION PLAN
DISCLOSURE REGULATION

APPLICATION

Applies to 'financial market participants' and 'financial advisers', which includes AIFMs, UCITS management companies, and MiFID investment firms (collectively referred to herein as 'asset managers').

WEBSITE DISCLOSURE REQUIREMENTS

Asset managers must disclose on their websites:

- information on their policies on the integration of *sustainability risks* in their investment decision-making process
- where they consider principal adverse impacts of investment decisions on *sustainability factors*, or if they have more than 500 employees, a statement on due diligence policies with respect to these principal adverse impacts
- where they do not consider adverse impacts of investment decisions on *sustainability factors*, clear reasons for not doing so and, where relevant, information as to whether and when they intend to consider such adverse impacts
- information on how their remuneration policies are consistent with the integration of *sustainability risks*.

SPOTLIGHT ON EXTRATERRITORIALITY:

- definition of AIFM refers back to Article 4(1)(b) of AIFMD, which includes non-EU AIFMs
- presumably non-EU AIFMs must only comply with the requirements in relation to the funds that they market into the EU – awaiting clarification.

PRE-CONTRACTUAL DISCLOSURE REQUIREMENTS

Asset managers must disclose, as part of their pre-contractual disclosure obligations:

- the manner in which *sustainability risks* are integrated into their investment decisions
- the result of the assessment of the likely impacts of *sustainability risks* on the returns of their funds or portfolios
- where *sustainability risks* are deemed not relevant, a clear and concise explanation of why they are not relevant
- where they consider principal adverse impacts of investment decisions on *sustainability factors*, or if they have more than 500 employees, by 3 years after entry into force of the Disclosure Regulation, for each fund or portfolio that they offer, a clear and reasoned explanation of whether and how that fund or portfolio considers principal adverse impacts on *sustainability factors* and a statement that information on principal adverse impacts on *sustainability factors* is available in periodic reports
- where they do not consider adverse impacts of investment decisions on *sustainability factors*, a statement that the asset manager does not consider the adverse impacts of investment decisions on *sustainability factors*, and a reasoned explanation for not doing so.

KEY CONCEPTS: SUSTAINABILITY RISKS, SUSTAINABILITY FACTORS AND SUSTAINABLE INVESTMENTS

- *Sustainability risk*: an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.
- *Sustainability factors*: environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.
- *Sustainable investments*: any of the following or a combination of any of the following:
  - investments in an economic activity that contribute to an environmental objective
  - investments in an economic activity that contribute to a social objective,

  provided that the investments do not significantly harm any of those objectives and the investee companies follow good governance practices.

THE EU'S SUSTAINABLE FINANCE ACTION PLAN

DISCLOSURE REGULATION (CONTINUED)

SPECIFIC REQUIREMENTS FOR PRODUCTS THAT PROMOTE ENVIRONMENTAL OR SOCIAL CHARACTERISTICS/SUSTAINABLE INVESTMENTS

Pre-contractual disclosures must include:

- information on how the environmental and/or social characteristics are met (this assumes that the relevant companies in which the investments are made follow good governance practices)
- if an index has been designated as a reference benchmark:
  - information on whether and how this index is consistent with environmental and/or social characteristics
  - information on how the designated index is aligned with the sustainable investments objective (including an explanation as to why and how that designated index differs from a broad market index)
- if no index has been designated as a reference benchmark, an explanation as to how the sustainable investments objective is attained
- where the fund or portfolio has as its objective the reduction in carbon emissions, information on the low carbon emission exposure objective
- an indication of where the methodology used for the calculation of the indices and benchmarks referred to above are to be found.

Website disclosures must include:

- a description of the environmental or social characteristics, or the sustainable investment objective
- information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the relevant fund or portfolio
- the information to be disclosed in the pre-contractual and periodic disclosures as set out immediately above and below.

Periodic report disclosures must include:

- in relation to funds or portfolios that promote environmental and/or social characteristics, a description of the extent to which environmental and/or social characteristics are attained
- in relation to funds or portfolios that have as their objective sustainable investments, a description of the overall sustainability-related impact of the fund or portfolio or, where an index has been designated as a reference benchmark, a comparison between the overall impact of the fund or portfolio with the designated index and a broad market index through sustainability indicators.

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THE EU'S SUSTAINABLE FINANCE ACTION PLAN

ESMA'S TECHNICAL ADVICE

BACKGROUND

In July 2018, the European Commission requested ESMA to provide it with technical advice to supplement its initial package of legislative proposals published in May 2018 (of which the Disclosure Regulation was one such proposal), and to assist it with potential amendments to the UCITS Directive, AIFMD, and MiFID 2 with regard to the integration of sustainability risks and sustainability factors. Following a public consultation, ESMA published its final technical advice on 30 April 2019. The final technical advice covers the following topics: organisational requirements, operating conditions, risk management provisions and, in relation to MiFID 2, product governance.

ORGANISATIONAL REQUIREMENTS

ESMA's Advice:

- UCITS management companies and AIFMs should: (i) take into account sustainability risks with respect to their internal procedures and organisation; (ii) take into account the necessary resources and expertise for the effective integration of sustainability risks; and (iii) ensure that senior management is responsible for the integration of sustainability risks
- investment firms should, where they are relevant for the provision of investment services to clients, take ESG considerations into account with respect to their internal procedures and organisation.

ESMA is of the view, in line with many of the responses to the consultations, that:

- the above 'principles-based' approach is balanced without introducing overly prescriptive requirements which may risk stifling innovation or creating regulatory inconsistencies; and
- a legal requirement to explicitly designate a qualified person for the integration of sustainability risks is neither necessary to reach the Commission's objective, nor proportionate.

OPERATING CONDITIONS

ESMA's Advice:

- when identifying the types of conflicts of interest whose existence may damage the interests of a UCITS, an AIF or their respective investors, UCITS management companies and AIFMs (as applicable) should include those conflicts that may arise in relation to the integration of sustainability risks (for example, conflicts arising from remuneration as well as any sources of conflicts that could give rise to greenwashing)
- such entities should also take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors when conducting due diligence on investments
- where applicable, such entities should develop engagement strategies with a view to reducing the principal adverse impact of investee companies on sustainability factors
- investment firms, when identifying the types of conflicts of interest whose existence may damage the interests of a client, should include those that may stem from the distribution of sustainable investments, and should have in place appropriate arrangements to ensure that the inclusion of ESG considerations does not lead to mis-selling practices.

ESMA explained in each of the final reports that:

- although it agreed with respondents that due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio, ESMA is of the view that this is already sufficiently reflected in the existing UCITS and AIFMD frameworks and so no further legislative clarifications in relation to sustainability risks were required;
- the provision of any more prescriptive guidance on the application of the due diligence requirements at this stage could raise the risks of regulatory inconsistencies, but ESMA will monitor the situation and may issue further guidance in future;
- although it acknowledged the operational challenges involved with gaining access to reliable data on sustainability risks and factors, the principle of proportionality is clearly ingrained in the existing due diligence requirements, as well as the additional wording proposed above; and
- in relation to investment firms, it was important to introduce in the MiFID 2 Delegated Regulation a clear reference to the need for firms to identify conflicts whose existence may damage the interests of a client, and that in doing so such firms should include those that may stem from the distribution of sustainable investments.

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ESMA'S TECHNICAL ADVICE (CONTINUED)

RISK MANAGEMENT

ESMA's Advice:

- UCITS management companies' and AIFMs' risk management policies should comprise such procedures as are necessary to enable them to assess, for each fund that they manage, the exposure of that fund to, *inter alia*, sustainability risks
- investment firms should take into account sustainability risk in the establishment, implementation and maintenance of their risk management policies and procedures. In order to do this, investment firms' compliance function, internal audit function, management body and senior management should also consider aspects related to sustainability risk in their respective duties.

ESMA agreed with respondents to the UCITS/AIFMD consultation paper that:

- the integration of sustainability risks would be best done by including sustainability in the list of material risks to be managed under the respective UCITS and AIFMD Level 2 framework provisions; and
- a more granular approach to the integration of sustainability risks in the risk management systems would raise the risks of creating regulatory imbalances and giving sustainability risks precedence over other types of risk.

ESMA confirmed in its response to the MiFID 2 consultation paper that:

- the methodology used to assess sustainability risks is not prescribed in the text of the technical advice and that, in its view, the text of the technical advice is general enough to allow a flexible approach.

PRODUCT GOVERNANCE

ESMA's Advice:

- investment firms should identify, at a sufficiently granular level, the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, and ESG preferences (where relevant), the financial instrument is compatible
- investment firms should determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining, *inter alia*¸ whether the instrument's ESG characteristics (where relevant) are consistent with the target market
- investment firms should consider whether the financial instruments they manufacture and offer are compatible, and remain consistent, with the needs, characteristics, and objectives, and ESG preferences (where relevant), of the target market.

ESMA noted in its final report that the above principles-based approach will facilitate the implementation of the requirements and the development of sustainable products, whilst also avoiding giving the impression that the identification of ESG preferences in the target market should be considered more relevant than clients' investment objectives and other characteristics.

In addition, ESMA explained that the amendments to the MiFID 2 delegated acts are just the first step in a more extensive project, and that the requirements for and regulation of sustainability will continuously take more shape as the Commission's initiative evolves.

NEXT STEPS

ESMA will cooperate closely with the European Commission in view of transforming the technical advice into formal delegated acts (i.e., as part of the UCITS, AIFMD, and MiFID 2 Level 2 frameworks).

C L I F F O R D

C H A N C E

THE EU'S SUSTAINABLE FINANCE ACTION PLAN

ISSUES FOR ASSET MANAGERS

OBTAINING QUALITY DATA

- There is a general acknowledgement across the industry sector that the quality of sustainability-related data provided by unregulated service providers is limited.
- In its final reports to the Commission, ESMA itself acknowledged this operational challenge, but pointed to the fact that the principle of proportionality existed to mitigate against this difficulty and noted that the question of whether to regulate service providers to ensure sufficient data quality was beyond the scope of its mandate.

COSTS

- Experience elsewhere in the financial markets shows that, with the introduction of increased disclosure obligations, it is almost inevitable that increased costs will follow. Stakeholders interviewed as part of the consultation process for the Disclosure Regulation identified the costs of reviewing and amending pre-contractual and contractual documents to ensure compliance with the increased transparency requirements as the most significant costs arising from that proposal.
- There are also potential extra costs to be considered as a result of ESMA's technical advice to the Commission on amendments to the UCITS, AIFMD and MiFID 2 Level 2 frameworks. For example, whether managers will need to hire extra staff with specific ESG expertise, or purchase new technology, to ensure that sustainability risks and factors are effectively integrated into their systems and processes.

REGULATORY ISSUES

- It is not clear how, pursuant to the Disclosure Regulation, the requirement to disclose sustainability-related information on their websites will conform to asset managers' various other regulatory obligations concerning general solicitation to the public.
- Asset managers should also take note that parallel requirements are being implemented with respect to the insurance industry and that, since insurance companies are likely to comprise a not insignificant portion of their investor base, managers could also become subject to increased sustainability-related information requests from such investors as part of their own compliance obligations.

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THE EU'S SUSTAINABLE FINANCE ACTION PLAN

ISSUES FOR ASSET MANAGERS (CONTINUED)

LEGAL UNCERTAINTY AND TIMING FOR COMPLIANCE

- As addressed by ESMA in its final reports to the Commission, it is important that there is clarity on the terminology used across the legislative proposals for their correct implementation, and the development of any binding definitions needs to consider all legislative initiatives developed in relation to sustainable finance to ensure a harmonised approach.
- Concerns have been raised that the Disclosure Regulation and the amendments to the UCITS, AIFMD and MiFID 2 Level 2 frameworks could come into effect before the implementation of a clear and compulsory taxonomy, which could create confusion and legal uncertainty with respect to the integration and disclosure of sustainability risks and factors.
- Not only that, but there have also been calls (including from ESMA) for the Commission to ensure that the application date of the Level 2 amendments is aligned with that of the Disclosure Regulation in order to avoid duplications and reduce compliance costs.
- In addition, concerns have also been raised that managers will not have sufficient time for implementation of the relevant requirements of the Disclosure Regulation and the UCITS, AIFMD and MiFID 2 amendments, as applicable.

PROPORTIONALITY

- The impact of the requirements of the Disclosure Regulation and the Level 2 framework amendments is potentially burdensome.
- Although ESMA has emphasised the application of the proportionality principle in its technical advice to the Commission, and the final text of the Disclosure Regulation states that it is without prejudice to the rules under UCITS, AIFMD and MiFID 2 relating to proportionality, it remains to be seen how this will be applied in practice, and whether managers, particularly smaller managers, will ultimately be forced to pass on increased compliance costs to investors.

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