EU SUSTAINABLE FINANCE REGULATORY OVERVIEW

The impacts for Irish funds

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Sustainable investing and ESG integration are key priorities for investors and policy makers are leading on a number of initiatives aimed at transitioning to a more sustainable economy.

As the EU Commission seeks to reorient private capital flows towards sustainable investments to meet its climate and energy targets, a package of legislative measures has been introduced to help achieve this. These measures will have impacts for asset managers, their products and their investors.

Sustainability gained profile in 2015 with the UN 2030 Agenda for Sustainable Development, a universal call to action to end poverty, protect the planet and improve the lives and prospects of everyone. The Paris Agreement followed in 2016, with the objective of strengthening the response to climate change by making finance flows consistent with a pathway toward low greenhouse gas emissions.

Sustainability has long been at the heart of the EU project and the treaties already give recognition to the EU’s social and environmental dimensions, but more was needed in response to these global developments so a high-level expert group was established with the aim of identifying how sustainability could be integrated into the EU’s regulatory and financial policy framework.

This resulted in the publication of the EU Action Plan (“Action Plan”) on financing sustainable growth, which has at its core a belief that financial services can play a key role in the transition to a more sustainable economy by redirecting capital flows towards sustainable investments. The Action Plan was followed by the European Green Deal, a 1tn Euro, 10-year plan to reduce the EU’s greenhouse gas emissions by at least 50% compared with 1990.
The EU has positioned itself at the forefront of sustainability, with a move to have financial markets assist in funding the required changes to promote a more sustainable economy. Under its Action Plan, the EU introduced a package of measures to reinforce the sustainability agenda within the asset management community.

The Action Plan identifies 10 key points but for funds and their management companies, the key proposals relate to:

1. Establishing a taxonomy for sustainable activities.
2. Creating standards for green financial products.
3. Incorporating sustainability as part of financial advice.
4. Developing sustainability benchmarks and better integrating sustainability into ratings.
5. Strengthening the disclosure made by asset managers and financial advisors to their clients.

These are achieved by three key measures:

1. Taxonomy Regulation: A regulation on the establishment of a framework to facilitate sustainable investment.
2. Low Carbon Benchmarks Regulation: An amendment to the EU Benchmarks Regulation to introduce new ESG related benchmarks.
3. Disclosures Regulation: The EU Regulation on sustainability-related disclosures in the financial services sector.
One of the issues in looking at ESG factors and sustainability and the implementation of measures to promote them is that many of the considerations call for a subjective interpretation. With a stated aim of channelling private investment into sustainable activities, it is key for the EU that investment gets into the right product.

Labelling products as ‘green’ helps investor awareness and some Member States do have existing labelling schemes, but they are inconsistent. Having different criteria for ESG labelling in different jurisdictions could damage investor confidence in an ESG brand and lead to fragmentation of the market.

The EU therefore set about defining a single EU wide set of criteria to provide a common-understanding of what “sustainable” means and on 18 June 2020 adopted the Taxonomy Regulation, which entered into force on 12 July 2020.

The Taxonomy Regulation aims to provide a common concept of environmentally sustainable investment. These EU-wide standards will form the basis for economic and regulatory measures and eventually the creation of labels, effectively an implementation tool that can enable capital markets to identify investment opportunities that contribute to the environmental policy objectives. The focus of the Taxonomy Regulation is mainly environmental objectives, although minimum social safeguards have been added.

For a product to be properly characterised as environmentally sustainable it should:
- Contribute substantially to one of the defined environmental objectives.
- Not harm any of the environmental objectives.
- Comply with a series of minimum social safeguards.
- Comply with performance thresholds.

There are six possible environmental objectives:
- Climate change migration
- 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 bio diversity and ecosystems

Each objective is explained further in the Taxonomy Regulation and its interpretation is linked to any existing Union law on that area.

Technical screening criteria will give even more granularity on the detail already set out in the Taxonomy Regulation and a Platform on Sustainable Finance comprised of various EU bodies and industry experts was established to advise on these, with its final report published in March 2020. The screening criteria are to be updated on a regular basis to reflect the changing nature of the science and technology that underpin them.

The technical screening criteria, or “taxonomy” for climate change mitigation and climate change adaptation should be established by the end of 2020 in order to ensure its full application by end of 2021. For the four other objectives, the taxonomy should be established by the end of 2021 for application by the end of 2022.

The Taxonomy Regulation recognises that while some activities may bring a positive output toward the relevant objective, they may be accompanied by a negative impact and so the taxonomy addresses the need to measure the combined outcome and identify the minimum requirements necessary to avoid a significant harm to other objectives.

A consistent issue identified in meeting these requirements is getting the right information from underlying investee companies. The Taxonomy Regulation seeks to assist with this by placing an obligation on undertakings that are subject to non-financial reporting requirements to include details of how and to what extent their economic activities are associated with environmentally sustainable activities and large companies will have to report on certain climate-related KPIs.

The Taxonomy Regulation is mainly relevant to asset managers that make available a product that has an express sustainability focus, however, all managers need to take account of it and managers that do not offer ESG products will at least need to make a negative disclosure to confirm that their product is out of scope and does not adhere to the taxonomy criteria.
A number of ‘green’ products are based on low carbon benchmarks and there can be a significant variance in the composition of these.

The Low Carbon Benchmarks Regulation is intended to provide investors with a comparison tool against which to analyse benchmarks claiming to have low-carbon methodologies. To ensure the integrity of low-carbon benchmarks, the Low Carbon Benchmarks Regulation introduces two prescribed categories of benchmark:

- **An EU Climate Transition Benchmark**
- **An EU Paris-Aligned Benchmark**

An “EU Climate Transition Benchmark” selects underlying assets so that the resulting benchmark portfolio is on a decarbonisation trajectory in line with the long-term global warming target set in the Paris Agreement. A decarbonisation trajectory means a measurable, science-based and time-bound movement towards alignment with the objectives of the Paris Agreement.

An “EU Paris-Aligned Benchmark” selects only components that actively contribute to the attainment of the 2°C temperature reduction target set out in the Paris Agreement, so the carbon emissions savings of each underlying asset exceed its carbon footprint.

The Low Carbon Benchmarks Regulation requires benchmark administrators to make disclosures regarding the methodology used to measure and reconcile ESG and low-carbon factors. Benchmark administrators must indicate within the benchmark statement (excluding those relating to interest rate and currency benchmarks) whether or not that benchmark pursues ESG objectives and where it does pursue ESG objectives, key elements of their methodologies must be published. Benchmarks that do not pursue ESG objectives must make a clear statement to that effect.

Further detail on the minimum standards for each of the new benchmarks and the requirements applicable to benchmark administrators will be provided for in delegated acts.
The third element of the package of measures is the Disclosures Regulation, which came into force at the end of December 2019 and will apply from 10 March 2021. The Disclosures Regulation seeks to harmonise existing provisions in relation to sustainability-related disclosures to investors to allow an easier comparison of financial products and services. Many of the provisions of the Disclosures Regulation apply to asset managers irrespective of whether or not they have a sustainability or ESG focus.

The Disclosures Regulation will require the integration of sustainability risks in the investment decision-making processes or advisory processes of financial market participants (which include UCITS management companies and AIFMs) (“FMPs”) and transparency on financial products that target sustainable investments. Specific requirements include pre-contractual disclosures, disclosures on websites and disclosures in periodic reports and the requirements differ depending on the sustainable objective of the product.

### Pre-contractual disclosure
FMPs must make pre-contractual disclosures, generally in the prospectus for a fund, of the manner in which sustainability risks are integrated into investment decisions and the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products. Where sustainability risks are deemed not to be relevant, an explanation must be provided.

### Website publications
FMPs will be required to publish information on their websites about their sustainability risk policies and the integration of sustainability risks in the investment decision-making process together with a statement of their due diligence policies regarding the principal adverse impacts of investment decisions on sustainability factors. Where a firm has less than 500 employees, it may publish clear reasons why it does not consider the adverse impacts of investment decisions on sustainability factors.

### Remuneration Policies
AIFMs and UCITS management companies are required to include information in their remuneration policies on how those policies are consistent with the integration of sustainability risks and to publish this information on their websites.

### 'Green' Products
For products that have a stated ESG focus, additional requirements apply and depend on the nature of the product.

Products promoting environmental and social characteristics should disclose in their prospectus information on how those characteristics are met and where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics and information on where the methodology used for the calculation of the reference index can be found.
Products that have sustainable investment as their objective and where an index has been designated as a reference benchmark need to include in the prospectus information on how the designated index is aligned with the objective, an explanation as to why and how the designated index aligned with that objective differs to a broad market index and information as to where the methodology used for the calculation of the reference index can be found. Where no index has been designated, pre-contractual disclosures will include an explanation of how the sustainable investment objective is to be attained.

These products will need to provide on their website a description of the environmental or social characteristics or sustainable investment objective. The website should also publish information on the methodologies used to assess, measure and monitor the environmental or social characteristics or impact of the sustainable investments selected for the financial product, including its data sources, 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.

From 1 January 2022 periodic reports should include information on:
- the extent to which environmental and social characteristics are met;
- the impact of sustainable investments by means of relevant sustainability indicators; and
- where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.

By 30 December 2020 the ESAs will develop draft technical standards to specify the details of the presentation and content of information to be provided to investors in respect of the sustainability indicators in relation to adverse impacts on the climate and other environment-related adverse impacts.

By 30 December 2021 the ESAs will also develop further draft technical standards in respect of sustainability indicators in relation to adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

It should be noted that the Taxonomy Regulation contains further definitions on the meaning of environmentally sustainable economic activities and provides clarification on the principle of “do not significantly harm”.

On 23 April 2020, the European Supervisory Authorities (ESMA, EBA and EIOPA) published a joint consultation on the level two measures (“RTS”) in respect of required ESG disclosures under the Disclosures Regulation.

The RTS set out the detailed content, methodologies and presentation of the required disclosures and set out the need to publish an Adverse Sustainability Impact Statement for which a mandatory reporting template was provided. The consultation also includes proposals under the recently agreed Taxonomy Regulation on the establishment of a framework to facilitate sustainable investment on the “do not significantly harm” principle. The interaction between the Taxonomy Regulation and the Disclosures Regulation has been identified as an area that requires further consideration and clarification.

Furthermore, the ESAs are proposing to create templates for pre-contractual and periodic product disclosures in order to ensure comparability of disclosures. However, given uncertainty over the content of pre-contractual disclosures, the ESAs decided to defer the drafting of these templates. The ESAs intend to undertake a separate process to develop these templates.
In conjunction with the three new legislative proposals, the EU Commission asked ESMA to provide it with technical advice on amendments to the UCITS Directive and AIFMD to help integrate sustainability. In April 2019, ESMA issued its final technical advice to the Commission, which the Commission is now considering.

The proposals look to change a number of elements, but ESMA has confirmed throughout the advice that changes should be implemented on a principles-based approach, which should allow entities to adapt their organisations more efficiently.

ESMA has also advised that the technical advice should be applied with the proportionality principle in mind, taking into account the nature, scale and complexity of an organisation’s activities.

The changes are across three key areas – organisational requirements, operational requirements and risk management.

The advice amends three elements of the organisational requirements so that UCITS management companies and AIFMs must:

1. Take into account sustainability risks when looking at their structure and decision making processes.
2. Ensure that when considering the adequacy of resources, they take into account the resources and expertise necessary for the effective integration of sustainability risks.
3. Ensure that the integration of sustainability risks will now be part of Senior Management’s responsibilities.

It had been proposed that there be an explicit designation of a qualified person for the integration of sustainability risk but ESMA believes that Senior Management should be collectively responsible and the management company should collectively have the skills, knowledge and expertise necessary without the need to entrust it to one individual.

The operating conditions were also reviewed as they currently do not require the integration of sustainability risks within the conduct of business or prudent person rules or due diligence requirements. ESMA’s advice is to introduce a new due diligence requirement that management companies take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors. The ‘where applicable’, is added so that the requirements are in keeping with those under the Disclosure Regulation where consideration of principal adverse impacts will not be mandatory for all market participants.

When considering due diligence requirements, it is noted that sustainability risks are not relevant in the same way for every portfolio and that due diligence should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio.

The review of operating conditions includes conflicts and a new recital is proposed to provide that when identifying the types of conflicts of interest that may damage the interest of the UCITS or AIF, those that may arise from sustainability risks should be included. These conflicts might arise from remuneration or personal transactions of staff, but management companies will also need to consider the conflicts that might arise from managing funds with different investment strategies, different relationships with investee companies or conflicting group interests.

The final element considered was risk management and ESMA has proposed inserting ‘sustainability’ into the matters that should be considered in a risk management policy. ESMA did not approach this in a more granular way as it believes that might create its own risks by potentially overbalancing the considerations given to sustainability and so instead proposed a holistic approach with sustainability considered in an integrated way.

On 8 June 2020, the European Commission published draft texts of the delegated acts to integrate sustainability risks and factors into the AIFMD and the UCITS legislative frameworks.

**Next Steps**

The legislative measures contained within the Action Plan will apply from different dates and clarity on certain aspects will only be provided in some cases close to the implementation date. Therefore, asset managers need to be reviewing their products and processes to see how they currently address sustainability in their investment processes and what changes may be needed to the process and the product documentation in the context of the new requirements.
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