

ESG for Asset Managers

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Sustainable Finance Disclosure Regulation

The Sustainable Finance Disclosure Regulation (SFDR) was published on 9th December 2019 and is part of the European Commission's (EC) Action Plan on Financing Sustainable Growth. It contains a host of new 'comply or explain' disclosures around the consideration of Sustainability Risks (see definitions¹) by asset managers² in their investment decision making processes. Some of these disclosures will apply to ALL asset managers, regardless of whether their products have a sustainability focus.

There are a number of strategic decisions firms need to make in order to determine how the SFDR applies to them – to help with this there is a Manager Level Decision Tree and a Product Level Decision Tree in the next section. Once firms have determined how the SFDR applies, they may find there are a large number of Pre-contractual and Periodic disclosures to prepare. The first of these are required by 10th March 2021, while others are not expected until later in 2021 and some not until 2022/23. To help with this, there are four Tables listing out what firms need to provide and when in Annex II.

Firms also need to bear in mind The Framework Regulation, which amends the SFDR by inserting some additional articles. These are also included in the Tables where relevant.

¹ Any word or phrase defined in Annex I is capitalised throughout, with the first instance highlighted in bold.

² Asset Managers in this context are MiFID firms providing the service of portfolio management, AIFMs and UCITS Managers

ESA Joint Consultation

*On 23rd April 2020 the European Supervisory Authorities (ESAs) published a **Joint Consultation Paper providing the Regulatory Technical Standards (RTS)** needed to provide the content, methodology and presentation of the SFDR disclosures. References to the relevant articles are included within the Tables in Annex II. It's worth noting the ESAs are not required to provide RTS for every disclosure; which may be problematic in some areas where some additional information would be welcome, for example around the additions to a firm's Remuneration Policy.*

*The SFDR specifically requires the ESAs to **draft templates in the RTS** which take into account the differences between financial products, their objectives and the need to ensure disclosures are accurate, fair, clear and not misleading – simple and concise. However, **current feedback indicates the RTS is far more complex than originally anticipated.***

The EC could have implemented the SFDR and The Framework Regulation more proportionately, however this would not help them meet the 2050 climate targets under the Paris Agreement and their ambitious plans to get there. It is expected that feedback on the RTS, required by 1st September 2020, will include calls to allow for greater proportionality in some areas.

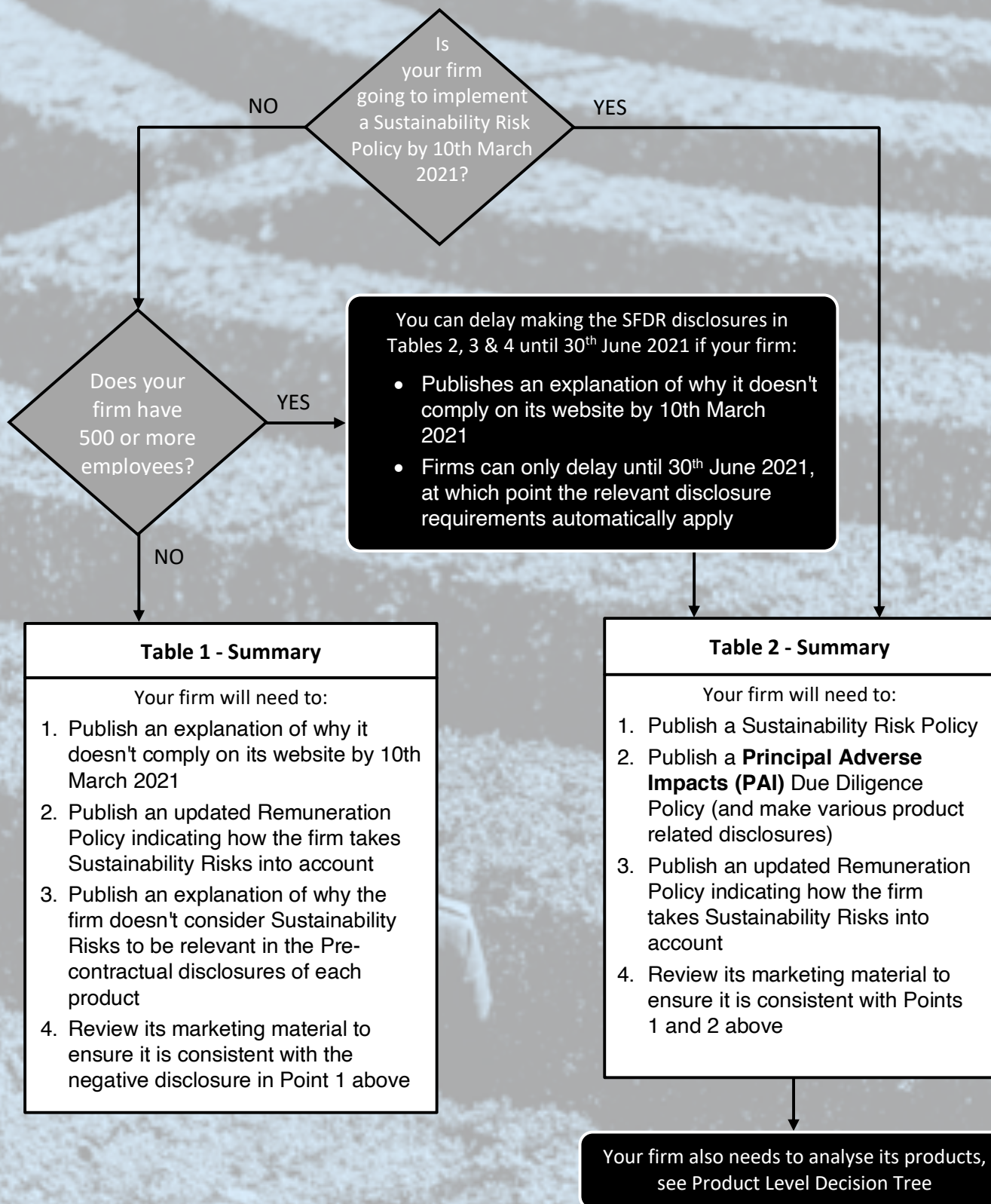
Brexit

As mentioned above, the first set of disclosures is expected by 10th March 2021, which falls outside of the Brexit transition period ending on 31st December 2020.

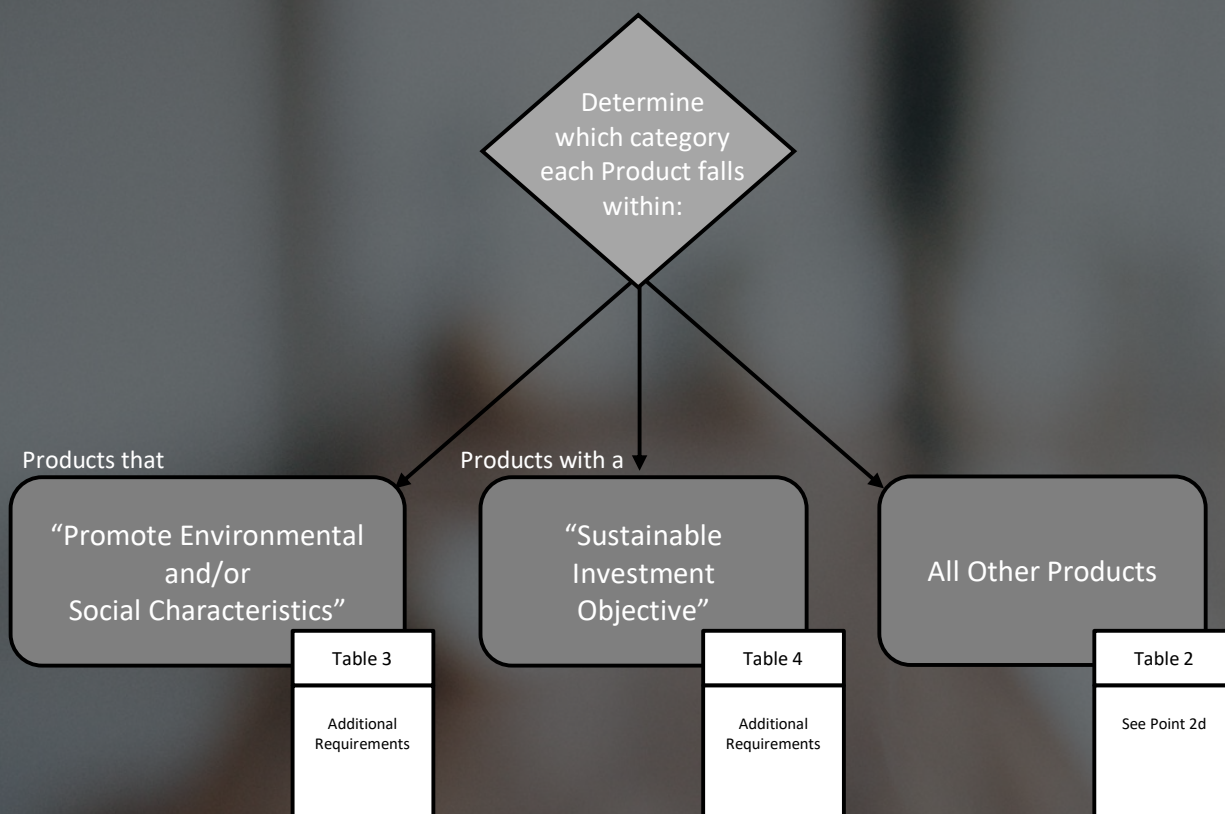
The UK Government has previously indicated its commitment to implementing the SFDR and The Framework Regulation into UK law; however formal agreement has not yet been provided because there is no clarity on the final outcome of the draft RTS.

Hence, firms await a final decision, with the expectation the Government will want to promote equivalence, perhaps with some changes to achieve a more proportionate outcome to suit the UK market.

Manager Level Decision Tree



Product Level Decision Tree



Conclusions & Next Steps

For those asset managers who either choose to or are required to adhere to the SFDR, it's safe to say that implementation will be challenging. If you are a small firm it's possible to opt-out altogether as long as you are prepared to make the negative disclosures; however if you are a small firm with product(s) that have a genuine sustainable focus, there won't be any choice but to adhere to the SFDR.

With such a lot to do and not much time, what should your firm be focusing on now?

- 1. **There is a discussion to be held** (if it hasn't been held already) by senior management, portfolio managers and product management, around the extent to which providing genuinely sustainable products is part of the firm's strategy – the outcome of which needs to be clearly communicated to the Sales and Marketing teams. This will impact the extent to which the SFDR applies and how much time you have to prepare. You also might want to think about **setting up a multi-disciplinary project team led by the business** (not Compliance);*
- 2. **Regulatory horizon scanning**, particularly in relation to the FCA's implementation of the SFDR and potential application of proportionality. You also need to track the progress made by the ESAs with their Joint Consultation Papers given the timescales remaining;*
- 3. Once you understand how the SFDR applies, **identify which documents you can start writing or updating now**. For example, do you already have something that looks a bit like a Sustainability Risk Policy? Can you begin reviewing Remuneration Policy and marketing materials?*
- 4. **Analyse the firm's products and allocate them into the three different categories**;*
- 5. **Work out if you need to update any product specific documents** which might require investor or regulatory consent (for example, the prospectus). What are the timescales for making these types of updates? How long will it take to update your website?*
- 6. **Start analysing the contents of the various disclosures**, especially around Principal Adverse Impacts – what does this mean for your firm and how will you source all of the data required? What IT related assistance will you need?*

Finally, it's worth noting that the ESMA Consultation Paper published on 8th June 2020, on proposed amendments to the Delegated Directives/Regulations of MiFID II, the AIFMD and UCITS, mutually reinforces the SFDR and should also be factored into project planning. My first article of the ESG for Asset Managers Series covers these requirements – please contact me for a copy.

Annex I – Definitions

‘Do No Significant Harm’ (DNSH) – This concept is part of the definition of a Sustainable Investment under Art 2(17). The SFDR indicates it is a precautionary principle to ensure that neither environmental or social objectives are significantly harmed by investments made by a financial product – and if they are, the investment cannot qualify as sustainable or be included in products captured by Tables 3 and 4 above (the so called, Art 8 & 9 products).

No methodology for assessing DNSH has been provided, however firms should consider the Principal Adverse Impact (PAI) indicators (see below) provided by the ESAs Joint Consultation Paper.

Note: SFDR Art 2(17) includes both environmental and social objectives in the DNSH principle, while The Framework Regulation is limited to environmental objectives. In their Joint Consultation Paper, the ESAs have recommended the EC consider aligning these in the future.

Periodic Disclosure – means in the periodic reports provided under MiFID II or the annual report for an AIF or UCITS, see SFDR Art 11(2). It also includes website disclosures, see SFDR Art 10.

Pre-contractual Disclosure – means in the MiFID II regulatory disclosures or terms and conditions for a portfolio management service; the AIFMD Article 23 disclosures for an AIF; or in the prospectus of a UCITS. It also includes website disclosures, see SFDR Art 10.

Principal Adverse Impacts (PAI) – also known as ‘Adverse Sustainability Impacts’. This disclosure is a statement regarding the adverse impacts of the investment decisions made by an asset manager on Sustainability Factors.

Annex I of the ESA Joint Consultation Paper provides a template for the ‘Adverse Sustainability Impact Statement’, which contains:

- 32 mandatory and 18 optional, ESG metrics or indicators that are quantitative in nature;
- 4 qualitative disclosures; and
- A two A4 page summary (see Table 3, Point 3 and Table 4, Point 5).

Sustainability Factors – environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery.

Sustainability Risks – environmental, social or governance events which, if it occurred, could cause a material negative impact on the value of an investment.

Annex II

Table 1: Asset Managers who are NOT implementing a Sustainability Risk Policy

Disclosures	SFDR Article	Draft RTS Article	Type	Template?	Due Date	Financial Advisors?
<p>1. Provide an explanation of why the firm is not publishing a Sustainability Risk Policy. The explanation must:</p> <ul style="list-style-type: none"> Be published in a separate section of the website, entitled: “No consideration of sustainability adverse impacts”; Begin with a statement that the firm “does not consider the adverse impacts of its investment decisions on Sustainability Factors”; Provide clear and concise reasons for not doing so; and If relevant, indicate whether the firm intends to consider adverse impacts and the timescales for doing so 	Art 4(1)(b) & 6	Art 11 Art 13 – for Financial Advisors	Pre-contractual and Website (See Art 33 of Draft RTS)	No	10 th March 2021	Yes
<p>2. Include information about how the Remuneration Policy is consistent with the Sustainability Risk Policy (or lack of in this case)</p> <ul style="list-style-type: none"> This information should be kept up to date and if amended, a clear explanation provided on the firms’ website 	Art 5 & 12	N/A	Pre-contractual and Website (See Art 33 of Draft RTS)	No	10 th March 2021	Yes
<p>3. Publish an explanation of why the firm doesn't consider Sustainability Risks to be relevant in the Pre-contractual disclosures of each product</p>	Art 7(2)	N/A	Pre-contractual	No	10 th March 2021	No
<p>4. Ensure all marketing material is consistent with the disclosure in Point 1 above to prevent greenwashing</p>	Art 13	N/A	Pre-contractual and Website (See Art 33 of Draft RTS)	None yet – the ESAs will consider developing	10 th March 2021	Yes

Table 2: Asset Managers who ARE implementing a Sustainability Risk Policy

Disclosures	SFDR Article	Draft RTS Article	Type	Template?	Due Date	Financial Advisors?
<p>1. Sustainability Risk Policy providing information on the:</p> <ul style="list-style-type: none"> Integration of Sustainability Risks in the investment decision making process; Results of the assessment of the likely impacts of Sustainability Risks on the returns of the firms' products; Also see Table 3 Point 1 in relation to products that promote ESG characteristics; and This information should be kept up to date and if amended, a clear explanation provided on the firms' website 	Art 3, 6 & 12	N/A	Pre-contractual and Website (See Art 33 of Draft RTS)	No	10 th March 2021 / 30 th June 2021	Yes
<p>2a. Statement on the due diligence policies employed in relation to the Principal Adverse Impacts (PAI) of investment decision making</p> <p>Published within the "Sustainability related disclosures" section of the firms' website under the heading: "Adverse sustainability impacts statement", including the following:</p> <ul style="list-style-type: none"> Information about policies for the identification and prioritisation of PAI on sustainability indicators; A description of the PAI and any actions being taken or planned; Brief summaries of engagement policies with investee companies; and Reference to responsible business conduct codes and internationally recognised standards for due diligence and reporting <p><u>Note: The Draft RTS Articles 4 to 10 provide additional information on the content of the above requirements</u></p>	Art 4	Arts 4 – 10 Art 12 - for Financial Advisors Annex I, Table 1	Pre-contractual and Website (See Art 33 of Draft RTS)	Yes – Draft RTS Annex I, Table 1	10 th March 2021 / 30 th June 2021 First report due latest - 30 th June 2022	Yes

Disclosures

	SFDR Article	Draft RTS Article	Type	Template?	Due Date	Financial Advisors?
2b. Where a firm considers PAI on Sustainability Factors it must also provide a: <ul style="list-style-type: none"> Clear and reasoned explanation of whether and if so, how, it considers them in relation to its products 	Art 7(1)(a)	No – However, see Arts 4 – 10	Pre-contractual	No – However see Draft RTS Annex I, Table 1	30 th December 2022	No
2c. Where a firm considers PAI on Sustainability Factors it must also provide a: <ul style="list-style-type: none"> Statement indicating the information on PAI described in 2b above is available in the Periodic disclosures of the relevant products 	Art 7(1)(b)	No – However, see Arts 4 – 10	Periodic	No	30 th December 2022	No
2d. Where PAI <u>are not</u> considered in relation to some or all of a firms' products, the Periodic disclosures of those products must include a statement that PAI are not considered and why	Art 7(2)	N/A	Periodic	No	10 th March 2021	No
3. Include information about how the Remuneration Policy is consistent with the Sustainability Risk Policy <ul style="list-style-type: none"> This information should be kept up to date and if amended, a clear explanation provided on the firms' website 	Art 5 & 12	N/A	Pre-contractual and Website (See Art 33 of Draft RTS)	No	10 th March 2021 / 30 th June 2021	Yes
4. Review marketing materials to ensure they are consistent with Points 1 and 2	Art 13	N/A	Pre-contractual and Website (See Art 33 of Draft RTS)	None yet – the ESAs will consider developing	10 th March 2021 / 30 th June 2021	Yes

Table 3: Additional Requirements for Financial Products that “Promote Environmental and/or Social Characteristics”

Disclosures (in addition to Table 2)	SFDR Article	Draft RTS	Type	Template	Due Date	Financial Advisors?
<p>1. Where firms promote environmental and/or social characteristics, provided the investee companies follow good governance practices, the Sustainability Risk Policy mentioned in Table 2, Point 1, should also include:</p> <ul style="list-style-type: none"> a. Information about how these characteristics are met; b. If an index is used as a reference benchmark, information about how the index is consistent with the characteristics; and c. An indication of where the methodology for the calculation of the index is located 	Art 6 & 8	Arts 14 to 22	Pre-contractual	Yes – Draft RTS, Annex II, not yet published	10 th March 2021 / 30 th June 2021	No
<p>2. The Framework Regulation inserts a new Art 8(2a) into the SFDR, which indicates where the product promotes one of six environmental characteristics¹ additional disclosures apply:</p> <ul style="list-style-type: none"> a. Information about the environmental characteristics; b. A description of the extent to which the investments qualify as sustainable and the proportion of the product these represents; and c. The following statement: “The ‘Do No Significant Harm’ principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’ 	Art 8(2a) Also see The Framework Regulation Art 6 & 25(2)	N/A	Pre-contractual	Yes – not yet published, deadline to submit to EC is 30 th December 2020 – however the ESA’s have included in its Joint Consultation Paper	(i) 1 st January 2022 for environ obj’s (a) & (b) (ii) 1 st January 2023 for environ obj’s (c) to (f)	No

¹ The Framework Regulation Article 9: (a) climate change mitigation; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; and (f) the protection and restoration of biodiversity and ecosystems

Disclosures (in addition to Table 2)	SFDR Article	Draft RTS	Type	Template	Due Date	Financial Advisors?
3. A summary document no longer than two A4 pages, providing: <ul style="list-style-type: none"> • A description of the environmental and/or social characteristics; • Information about the methodologies used to assess, measure and monitor the investments, including data sources, screening criteria and sustainability indicators - <u>see Draft RTS Art 34 for additional details</u>; • This information should be clear, succinct and understandable for investors; and published in an accurate, clear, fair, not misleading simple and concise manner in a prominent, easily accessible part of the firm's website; and • This information should be kept up to date and if amended, a clear explanation provided on the firms' website 	Art 10 & 12	Arts 33 & 34	Pre-contractual on Website – in same section as other product information and materials	Yes – Draft RTS, Annex II, not yet published	10 th March 2021 / 30 th June 2021	No
4. Description of the extent to which the environmental and/or social characteristics were met – <u>see Draft RTS Arts 36 to 42 and 51 for additional details</u>	Art 11(1)(a)	Arts 36 to 42 and 51)	Periodic	Yes – Draft RTS, Annex IV, not yet published	1 st January 2022	No
5. The Framework Regulation inserts a new Art 11(1c) into the SFDR, which indicates where the product promotes one of six environmental objectives (see Footnote 1) additional disclosures apply: <ol style="list-style-type: none"> a. Information about the environmental objectives; and b. A description of the extent to which the investments qualify as sustainable and the proportion of the product these represent 	Art 11(1)(c) – also see The Framework Regulation Art 6 & 25(2)	N/A	Periodic	Yes – not yet published	(i) 1 st January 2022 for environ obj's (a) & (b) (ii) 1 st January 2023 for environ obj's (c) to (f)	No

Table 4: Additional Requirements for Financial Products with a “Sustainable Investment Objective”

Disclosures (in addition to Table 2)	SFDR Article	Draft RTS Article	Type	Template?	Due Date	Financial Advisors ?
<p>1. <u>If an index is used as a reference benchmark</u>, in the Sustainability Risk Policy mentioned in Table 2, Point 1, the firm should provide:</p> <ul style="list-style-type: none"> Information about how the index is aligned with the “sustainable investment objective”; An explanation of why and how the index differs from a broader market index; The location of the methodology used to calculate the index; and See Draft RTS Arts 23 to 32 for additional details <p>2. <u>If no such index is used</u> the Sustainability Risk Policy mentioned in Table 2, Point 1, should include an explanation of how the objective will be achieved</p> <p>3. Where a reduction in carbon emissions is the “sustainable investment objective” and:</p> <ul style="list-style-type: none"> An index is not used as a reference benchmark, the Sustainability Risk Policy mentioned in Table 2 should include an explanation of how the objective will be achieved²; Where an index or benchmark as described in Footnote 2 is used, the Sustainability Risk Policy should include the location of the methodology used in their calculation 	Art 9	Arts 23 to 32	Pre-contractual	Yes – Draft RTS, Annex III, not yet published	10 th March 2021 / 30 th June 2021	No
<p>4. The Framework Regulation inserts a new Art 9(4a) into the SFDR, which indicates where the product promotes one of six environmental objectives (see Footnote 1) additional disclosures apply:</p> <ul style="list-style-type: none"> Information about the environmental objectives; 	Art 9(4a) Also see The Framework Regulation	N/A	Pre-contractual	Yes – not yet published, deadline to submit to EC is 30 th	(i) 1 st January 2022 for environmental objectives (a) & (b)	No

² A derogation is provided here which indicates that where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark is available, the Sustainability Risk Policy must include a detailed explanation of how the objective of reducing carbon emissions is ensured in relation to the global warming objectives of the Paris Agreement

Disclosures (in addition to Table 2)	SFDR Article	Draft RTS Article	Type	Template?	Due Date	Financial Advisors ?
<ul style="list-style-type: none"> A description of the extent to which the investments qualify as sustainable and the proportion of the product these represent; and The following statement: “The ‘Do No Significant Harm’ principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’ 	Art 5 & 25(3)			December 2020 – however the ESAs have included in its Joint Consultation Paper	(ii) 1 st January 2023 for environmental objectives (c) to (f)	
5. A summary document no longer than two A4 pages, providing: <ul style="list-style-type: none"> A description of the sustainable investment objective and strategy; Information about the methodologies used to assess, measure and monitor the investments, including data sources, screening criteria and sustainability indicators - <u>see Draft RTS Art 35 for additional details</u>; This information should be clear, succinct and understandable for investors; and published in an accurate, clear, fair, not misleading simple and concise manner in a prominent, easily accessible part of the firm’s website; and The information should be kept up to date and if amended, a clear explanation provided on the firms’ website 	Art 10 & 12	Art 35	Pre-contractual on Website – in same section as other product information and materials (See Art 33 of Draft RTS)	Yes – Draft RTS, Annex III, not yet published	10 th March 2021 / 30 th June 2021	No
6. The following disclosures are also required: <ol style="list-style-type: none"> The overall sustainability related impact of the product using relevant sustainability indicators; OR Where an index is used as a reference benchmark, a comparison between the sustainability related impact of the product with: <ol style="list-style-type: none"> The impact of the designated index; A broad market index through sustainability indicators; and See Draft RTS Arts 43 to 51 for additional details 	Art 11(1)(b) Art 11(1)(d) – also see The Framework Regulation Art 5 & 25(3)	Arts 43 to 51	Periodic	Yes – Draft RTS Annex V, not yet published	1 st January 2022	No