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European ESG Disclosure Requirements for Asset Managers

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A new European regime on sustainability-related disclosures in the financial sector will come into force from March 2021, after first being announced in 2018 during the European Commission's Action Plan on Sustainable Finance.

The new rules are drafted to have a wide scope and will impose environmental, social and corporate governance ("**ESG**") requirements for a wide range of "financial services participants", including investment firms and fund managers which will include non-EU fund managers such as US fund managers, that market funds in the European Economic Area ("**EEA**") under the national private placement regime ("**NPPR**").

The new regulatory framework is intended to drive sustainability in an effort to make EU financial markets more sustainable. The two key aspects are the EU Taxonomy Regulation (2018/0178 (COD)) and the Regulation on Disclosures (EU/2019/2088) – (referred to as the "**Disclosure Regulation**" or the "**SFDR**").

These disclosure-based requirements are an effort to drive consistency for fund managers and investment firms as to ESG, in contrast to the more principles-based approach taken by the US SEC. The SEC's Investor Advisory Committee has recommended that US regulators provide issuers with more detailed requirements in the space, but this approach has not been embraced by the current Commission. Although a number of ESG-focused fund managers have received detailed examination requests relating to ESG strategies, detailed disclosure requirements are not on the horizon. For SEC-regulated managers, the regulatory focus has been on whether material information on ESG strategies and returns has been disclosed to current and potential fund investors, and whether disclosures adequately reflect the firm's practices.

The Taxonomy Regulation

A key focus of the new regime is to address sponsors and firms “Greenwashing” their products, by labelling them as more environmentally friendly than they are or investors expect them to be. This has been addressed in several different ways, one of which is to harmonise standards as to which investments can be classified as “green”, before products can be marketed in that way.

The Taxonomy Regulation therefore aims to establish an EU-wide classification system (or taxonomy) intended to provide firms and investors with a framework to identify the degree at which their economic activities can be considered to be environmentally sustainable. It serves to establish a common language and a classification tool to help investors and companies make informed investment decisions as to what can be considered environmentally sustainable economic activities.

The majority of the provisions of the Taxonomy Regulation will apply from 31 December 2021.

Disclosure Regulation – “SFDR”

The SFDR introduces obligations on investors and asset managers to disclose how they integrate ESG factors into their risk processes.

Firms in scope will have to integrate ESG factors into their investment decision-making processes, as part of their duties towards investors and beneficiaries. It is important to note that firms and advisers will be subject to additional disclosure obligations when the financial product promotes environmental and social characteristics, or has sustainable investment as part of its objective or has a reduction in carbon emissions as its objective.

The majority of the SFDR provisions will apply from 10 March 2021.

Key disclosure requirements

The SFDR impacts both firms and their investment products. At firm level, it applies broadly to investment firms and managers of funds regardless of whether they have an ESG focus or strategy. At product level, sponsors will be required to review their whole portfolio and consider a range of complex metrics to ensure compliance.

The disclosure requirements are wide-ranging, and there are 50 sustainability measures to consider, of which 30 are mandatory. The form of disclosures is prescriptive, so firms will need to work through these requirements and consider how they will implement them into their own disclosures.

Action points at the manager level will include analysing and determining the extent to which the manager integrates sustainability risks into its investment decision-making process and update investment due diligence and risk management policies accordingly

Asset managers in scope will need to comply by implementing a due diligence policy with respect to the principal adverse impacts of its investment decisions on sustainability factors at manager level or provide reasons why it does not consider 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.

The draft RTS requires the non-compliance explanation to be published in a separate section of the asset manager's website, entitled, "*No consideration of sustainability adverse impacts"* and commence with a prominent statement that the manager/financial participant does not consider the adverse impacts of its investment decisions on sustainability factors.

At the product level, managers will need to decide, for each financial product that it "makes available" (for example, a non-EU manager marketing in the EU under the national private placement regimes), whether to either comply by assessing the likely impacts of sustainability risks on the returns of each financial product or explain why the manager does not consider sustainability risks to be relevant to a particular financial product.

Pre-contractual Disclosure Requirements

The following disclosure obligations will have to be complied with and included in firms' pre-contractual disclosures, which will generally mean a prospectus for a UCITS fund and the Alternative Investment Fund Directive (EU/2011/61) ("**AIFMD**") Article 23 disclosures for an alternative investment fund ("**AIF**") and also the fund annual reports. The exact level of information to be disclosed remains to be finalised, though broadly the disclosures must consider:

- how sustainability risks are integrated into the investment decision or insurance advice;
- the potential impacts of sustainable risks on the returns of financial products; and
- information on how the financial products consider principal adverse impacts on sustainability factors.

Website Disclosure Requirements

In addition the SFDR prescribes certain information that will need to be published on firms' websites. Firms will have to factor in things such as information on strategies – to consider adverse impacts of investment decisions on sustainability and it will require alternative investment fund managers ("**AIFM**s") and other firms in-scope to set out how they consider their remuneration policies to be consistent with the integration of sustainability risks.

While this information will need to be published on the firm's website, these requirements are intended to apply alongside provisions in the AIFMD and other EU legislation concerning remuneration.

Detailed Guidance to Follow at the End of 2020…

Further information in relation to the above is expected to be published through delegated acts and the consultation on regulatory technical standards ("**RTS**"), which is currently ongoing. The RTS will set out in further detail the rules on how the disclosures should be carried out, ensuring transparency to investors regarding how products meet their sustainability characteristics or objectives. These RTS will be finalised at the end of 2020, which make the timeline for implementation challenging for in-scope firms.

In June 2020, the European Commission has published draft amendments to the MiFID, AIFMD and UCITS regimes, which focus on the integration of sustainability into existing organisational rules and conduct of business rules under the three regimes (the "**Delegated Acts**"), which cross refer to the concepts contained within the SFTR.

The UK's Withdrawal from the European Union (Brexit)

The Brexit transitional period is due to come to an end at the end of 2020, meaning that EU law would no longer automatically apply in the UK from that point on. However, unless the transitional period is extended beyond 10 March 2021, when the SFDR takes effect, the requirements under it will not apply in the UK. However, it is expected that the UK will implement measures that are broadly aligned with the EU sustainability measures, which are consistent with the UK's Green Finance Strategy, launched in July 2019 with the objectives of aligning private sector financial flows with clean, environmentally-sustainable growth and strengthening the competitiveness of the UK financial sector. As such, firms in scope of the rules should assume the regulatory requirements under the SFDR apply in the UK and plan accordingly.

A Checklist for Asset Managers

As preparation for the introduction of these new measures, asset managers should consider the following points.

1. Assess whether they are in scope of the new requirements;
2. Carry out an assessment on whether the firm or its products are currently promoted as an ESG or sustainable product, which would trigger additional requirements;
3. Consider how the firm will market funds and products going into 2021, as this will impact the level of disclosure requirements; and
4. start working on a roadmap for compliance with the new regime, with a particular focus on the disclosure requirements coming into force from March 2020.

ESG is becoming increasingly relevant for fund managers and investors alike and this trend is likely to continue. Irrespective of whether or not a firm is technically caught by the EU regulations, firms should be developing their ESG policies and procedures and factor in ESG into their decision-making processes as the reach of the regulations can be wider than expected. Even where completely out of scope of the rules, non-EU asset managers may still nonetheless be indirectly impacted. For example, where a non-EU firm acts as a delegate of EU financial market participants (such as an EU AIFM), it is likely that firms will experience an indirect impact seen with other EU regulations such as MiFID II. EU firms are likely to require the information from the non-EU delegate to comply with their own regulatory obligations so while a non-EU manager might not have a direct regulatory obligation to prepare the disclosures, it may well find itself contractually required to do so by the delegating EU manager.

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