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Navigating the European ESG Disclosure Regime in a Post-Brexit World

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Following increased public attention to the global sustainability agenda, investors, public institutions, and companies around the world are increasingly prioritizing environmental, social, and governance (ESG) measures as part of their investment criteria. With this growing demand for sustainable investment strategies, it is unsurprising that the global regulatory landscape has been rapidly developing to accommodate this shift.

In the United States, the Biden administration is making active efforts to promote sustainability across many of its government departments and is moving to address climate change and its impact on various industries. In two early moves, the administration rejoined the Paris climate accord and suspended new oil and gas leases on federal land. Securities and Exchange Commission Acting Chairwoman Allison Herren Lee has appointed Satyam Khanna to a newly created post: Senior Policy Advisor for Climate and ESG. Treasury Secretary Janet Yellen is also reportedly planning to hire a Treasury Department "climate czar."

Meanwhile, the UK government has demonstrated a clear desire to comply with global reporting standards, with the Chancellor of the Exchequer having confirmed that, by 2025, the United Kingdom will be the first country in the world to make compliance with the Task Force on Climate-Related Financial Disclosures[1] compulsory. Further afield, countries such as Canada and Sweden are taking steps to redefine the concept of "fiduciary duty" to reinforce that investment managers will breach their duty to investors by failing to consider ESG factors when making investment decisions. Meanwhile, the Japanese government is undertaking a study to explore a potential ESG disclosure framework.

However, Europe continues to lead the way in respect of both ESG investing and ESG regulation. Sustainable investment in the European Union is no longer optional but has instead become a focal point of the asset management industry in Europe. As a part of the European Commission's Action Plan on Financing Sustainable Growth in 2018, the EU Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU) (SFDR or Regulation) was rolled out in a bid to make ESG investing more accessible and easier to understand.

Asset managers face a major challenge with the shift towards a global sustainability agenda: their fiduciary duties require them to pursue a client's financial objectives, and these objectives may or may not require a consideration of ESG factors. The SFDR framework integrates the concept that ESG factors may impact the value of investment, implicitly requiring that investment managers now take sustainability risks into account in their investment decision making process. Under SFDR, a “sustainability risk” is an ESG event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment and SFDR requires that asset managers disclose these sustainability risks as outlined below. Other important ESG-related changes are also on the horizon with respect to Markets in Financial Instruments Directive (MiFID II), Alternative Investment Fund Managers Directive (AIFMD), and Undertakings for the Collective Investment in Transferable Securities (UCITS) rules. Whilst these are discussed further below, this is a constantly evolving area which continues to be monitored closely.

ESG In Europe--The EU Disclsoure Regulation

SFDR aims to clamp down on ‘greenwashing’ (the act of conveying a misleading or false impression that a product is more environmentally sound than it actually is) by requiring greater transparency as to how sustainability risks and ESG factors are integrated into the investment decisions, advice, and wider business processes of asset managers.

SFDR is designed to achieve this goal by mandating for disclosures to be made by asset managers and financial advisers at an entity level regarding how they incorporate sustainability into the services they provide. Asset managers offering separate accounts or funds with a sustainable objective or with environmental or social characteristics will also need to disclose at the product level how those characteristics or objectives are met.

SFDR requires that these disclosure requirements are made by asset managers through a variety of methods including on websites and through pre-contractual disclosures such as prospectuses and annual reports. SFDR entered into force on 29 December 2019, and most substantive provisions of the Regulation applied from 10 March 2021.

In addition, there are Regulatory Technical Standards (also known as Level 2 measures)[2] which set out templates for required disclosure under SFDR. The earliest intended implementation date for these measures is 1 January 2022.

Scope of SFDR

SFDR is applicable to MiFID II investment firms[3], managers of UCITS, and alternative investment fund managers (AIFMs). The obligations of a firm under SFDR differ depending on whether the firm is providing discretionary portfolio management (referred to as a financial market participant or FMP) or non-discretionary investment advice (referred to as financial adviser or FA). For the purposes of this article, we refer to these entities collectively as “asset managers.”

SFDR applies in part to all asset managers and their financial products, with additional disclosure requirements for asset managers offering financial products which promote environmental or social characteristics, or that have sustainable investment, or the reduction of carbon emissions as an objective.

What Disclosures are Required for Asset Managers?

SFDR requires asset managers to make a number of sustainability-related disclosures, at both an "entity level" (disclosures required by asset managers) and a "product level" (disclosures required in respect of the funds and financial products asset managers manufacture and manage).

Entity Level Disclosures

Asset managers need to make the following disclosures on their websites:

- Information about their policies on the integration of sustainability risks into their investment-decision making process.[4]

- A statement on their due diligence policies with respect to their consideration of the principal adverse impacts of their investment decisions on sustainability factors. This statement must include details such as: i) a description of the principal adverse sustainability impacts and actions taken or planned in relation to them, ii) information about their policies on the identification and prioritization of the principal adverse impacts and indicators, iii) a brief summary of their shareholder engagement policy, and iv) the level of adherence to responsible business conduct codes, internationally recognized standards on due diligence and reporting, and (if relevant) the degree of alignment with the Paris Agreement objectives. Firms whose average number of employees is under 500 are able to choose not to consider adverse impacts. However, firms that choose this approach must provide a clear explanation as to why they have chosen not to do so and whether this will change.[5]

- Information on how their remuneration policies are consistent with the integration of sustainability risks.[6]

Product Level Disclosures

For all financial products (including UCITS, alternative investment funds (AIFs) and separately managed accounts subject to MiFID II regulation), disclosure regarding how the product considers principal adverse impacts on sustainability factors is required.[7] If adverse impacts are not considered, a clear and reasoned explanation will need to be provided.

Products that have ESG as a focus fall under Article 8 of SFDR (sometimes described as E/S funds) and Article 9 (or, as sometimes described, ESG funds). E/S funds promote certain environmental or social characteristics. For these funds, sustainable investment is not the primary objective, but sustainability remains an important and binding aspect of the investment process. ESG funds are financial products where the objective of the financial product relates to a sustainability objective or impact. Those products that do not have an ESG focus and therefore do not fit within Article 8 or Article 9, will fit within Article 6.

Article 6 applies disclosure requirements that are applicable to all types of investment funds. Article 6 requires that asset managers provide descriptions in pre-contractual disclosures regarding the manner in which sustainability risks are integrated into their investment decisions and the results of their assessment of the likely impacts of sustainability risks on the returns of all of their financial products. If the sustainability risks are deemed not to be relevant by the asset manager, clear and concise reasons need to be provided. Most asset managers are expected to satisfy this requirement through prospectus disclosure.

For E/S and ESG funds, there are additional disclosure requirements. These include:

- For E/S funds: Disclosure in periodic reports regarding the extent to which environmental and social characteristics are attained or the overall sustainability-related impact of the product using relevant sustainability indicators (or, if an index has been used, a comparison between the sustainability-related impact of the fund with impacts of the designated index and a broad market index).[8] Pre-contractual disclosure for products which, among other characteristics, promote environmental or social characteristics or a combination of these, must include disclosure regarding how those characteristics are met and, if an index is used, the consistency of the index with those characteristics.[9]

- For E/S and ESG funds: Disclosure on the websites of asset managers setting out (i) the environmental and social characteristics or the sustainable investment objective of each financial product; (ii) information on how those characteristics or objectives are met; (iii) 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 financial product, including its data sources and screening criteria for the underlying assets; and (iv) the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product.[10]

- For ESG funds: Pre-contractual disclosure for products with sustainable investment objectives must include information on how the investment objective is to be obtained where no index has been designated as a reference benchmark. If a designated benchmark is included, information on how the index is aligned with the objective should be provided, along with an explanation of how the index is aligned with the objective.[11]

Information regarding where the calculation of the indices can be found will need to be included in the pre-contractual disclosure for both products with sustainable investments objectives and products with environmental and social characteristics.

Asset managers should ensure that marketing documents do not contradict the disclosures required under SFDR. We suggest that firms include the review of marketing material in their project planning for SFDR.

On 4 February 2021, the European Supervisory Authorities (ESAs) published the final draft of the technical standards which build on the framework regulation and provide firms with the detailed measures that look set to apply from 1 January 2022. These also need to be reviewed carefully and incorporated within project planning for SFDR and will be the subject of a further alert.

Interaction with the Taxonomy Regulation

Regulation (EU) 2020/852 (the Taxonomy Regulation), which entered into force on 12 July 2020, is another key element of recent EU measures designed to encourage environmentally sustainable investment decision-making, by implementing a technical framework to help to ascertain how sustainable an economic activity is. The Taxonomy Regulation establishes an EU-wide taxonomy of economic activities that can be viewed as environmentally sustainable by reference to six economic objectives: (i) climate change mitigation, (ii) climate change adaptation, (iii) the sustainable use and protection of water and marine resources, (iv) the transition to a circular economy (v) pollution prevention and control, and (vi) the protection and restoration of biodiversity and ecosystems.

The Taxonomy Regulation, which applies to FMPs but not to FAs, makes targeted amendments to

SFDR that require asset managers to provide further pre-contractual and periodic disclosures for financial products that promote environmental and social characteristics, or have an objective of sustainable investment (in other words, E/S and ESG funds). FMPs will be obliged to provide information on the environmental objective to which the investment underlying the financial product contributes and a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.[12]

The Taxonomy Regulation also requires that all products which do not have an environmental focus make a disclosure stating that the investments underlying the financial product do not take into account the EU criteria for environmentally sustainable economic activities.[13] This disclosure will be a signpost to assist ESG-focused investors in identifying investments that do not have ESG as a focus, thereby accelerating the trend towards ESG investing in Europe.

The combined effect of the Taxonomy Regulation and SFDR will provide greater clarity to investors on the substance behind sustainability claims. The Taxonomy Regulation is intended to provide empirical evidence as to the underlying portfolio's sustainability, while SFDR will expose the extent of an asset manager's stated ESG-risk management for a product, consideration of the negative impacts of investment decisions on sustainability factors and key aspects of the product's sustainability characteristics or objectives.

Implementation of the Level 2 Measures

At the time of writing, the European Commission has delayed the application of Regulatory Technical Standards (RTS) (the Level 2 measures), which set out more detail regarding how information under SFDR will be presented—with 1 January 2022 being confirmed as the intended application date.[14] The application of the SFDR is not conditional on the formal adoption and entry into force of the Level 2 measures, meaning that some of the Level 1 requirements laid down in SFDR applied from 10 March 2021. Within the Level 2 measures, there are mandatory disclosure templates setting out how asset managers should set out their disclosures under SFDR.

Until 1 January 2022, the correspondence we have seen would suggest that in the absence of the Level 2 measures, firms should take a principles-based approach to compliance with those provisions of SFDR that rely on the implementation and technical standards details set out in the Level 2 RTS. This should be done on an evidenced "best efforts" basis.

Amendements to UCITS, AIFMD and MIFID II

In addition to the requirements under SFDR and the Level 2 measures described above, in June 2020 the European Commission published draft delegated acts, which once implemented, will amend the AIFMD,[15] the MiFID II,[16] and the UCITS Directive.[17] Broadly speaking, the proposed amendments seek to complement the manager-level requirements under SFDR, by clarifying and setting out how asset managers should integrate the active consideration of sustainability risk into compliance with the existing regimes.

Changes to the requirements of the UCITS and AIFMD regimes will involve integration of sustainability risks into processes regarding investment due diligence, organizational requirements, identification of conflicts of interests, and risk management policies.

The MiFID II amendments provide that sustainability preferences should be taken into account in the product oversight and governance process, and provide that both portfolio managers and FAs must take into account the client's sustainability preferences in carrying out suitability assessments.

How do these Measures Apply to Non-EU Managers?

An FAQ document published by the European Commission and the Technical Expert Group on Sustainable Finance provides that the disclosure obligations applicable to asset managers in the Taxonomy Regulation (which build on the respective obligations in SFDR) are applicable to anyone offering financial products in the European Union, regardless of where the manufacturer is based. This gives us an indication of the view at the level of the EU Commission and the direction of travel regarding the applicability of SFDR outside of the European Union.

As mentioned above, SFDR defines 'an alternative investment fund manager (AIFM)' as one of the financial market participants to which SFDR applies. It is noted that the application of SFDR to non-EU AIFMs was recently flagged in a letter from the ESAs to the EU Commission as an area of uncertainty, that would benefit from urgent clarification to facilitate the orderly application of SFDR. A particular point requiring clarification is the applicability of the entity level disclosures to non-EU AIFMs. At the date of this Article, the EU Commission is yet to respond.

Until the EU Commission responds to the ESAs' request for clarification, we anticipate that there are broadly two ways in which the SFDR could have the most impact on non-EU AIFMs and non-EU managers providing portfolio management to EU firms are as follows:

1. Marketing of AIFs in the European Union by Non-EU AIFMS

SFDR may directly apply to non-EU AIFMs (whether EU AIFs, or non-EU AIFs) marketing into the European Union under AIFMD national private placement rules. In this scenario, non-EU managers would be required to make product level disclosures as described above in respect of all AIFs registered for marketing in the European Union.

2. Indirect Impact on Non-EU Managers

SFDR may also apply indirectly to non-EU investment managers providing portfolio management and non-discretionary investment advice to EU firms that are themselves subject to the new rules. For example, where a non-EU firm acts as a delegated investment manager to an EU AIFM or UCITS management company, it may be required to provide the information necessary to the EU management company to assist it in complying with disclosure requirements under SFDR. In this scenario, while the non-EU investment manager might not have a direct regulatory obligation to prepare the disclosures, it may be contractually required to do so by the delegating EU manager.

There may also be instances where investors in funds and/or segregated accounts managed by non-EU investment manager are themselves (directly or indirectly) subject to SFDR and the Taxonomy Regulation. Where this is the case, investors may, for the purpose of fulfilling their own SFDR and Taxonomy Regulation obligations, require commitments from non-EU investment managers to provide information, or to carry out certain responsibilities.

Impact of Brexit

Under section 3 of the UK European Union (Withdrawal) Act 2018 (EUWA), direct EU legislation (so far as it was operative immediately before 31 December 2020) now forms part of domestic UK law.

The operative disclosure obligations under SFDR came into effect on 10 March 2021 and the disclosure obligations in the Taxonomy Regulation do not apply until 2022 (for climate-related environmental objectives) and 2023 (for the other environmental objectives). As a result, none of these operative disclosure obligations have become EU-retained law in the United Kingdom from 1 January 2021.

HM Treasury has previously expressed the view that a more flexible set of regulatory guidance on ESG disclosures may be more helpful than a prescriptive legislative framework. However, due to concerns around maintaining the UK's regulatory equivalence post-Brexit, it could be that the United Kingdom looks to adopt domestic measures that closely align with Level 2, on the basis that one considerably onerous (but uniform) regime may prove less problematic for the industry than two completely different ones.

There is, however, a clear desire of the UK government to comply with global reporting standards. The Chancellor of the Exchequer, Ritchie Sunak, has announced that Britain will be the first country in the world to make compliance with Task Force on Climate-Related Financial Disclosure compulsory for British companies by 2025. In addition, a green taxonomy will also be introduced which will take scientific measures from the EU taxonomy as its basis and a UK Green Technical Advisory Group will be established to ensure that those metrics are right for the UK market. The United Kingdom will also launch its first sovereign green bond this year, which will be used to finance projects tackling climate change, infrastructure, and to create green jobs.

In any event, in anticipation of these projects, as the European authorities currently intend for products marketed into Europe by non-EU firms to be subject to the Level 2 disclosure requirements, UK FMPs and FAs will need to factor the reforms into their activities until there is further clarity from the UK government. Practically, a UK firm may decide to comply with the SFDR voluntarily, due to pressure from investors or due to the global nature of its business.

Conclusion

Although SFDR is a welcome change in promoting transparency regarding the ESG practices of investment funds and preventing greenwashing, it is apparent that the draft RTS leaves much to be desired. Industry bodies have shared concerns that the highly detailed sustainability metrics are too prescriptive, and that the Level 2 currently fails to strike an appropriate balance between the importance of the comparability of funds and ensuring that disclosures remain meaningful. Although the United Kingdom has the opportunity to re-strike the balance following the transition period, it remains unclear whether it will decide to do so.

Over time, as there is an increasing movement towards more standardization in the industry in ESG related disclosures, it may be that non-EU investors also request the same level of disclosure from asset managers.

1 The Task Force on Climate-Related Financial Disclosures is an organization that was established in December of 2015 with the goal of developing a set of voluntary climate-related financial risk disclosures which can be adopted by companies so that those companies can inform investors and other members of the public about the risks they face related to climate change. The organization was formed by the Financial Stability Board as a means of coordinating disclosures among companies impacted by climate change.

2 Final Report on Draft Regulatory Technical Standards, ESMA, 2 February 2021.

3 Firms authorised pursuant to the EU Markets in Financial Instrument Directive (recast) (Directive 2014/65/EU).

4 Article 3, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

5 Article 4, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

6 Article 5, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

7 Article 7, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

8 Article 11, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

9 Article 8, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

10 Article 10, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU)

11 Article 9, Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU).

12 Article 5, Taxonomy Regulation (Regulation (EU) 2020/852).

13 Article 7, Taxonomy Regulation (Regulation (EU) 2020/852).

14 Final Report on Draft Regulatory Technical Standards, ESMA, 2 February 2021.

15 Sustainable finance – obligation for alternative investment funds to advise clients on social & environmental aspects, European Commission, July 2020.

16 Sustainable finance – obligation on investment funds to advise clients on social & environmental aspects, European Commission, July 2020.

17 Sustainable finance – obligation for mutual funds to advise clients on social & environmental aspects, European Commission, July 2020.

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