



all things

# Regulatory

for the

FUNDS & ASSET MANAGEMENT INDUSTRIES



Merlys

# What Changes Have Happened to ESG in Europe?

ESG is a fast-evolving area of the law and it is increasingly influencing the funds management industry. It is very much on our radar at Merlys and we are actively keeping abreast of developments. We will be posting regular updates to add our take on this evolving area and we very much hope that you will find this bulletin and those that follow to be useful and of interest.

## What is the Taxonomy Regulation?

The EU adopted the Taxonomy Regulation in late 2019. Following lengthy debate, the EU institutions agreed on a proposal to create a taxonomy or classification system to provide market clarity on what economic activities should be considered “sustainable” and to prevent “greenwashing”. The Council and the European Parliament voted to formally adopt the Taxonomy Regulation on 22 June 2020. The Taxonomy Regulation will apply to activities that substantially contribute to climate change mitigation and adaptation from 1 January 2022. The Regulation will apply to activities that substantially contribute to the four other environmental objectives set out in the legislation from 1 January 2023.

## Who and what is impacted by the Sustainable Finance Disclosure Regulation (SFDR)?

The SFDR (adopted in the EU on December 2019 with most of its provisions becoming effective on 10 March 2021 despite COVID-19) imposes transparency and disclosure requirements on the following financial market participants:

- AIFMs;
- UCITS managers; and
- MiFID firms providing the service of portfolio management.

These disclosure requirements relate to the sustainability risks and their integration in the investment decision-making process and advisory processes.

Under SFDR in-scope firms must:

- have in place and publish **written policies** on the integration of sustainability risks in their investment decision-making process;
- make **pre-contractual disclosures** to investors and potential investors on how they incorporate sustainability risks in their businesses;
- comply with pre-contractual transparency rules on sustainable investments;

- publish an **online description** of the sustainable investments target and information on the methodologies used to assess, evaluate and monitor the effectiveness of investments;
- issue **periodic reports** which include descriptions of the specification of the impacts of sustainable investments by means of relevant sustainability indicators; and
- regularly review all the information published on their websites so that it is kept up to date and ensuring there is a clear explanation of any amendments to the published information.

A number of aspects of the SFDR will apply to all asset managers – irrespective of whether there is an express ESG or sustainability focus - but particularly for two types of financial product:

- products promoting environmental or social characteristics or a combination of these characteristics; and
- products which have sustainable investment as their objective.

### **Why are RTS needed under SFDR?**

On 23 April 2020, a consultation paper setting out draft regulatory technical standards (“RTS”) governing the content, methodologies and presentation of sustainability-related disclosures under the SFDR was published.

The RTS set out details on the content and presentation of information to be disclosed in the pre-contractual, website and periodic report disclosures required under the SFDR.

There are proposals for mandatory disclosure templates for the pre-contractual and periodic product disclosure to harmonise how the information is provided. The drafting of these

templates has been delayed pending greater certainty regarding what should be disclosed. Currently it is envisaged that a separate process will be launched to develop these templates after the consultation paper has been published.

The closing date for comments on the draft RTS was 1 September 2020. Following the close of the consultation period, the draft RTS will be finalised and submitted to the European Commission.

The RTS will generally apply from 10 March 2021, although certain provisions relating to those products with an ESG-focus or objective will apply from 1 January 2022.

### **What are the challenges posed by Inconsistencies between SFDR and Taxonomy Regulation?**

The SFDR is closely linked with the Taxonomy Regulation, although they were not agreed and adopted at the same time. The finalised SFDR defined “sustainable investments” without reference to the Taxonomy Regulation. It does not link environmentally sustainable investments to the Taxonomy Regulation. The RTS are intended to “iron out” any “wrinkles” between the two. For example, the relationship between the concept of “principal adverse impact” in the SFDR and the concept of “no significant harm” in the Taxonomy Regulation should ultimately be clarified.

### **What is a “Principal Adverse Impact Disclosure”?**

The SFDR introduces the concept of “principal adverse impact of investment decisions on sustainability factors” which are then required to be disclosed on a firm’s website where a firm has decided to take adverse impacts into account. The “impacts” are described in the recitals to the SFDR as impacts of investment decisions and advice that result in negative effects on sustainability factors (i.e. environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters). The RTS elaborates on the content and presentation of information required in relation to the principal adverse impact disclosure, including the use of a mandatory reporting template.

### **What are the Pre-contractual, Periodic and Website Disclosures?**

The RTS set out details on the content and presentation of information to be disclosed in the pre-contractual, website and periodic report disclosures required under the SFDR.

It is proposed that mandatory disclosure templates for pre-contractual and periodic product disclosure should be developed to harmonise how the information is provided. However, the drafting of these templates has been delayed pending greater certainty regarding what should be disclosed. It is envisaged that a separate process will be put in place to develop these templates after the consultation paper has been published.

### **What is the effect of Sustainability Factors on the UCITS Directive and the AIFMD?**

Along with the Taxonomy Regulation and the SFDR, a further element of the EU Commission’s Action Plan on Sustainable Growth (2018) was the amendment of the level 2 measures under various pieces of legislation forming the EU financial services regulatory framework. That framework includes both the UCITS Directive and the AIFMD which would need to be amended to explicitly require management companies to integrate sustainability risks in the investment decision-making process. As the existing legislative frameworks do not explicitly mention sustainability risks, the Commission has clearly indicated “it is necessary to clarify that processes, systems and internal controls of management companies reflect sustainability risks, and that technical capacity and knowledge is necessary to analyse those risks.”

The key elements of the proposed amendments are:

- The addition of definitions of “sustainability preferences”, “sustainability risks” and “sustainability factors” into the level 2 measures, as well as the concept of “material adverse impact” on the value of investments.
- Management companies being required to assess all relevant sustainability risks when conducting due diligence on investments.
- Management companies being required to identify conflicts of interest which arise as a result of the integration of sustainability risks in processes, systems and controls.
- Assessment and management of exposure to sustainability risk required to be incorporated into the risk management policy and procedures of the management company.
- Sustainability risks having to be taken into account in the organisational structure of the management company.
- Management companies having to retain the necessary resources and expertise required for the integration of sustainability risks.
- Larger management companies, (i.e. with an average of more than 500 employees) and those who voluntarily comply with the SFDR principal adverse impact reporting obligation, being required to analyse and then adopt principal adverse impact of their investments on sustainability factors.

In addition to the above proposals, the Commission also published proposals to integrate sustainability factors into MiFID II, the Solvency II Directive and the Insurance Distribution Directive.

### **Further Developments**

The EU Commission is pushing ahead with its sustainable finance initiatives at full speed. These include the Renewed Sustainable Finance Strategy consultation that closed in July 2020 and its letter (in June 2020) in relation to the establishment of a centralised register for ESG data. The letter emphasises that the recent regulatory developments in the context of the EU sustainable finance agenda create an urgent need for publicly available ESG data as well as a need to identify how to enhance their sourcing.

### **Conclusion**

Over the course of this summer, firms should think about their approach to ESG matters, develop their awareness of the new EU ESG rules and consider putting ESG planning updates on their compliance agenda.



**Author:** Verena Charvet MBA, Solicitor and Senior Partner at Merlys  
Connect on LinkedIn: <https://www.linkedin.com/in/verenacharvet/>  
Email: [verena.charvet@merlys.uk](mailto:verena.charvet@merlys.uk)

*This briefing note is intended to act as general guidance and is not intended to offer specific legal advice. Merlys is very happy to assist you with any aspect of the content in this article, as it relates to your business.*

Contact Verena Charvet as above or call us at Merlys on +44(0) 20 7821 5395  
Follow Merlys: <https://www.linkedin.com/company/merlys/>