ESG FOR FUND MANAGERS: BRIEFING 2

Disclosures Regulation

September 2020

This briefing in our ESG series for Irish funds and fund management companies focuses on the European Commission's proposals for disclosure requirements in respect of ESG factors to allow investors to make informed investment choices about ESG products.

With the aim of furthering sustainable finance and environmental, social and governance ("**ESG**") integration, the European Commission ("**Commission**") introduced a package of legislative measures in 2018 that includes three key Regulations: the Taxonomy Regulation, the Disclosures Regulation[1] and the Low Carbon and Positive Impacts Benchmarks Regulation. These will be supplemented with changes to the UCITS, AIFMD and MiFID frameworks.

Although framed as rules about disclosures, the Disclosures Regulation will not just require disclosures on ESG matters to be made, it will require impacted firms to integrate sustainability into their investment processes and to consider the adverse impacts of their investments on sustainability factors.

The Disclosures Regulation has been adopted by the Commission and will come into effect, in the main, from 10 March 2021. Its aim is to lay down harmonised rules on transparency for impacted entities with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability related information. The requirements are to be supplemented by Level 2 requirements, which are yet to be agreed and only currently available in draft form.

APPLICATION

The Disclosures Regulation will apply to all "financial market participants" ("**FMPs**"), which include, alternative investment fund managers ("**AIFMs**") and management companies of undertakings for collective investment in transferable securities (including self-managed UCITS) ("**UCITS ManCos**") (together "**Management Companies**") and investment firms which provide portfolio management ("**MiFID firms**"). The Disclosures Regulation also applies to "financial advisers" which include, among others, credit institutions, Management Companies and MiFID firms providing investment advice. We will refer to these entities collectively as asset managers in this briefing.

The Disclosures Regulation will apply in part to all asset managers, with additional requirements for FMPs with financial products that promote environmental or social characteristics, have a focus on sustainable investments, or have an objective of a reduction in carbon emissions ("**ESG Products**").

KEY CONSIDERATIONS

The Disclosures Regulation will require FMPs to consider sustainability from a number of perspectives. There will be internal considerations for FMPs as policies are developed and disclosure considered in terms of integrating sustainability into investment decisions

1 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (the "Disclosure Regulation").

and ensuring remuneration policies are consistent with any such integration. FPMs will also need to consider how their investment decisions impact on sustainability factors and make disclosures on adverse impacts at an entity level. Disclosures will be required from a product perspective in terms of the pre-contractual, website and periodic reporting disclosures and consideration of product level adverse impacts.

DISCLOSURES REQUIRED

FMPs will need to make changes to website disclosures, pre-contractual disclosures and, in some instances, periodic reporting disclosures.

Website disclosures

Requirements for all FMPs:

- FMPs will need to publish information relating to the policies on integration of sustainability risks into decision-making processes / investment or investment advice, as applicable, as well as an assessment of the likely impacts of sustainability risks on the returns of the relevant financial products.
- FMPs will need to publish a statement on due diligence policies with respect to principal adverse impacts on sustainability factors (where considered) covering details such as a description of the principal adverse sustainability impacts and actions taken or planned, information about their policies on the identification and prioritisation of principal adverse sustainability impacts and indicators, the level of adherence to responsible business conduct codes, internationally recognised standards on due diligence and reporting and (if relevant) the degree of alignment with the Paris Agreement objectives. FMPs should take account of their size, the nature and scale of their activities and the types of financial products they make available.
- If an FMP chooses not to consider adverse impacts, it will have to provide a clear explanation as to why they have chosen not to do so and whether this will change. This approach will only be available after 30 June 2021 to FMPs with less than 500 employees.
- FMPs will need to provide information on how their remuneration policies are consistent with the integration of sustainability risks. The Disclosures Regulation states that these requirements are intended to complement provisions in AIFMD and other EU legislation concerning remuneration, and so proportionality may be taken into account.

Additional information should be disclosed for ESG Products, including:

- a description of the environmental or social characteristics or the sustainable investment objective;
- information on how those characteristics or objective are met;
- 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 ESG Product, including its data sources and screening criteria for the underlying assets; and
- the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product.

Where an index has been designated as a reference benchmark, FMPs will also need to disclose information on whether and how the index is consistent with those characteristics and information as to where that index can be found.

Where no index has been designated as a reference benchmark, the FMP's pre-contractual disclosure must explain how the fund's sustainable investment objective is going to be met. Where no index is referenced because no EU Climate Transition or EU Paris-aligned Benchmark is available under the Benchmarks Regulation[2], a detailed explanation must be included as to "*how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement*".

The Disclosures Regulation provides that the requested information needs to be clear, succinct and understandable to investors, as well as published in a way that is accurate, fair, clear, not misleading, simple and concise and in a prominent, easily accessible area of the website.

Pre-contractual disclosures

Requirements for all FMPs:

- FMPs will need to make "pre-contractual disclosures" explaining how sustainability risks are integrated into investment decisions and the likely impacts of sustainability risks on the returns of financial products.
- Where sustainability risks are not relevant, FMPs should explain why.

In circumstances where financial products promote environmental or social characteristics or focus on sustainable investments, there are additional requirements including:

- disclosure of the extent to which environmental or social characteristics are to be attained and the extent to which they are attained;
- where an index is used as a reference benchmark, information on whether and how this index is consistent with those environmental or social characteristics, aligned with the ESG objective and why and how the designated index aligned with that objective differs from a broad market index. FMPs will also need to provide information on where the methodologies used for the calculation of the indices are to be found;
- where a financial product has a reduction in carbon emissions as its objective, the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement; and
- a statement on whether and how the financial product considers principal adverse impacts on sustainability factors. If adverse impacts are not considered, an explanation as to why will need to be given.

AIFMs should include the pre-contractual disclosures in the Article 23 AIFMD disclosures, UCITS ManCos should include these in their prospectus, and MiFID firms should do so in accordance with Article 24 of MiFID II.

FMPs should also ensure that marketing communications do not contradict the disclosures under the Disclosures Regulation.

Periodic reporting

This requirement will come into effect on 1 January 2022 and from that date, the periodic reports for ESG Products will need to disclose:

- the extent to which environmental or social characteristics are attained; or
- the overall sustainability-related impact of the product using sustainability indicators (or if an index used, a comparison between impact with designated index and a broad market index).

LEVEL 2 DISCLOSURES

Many of the requirements of the Disclosures Regulation will be supplemented in terms of the content, methodology and presentation of certain disclosures. Draft technical standards ("RTS") issued in relation to parts of this and are the subject of a consultation that closed on 1 September 2020. The level of detail required is extensive and significantly more onerous than was expected. Some elements of the required RTS have not issued pending a review of the outcome of the consultation.

2 On indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending directives 2008/48/EC and 2014/17/EU and Regulation (EU) no. 596/2014.

ACTIONS

While we are still awaiting finalisation of the Level 2 requirements and Central Bank of Ireland guidance on practical implementation, it may be difficult to finalise some elements of the required disclosure. However, strategic decisions around how these matters might be approached can be taken and certain policy matters attended to at this stage.

The Disclosures Regulation requires FMPs to consider obligations both at an entity and a product level and develop policies including:

1. at an entity level:
    - a policy on the integration of sustainability risks in investment decision making;
    - a due diligence policy on the principal adverse impacts of investments on sustainability factors or an explanation as to why these are not considered;
    - an update to the remuneration policy.
2. at a product level, consider whether to assess the impact of sustainability risks on return or to explain why they do not consider the risks to be relevant.

In addition FMPs can:

- review each of its financial products to consider if they will be considered ESG Products;
- consider how the information required for the required disclosures might be gathered and project plan for updates to website disclosures and offering documentation in a short turnaround time;
- if it is intended to consider adverse impacts, look at the draft Annex to the Level 2 requirement and consider how the relevant information will be gathered;
- where any FMPs promote ESG products, take a look at the metrics they use to establish the extent to which these products are aligned with the Taxonomy (see our briefing on the Taxonomy Regulation here), as this will assist with the drafting of disclosures;
- review any benchmarks used to establish whether these are appropriate, particularly in the circumstances where a product is an ESG Product but the benchmark is not aligned with the ESG objective.

The RTS are required to be delivered by 30 December 2020 and many of the requirements of the Disclosures Regulation have an effective date of 31 March 2021, so this will leave little time for asset managers to address the requirements if some planning is not actioned now.

For more information on the impact of the EU's ESG initiative on asset managers, see our overview briefing here.

If you would like to discuss the forgoing, or require assistance assessing these or any other sustainable finance related requirements, please contact a member of our team.

ARTHUR COX & ESG

Arthur Cox is very mindful of its own ESG responsibilities. We have actively reduced our carbon footprint through energy efficiency, waste management and sustainable procurement. Our Dublin HQ was awarded the highest energy efficiency standard ISO 50001:2018, which we only retain through a continuing reduction of energy use each year. We address our social and governance responsibilities though active CSR and D&I programmes. We aim to achieve improvements in all these aspects each year.

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