London

ESG Regulatory Reform

Impact on Asset Managers

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Baker McKenzie.

INTRODUCTION: ESG REFORM AGENDA

Following publication of the European Commission's Action Plan on Sustainable Finance in March 2018[1], there have been a flurry of EU legislative proposals in the ESG space. These proposals are set to embed a consideration of ESG issues into governance standards applying across the finance sector, and will touch on certain fundamental components of the EU financial services regulatory architecture, including MiFID II, the AIFMD and the UCITS Directive. Given its role in driving investment strategy, the EU sees the asset management sector in particular as key to advancing its ESG agenda. With that in mind, we aim in this client briefing to rationalise the scope and implications of the ESG reforms that have so far been proposed for both EU and non-EU managers. **See below a quick reference guide to the impact of each reform outlined in this briefing to EU and non-EU managers*:**

Proposed Reform	Application to EU Managers	Application to Non-EU Managers with EU Sub-Manager	Application to Non-EU Managers with no EU Sub-Manager	Page No.
Amendments to the AIFMD and UCITS Regimes	Direct impact on EU AIFMs and UCITS ManCos	Indirect impact on non-EU managers acting as sub-managers to UCITS ManCos No direct impact on other non-EU managers	Indirect impact on non-EU managers that act as sub-managers to UCITS ManCos No direct impact on other non-EU managers	p. 6
Organisational Requirements for Investment Firms	Direct impact on: • EU AIFMs with top-up permissions; • any EU investment firms in the group	No direct impact on non-EU manager Direct impact on EU sub-manager to non-EU manager	No direct impact on non-EU managers	p. 10
Disclosure Requirements	Direct impact on: • EU AIFMs; • UCITS ManCos; • any investment firms in the group with authorisation to provide portfolio management services	Direct impact on: • non-EU managers marketing funds to EEA investors • EU sub-managers to non-EU managers Indirect impact on non-EU managers that act as sub-managers to UCITS ManCos	Direct impact on non-EU managers marketing funds to EEA investors Indirect impact on non-EU managers that act as sub-managers to UCITS ManCos	p. 12
Product Governance	Indirect impact where fund shares are distributed to EU investors	Indirect impact where fund shares are distributed to EU investors	Indirect impact where fund shares are distributed to EU investors	p. 14
Suitability	Indirect impact where fund shares are distributed to EU investors Direct impact on: • EU AIFMs with top-up permissions; • any investment firms in the group with investment advice or portfolio management permissions	Indirect impact where fund shares are distributed to EU investors	Indirect impact where fund shares are distributed to EU investors	p. 16

** Note that small AIFMs will remain outside scope of the majority of these reforms, unless they have MiFID top-up permissions*

[1] See Communication from the Commission, "Action Plan: Financing Sustainable Growth", dated 8 March 2018.

NOTE ON TIMING

Although the reform proposals discussed in this client briefing are largely still in draft form, and are therefore still subject to amendment, they are progressing quickly. Political agreement has already been reach on both the Disclosures and Low Carbon Benchmark Regulations, and the European Parliament has published a provisional version of the text of its position on the Taxonomy Regulation, discussed below, which gives a good indication of travel. Given that certain related proposals (e.g. the Commission's draft Delegated Regulations amending suitability requirements in MiFID II) cannot be adopted until the text of the Disclosure Regulation have been formally agreed, it is likely that the package of reforms will be finalised at a similar time.

However, the draft texts do contemplate a phase-in period (for example, the Parliament has proposed that the Disclosure Regulation should only apply fifteen months after publication in the Official Journal[2], and the Taxonomy Regulation will only be phased in fully after the adoption of certain delegated acts establishing technical screening criteria). Therefore, although we do not yet have certainty around timing, firms should still have at least 18 - 24 months to prepare for full implementation.

Brexit

HM Treasury has noted that the Disclosure Regulation in particular is unlikely to come into force prior to Brexit[3], so it remains to be seen whether the UK adopts all of the proposed ESG reforms in the same form as are adopted at EU level. HM Treasury has, for example, expressed the view that a more flexible set of regulatory guidance on ESG disclosures may be more helpful than a prescriptive legislative framework (as is contemplated at EU level). However, given the UK's concerns around maintaining regulatory equivalence in a post-Brexit environment, and given the extraterritorial impact of the new ESG regime, it seems likely that UK managers will need to factor the reforms into their activities in some way.

HOW CAN BAKER MCKENZIE HELP?

Baker Mckenzie was named Climate Change Firm of the Year at the Who's Who Legal Awards 2019 and is dedicated to helping clients navigate the increasingly complex and constantly evolving ESG regulatory landscape. Baker McKenzie assists clients on a range of issues relating to sustainability, including advice on ESG financing (e.g. green and "blue" bonds, green loans and impact investing), drafting ESG policies and advising on principles governing responsible investment. Our Chambers Tier 1 ranked corporate governance practice advises on all aspects of corporate governance and how buyside firms may engage effectively with investee companies. With extensive experience advising market participants ranging from "pure-play" renewables entities to investment banks to buyside firms on ESG matters, Baker McKenzie is uniquely positioned to provide constructive advice and guidance in jurisdictions around the world on these increasingly vital issues.

[2] The original European Commission text, on the other hand, referred to a transition period of 12 months.

[3] See http://europeanmemoranda.cabinetoffice.gov.uk/files/2018/07/EM_-_Sustainability_Disclosures.pdf

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E,S OR G? MOVING TOWARDS A COMMON TAXONOMY

The European Commission's proposals refer throughout to "sustainability", "sustainable investments" and "sustainability risk". However, the definitions attaching to these terms refer back to "environmental, social or governance" (E, S, or G) events, conditions, or risks. As a threshold issue, it is therefore worth considering how E, S and G should be interpreted in the context of the reforms.

E: Environmental factors

The EU's regulatory reform initiative is underpinned by a proposed "Taxonomy Regulation"[4], which is intended to establish an EU-wide taxonomy on environmental sustainability, and to give both corporates and financial institutions a common language to identify which activities and financial instruments may be considered to be environmentally sustainable.

Pursuant to the Taxonomy Regulation, in order for an economic activity to be classified as "environmentally sustainable", it must substantially contribute to one or more specified environmental objectives, and must not simultaneously cause significant harm to another environmental objective. These environmental objectives, as specified in the Taxonomy Regulation, are as follows:

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, waste prevention and recycling;

e) pollution prevention and control; and

f) the protection of healthy ecosystems.

In order to qualify as environmentally sustainable, the activity must also be carried out in accordance with certain baseline governance and social safeguards, and it must also comply with "technical screening criteria" to be mandated by the European Commission. The technical expert group on sustainable finance (**TEG**), which was set up by the Commission, has now published its first Technical Report on Taxonomy.[5] This report is intended to be the first step in developing a unified classification system for sustainable economic activities and the TEG has noted that, over time, it intends for the classification system to be "as comprehensive as possible and cover all relevant parts of the economy".[6]

S: Social factors

Although the Taxonomy Regulation focuses on environmental sustainability, the accompanying draft Disclosure Regulation gives a number of examples of "economic activities that contribute to a social objective"; namely, "investments that contribute to tackling inequality, that foster social cohesion, social integration and labour relations, or investments in human capital or economically or socially disadvantaged communities".

G: Governance factors

The European Commission's draft text originally defined "good governance investments" as investments in

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[4] The Proposed Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment.

[5] See: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf

[6] See page 23 of the Technical Report.

companies following good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance.

More recent drafts of the Disclosure Regulation, however, indicate that, rather than good governance investments forming a specific sub-category of sustainable investments, governance will instead form a "baseline", such that an investment in a corporate entity may not be labelled sustainable unless the corporate itself demonstrates good governance practices.

How do asset managers currently think about ESG?

There are already a number of EU and UK-specific voluntary market codes and existing regulatory reforms which relate to ESG and which are relevant to certain sectors of the asset management community. To date, these reforms have focused most heavily on governance, although environmental and social factors have received some degree of attention. For example:

- the revised Shareholder Rights Directive ("**SRD II**"), which aims to increase the level and quality of engagement that asset managers have with their investee companies, has recently introduced a requirement for asset managers to make disclosures around their engagement policies with companies they invest in[7];
- the UK Stewardship Code sets out good practice for institutional investors when engaging with UK listed companies;
- the Principles for Responsible Investment, which focus on incorporating ESG issues into investment practice, have informed the investment practices of certain asset managers, particularly in the PE space[8]; and
- the UK Corporate Governance Code sets certain standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and dealings with shareholders, and is a helpful reference source for UK asset managers making active investments in listed companies.

This focus on governance means that many EU asset managers will not be starting from scratch in drafting ESG policies, particularly following full implementation of the revised Shareholder Rights Directive, although there may be some way to go for legal and compliance teams in terms of commencing internal conversations around where risks and opportunities relating to environmental and social factors may lie.

However, although the proposed ESG reforms may well cause asset managers to broaden their focus, governance is set to remain a priority for the EU. This is made clear in ESMA's recent survey on short-term pressure on corporations from the financial sector[9], which arose from a concern that current decision-making within corporates does not take a sufficiently long-term view, thus reducing the incentives for corporates to move towards a more sustainable economy. The survey specifically raises the question of whether the remuneration policies and practices of fund managers and the use of CDS by investment funds could be a driver of "short-termism" in this respect. As a result of this paper and other statements coming out of the EU in relation to the capital markets union project, it seems likely that there will be an increasing focus on encouraging institutional investors and asset managers to take a longer-term approach to their corporate engagement strategies, with a view to increasing consideration of sustainability factors.

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[7] Albeit that the requirement for UK managers to disclose engagement policies under SRD II is subject to a phase-in period.

[8] We note that the Principles are elaborated upon in industry specific publications including "ESG monitoring, reporting and dialogue in private equity".

[9] https://www.esma.europa.eu/press-news/esma-news/esma-consults-short-termism-in-financial-markets

Key Takeaways

- The proposed Taxonomy Regulation will be key to ensuring that asset managers, corporates and banks all have a common means of making disclosures and performing due diligence on ESG products and investments. However, it is notable that, thus far, the EU has concentrated more heavily on defining environmental sustainability than on social and governance factors, so there is still some uncertainty around how these factors will look in practice.
- The definition of "sustainability risk" will be key for asset managers (see "Amendments to the AIFMD and UCITS Regimes" below). Although the definition of a sustainability risk has not yet been fully settled, recent drafts of the Regulation indicate that it should be defined as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact". Thus, it is clear that the definition is intended to draw in governance and social as well as environmental risk factors.
- In terms of the EU's focus on corporate engagement, the recent implementation of SRD II may be the first step towards refocusing corporate engagement on long-term, sustainable decision making.

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AMENDMENTS TO THE AIFMD AND UCITS REGIMES

Draft legal reform: ESMA Final Report on technical advice to the European Commission on integrating sustainability risks and factors into the UCITS Directive and the AIFMD

Key impact of AIFMD and UCITS Reforms	
Proposed requirement	***Organisational requirements*** ESMA's proposed reforms to the UCITS and AIFMD regimes[10] would embed a requirement to consider sustainability into the organisational rules that apply to UCITS ManCos and AIFMs. For example, both AIFMs and UCITS ManCos would be required to take sustainability risks into account when establishing decision making procedures, allocating responsibilities and ensuring compliance with internal procedures. UCITS ManCos and AIFMs would also need to take into account whether they have the necessary resources and expertise for the "effective integration of sustainability risks" into their governance structure. This requirement would need to be considered in light of the general obligation on UCITS ManCos and AIFMs to employ personnel with the skill, knowledge and expertise necessary for the discharge of their responsibilities. Finally, both AIFMs and UCITS ManCos would need to ensure that their senior management is made responsible for integrating a consideration of sustainability risks into the manager's business. ***Conflicts of interest*** ESMA has proposed new Recital wording to be inserted into the AIFMD and the UCITS regimes on conflicts of interest. The new Recitals would require that, when identifying conflicts of interest that may damage the interests of a fund or its investors, managers consider conflicts "that may arise in relation to the integration of sustainability risks". Greenwashing, misselling and misrepresentation of investment strategies are all listed as potential sources of "sustainability" conflicts. ***Due diligence*** AIFMs and UCITS ManCos are already subject to due diligence requirements relating to the selection and ongoing monitoring of investments. For example, they are required to ensure that there is an adequate level of understanding and knowledge of relevant investments within their organisations, and that investment decisions are taken in line with the investment objectives of underlying funds. ESMA's proposed revisions to the AIFMD and UCITS regimes would require that, when complying with these general due diligence obligations, managers take into account: • sustainability risks (defined in recent drafts of the Disclosure Regulation as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact"); and • the principal adverse impact of investment decisions on "sustainability factors" (defined in recent drafts of the Disclosure Regulation as environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters).

[10] The proposed amendments would appear in the Directive implementing the UCITS Directive as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company (2010/43/EU) (the UCITS "**Organisation Directive**") and Commission Delegated Regulation 231/2013 supplementing the AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the "**AIFMD Level 2 Regulation**").

	Direct engagement Pursuant to the proposed reforms, UCITS ManCos and AIFMs will be required to develop corporate engagement strategies (including the exercise of voting rights) with a view to reducing the principal adverse impact of investee companies on sustainability factors. ***Risk management*** The risk management policies put in place by AIFMs and UCITS ManCos will be required to incorporate a consideration of sustainability risks.
Impact on EU Asset Managers	The reforms will apply directly to EU AIFMs (excluding small AIFMs) and UCITS ManCos.
Impact on non-EU Asset Managers	The reforms will not apply directly to non-EEA asset managers (this should be the case even for non-EEA managers that market funds to EEA investors, unless individual EEA states attempt to extend the application of the rules in some way to non-EEA managers under their national private placement regimes). However, where non-EEA asset managers act as sub-manager to a UCITS ManCo, the UCITS ManCo will likely seek to require the non-EEA manager to adhere to certain of the new requirements when performing its portfolio management responsibilities (e.g. in relation to investment due diligence), in order for the ManCo to ensure that it satisfies its own regulatory obligations.

AIFMD and UCITS Reforms: Key Takeaways

Organisational requirements

- Given that ESMA's proposals would require AIFMs and UCITS ManCos to incorporate a consideration of "sustainability risks" into their operating models, it is clear that relevant employees will need to have some understanding of what those risks are, and how they could apply in the context of the manager's activities.
- For certain larger managers, staying on top of sustainability issues may require the designation of a specific Sustainability Officer. However, ESMA noted in its Final Report that the appointment of a specific individual should not be required in all cases, given that the organisational requirements are intended to apply in a proportionate manner. In those cases where managers choose not to appoint a Sustainability Officer, however, they should consider how best to ensure that their senior management are kept apprised of relevant developments in the ESG space.
- ESMA notes in its Final Report that the proposed reforms are intended to ensure that Senior Management is made collectively responsible for integrating a consideration of sustainability risks into the business. In practice (and particularly for UK managers, who will need to take the SMCR into account) this will mean ensuring that senior management:
    - has a good grasp of the firm's policy in relation to sustainability issues;
    - receives the necessary management information around the manager's steps to comply with its sustainability policy;
    - stays on top of key developments in the ESG space that could affect the manager's business; and

- takes leadership on sustainability issues where necessary.

- Although the organisational requirements are designed to apply in a proportionate manner, they are nonetheless intended to apply across a wide range of trading strategies etc. So in other words, hedge funds pursuing pure algorithmic, non-activist trading strategies will need to consider the application of these new rules, just as PE managers will need to take them into account. The answer may of course be that for trading strategies that are simply intended to follow market movements, and where there is a limited buy to hold element, the manager will simply incur a more limited degree of sustainability "risk". However, it is likely that the market will see an ever-increasing flow of ESG data relating to financial instruments, and this may ultimately need to be factored into firms' trading strategies (see "How Can Asset Managers Assess the ESG Profile of Potential Investment Opportunities?" below).

Conflicts

- The proposed drafting around conflicts appears partly intended to highlight issues around products being mislabelled as "green" when they do not, in reality, meet commonly accepted criteria for being environmentally friendly.
- What this means in practice is that AIFMs or UCITS ManCos that indicate to investors that their funds have a particular ESG profile will need to ensure that there is no risk of having mischaracterised the fund or its strategy on that basis.
- AIFMs and UCITS ManCos may also need to work harder to assess whether "green" products that they invest in do in fact meet the criteria set forth in the Taxonomy Regulation and other commonly accepted industry standards, or whether the investments themselves could be the subject of misrepresentation or greenwashing.

Due diligence

- AIFMs and UCITS ManCos may find that if the proposed reforms enter into force, they will be required to engage more actively with practical questions around products' "true" ESG profile (e.g. by interacting directly or *via* an intermediary with issuers, in order to ensure that fundraisings labelled as "green" or "sustainable" do in fact meet objective criteria on sustainability). This may ultimately require an understanding of some fairly practical questions around projects being financed by fundraisings.
- This requirement for due diligence in turn raises questions about the quality and availability of ESG data. One concern that was repeatedly raised across the various consultations preceding publication of the draft reforms was the inconsistent quality of data sources on ESG, and the lack of regulation around intermediaries providing such data (albeit that there is now a suggestion that verifiers of EU Green Bonds could in the future be subject to registration requirements[11]).

Direct engagement

- The requirement for all UCITS ManCos and AIFMs to develop strategies around engaging with investee companies on sustainability issues has the potential to create a broader shift in how the corporate sector engages with ESG more generally. This builds on the new requirement for managers to publish corporate engagement policies under SRD II.
- However, it is unclear how far this proposed requirement is intended to extend; for example, there is no definition of "investee company" given for these purposes, or any shareholding threshold

[11] See page 10 of the EU Technical Expert Groups' report on the EU Green Bond Standard.

beyond which firms will need to begin engaging around ESG issues (or even whether a substantial investment in a debt issuance rather than equity would, for example, result in an "investee company" relationship). The new requirement seems likely to raise similar questions to the SRD II (e.g. where managers pursuing passive strategies fit in, and how synthetic positions should be dealt with). However, in reality this new engagement requirement is far wider ranging than SRD II in the sense that it is not limited to listed companies, but appears intended to extend to any investee company relationship.

- Although corporate engagement on ESG issues has been being considered in the private equity sector in particular for some time (see the PRI Report on ESG Monitoring, Reporting and Dialogue in Private Equity[12], for example), this requirement may well cause a shift in how other types of asset managers approach corporate engagement in general.

Risk management

- Although ESG may not traditionally have been considered to be a risk management issue, the EU is keen that where sustainability related events or conditions could cause a material decrease in the value of an investment, this is taken into account in firms' risk management frameworks.

Note on Small AIFMs

- Small AIFMs below the thresholds set out in the AIFMD are generally exempt from the requirements of AIFMD and its delegated regulations. These small AIFMs will not be directly impacted by ESMA's proposed reforms as the underlying AIFMD rules which are being amended should not apply. We note, however, that some EU Member States have gold-plated AIFMD requirements for small AIFMs (e.g. Germany) and may decide to apply the reforms to small AIFMs in the future. Where asset managers have EU small AIFMs in their group they should consider whether their Home Member State applies the AIFMD regime and how this may be impacted by ESG reforms.

[12] See: https://www.unpri.org/private-equity/esg-monitoring-reporting-and-dialogue-in-private-equity/3295.article

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ORGANISATIONAL REQUIREMENTS FOR INVESTMENT FIRMS

Draft legal reform: ESMA Final Report on technical advice to the European Commission on integrating sustainability risks and factors in MiFID II

<table>
<tr><th colspan="2">Key impact of organisational reforms</th></tr>
<tr><td>Proposed requirement</td><td>
Organisational requirements
Under ESMA's proposed ESG reforms, firms that are subject to the organisational requirements set out in Article 16 of MiFID II will be required to build "ESG considerations" into their organisational framework (i.e. considerations related to environmental sustainability, social issues or good governance).
This means that firms will need to take ESG considerations into account in complying with organisational requirements including:

establishing decision-making procedures and documented reporting lines;
ensuring that personnel comply with decisions and procedures at all levels of the firm; and
employing personnel with the skills, knowledge and expertise necessary for the discharge of their responsibilities.

Note, however, that this requirement will only apply where ESG considerations are relevant to the provision of investment services to clients.
Risk management
Pursuant to ESMA's proposed reforms, investment firms would be required to take sustainability risk into account in constructing their risk management frameworks. For example, ESG would need to be factored in when identifying the risks facing the firm and setting the firm's risk tolerance limits (where relevant).
Conflicts of interest
ESMA has proposed new wording to be inserted into the Recitals of the MiFID Org Regulation[13], indicating that:

when identifying conflicts of interest that may damage the interests of a client, firms should include conflicts that may stem from the distribution of sustainable investments; and
where firms provide investment advice or portfolio management services, they should ensure that the inclusion of ESG factors considered in the advisory or portfolio management process does not lead to misselling practices or the misrepresentation of products or strategies as fulfilling ESG preferences where they do not.

</td></tr>
<tr><td>Impact on EU Asset</td><td>AIFMs with a top-up permission enabling them to perform MiFID-regulated services such as individual portfolio management, advising and arranging would be required to apply the</td></tr>
</table>

[13] the MiFID II Delegated Regulation on Organisational Requirements for Investment Firms, (EU) 2017/565.

Managers	revised organisational requirements in respect of their MiFID business. In addition, any MiFID authorised entity within the asset manager's group will need to comply with the revised framework.
Impact on non-EU Asset Managers	Any MiFID authorised entity within the non-EU manager's group will need to comply with the revised framework (so, for example, UK sub-managers of US asset managers would be within scope). Nonetheless, as noted above, ESG considerations should only be factored into the sub-manager's compliance with MiFID organisational requirements in circumstances where they are relevant to the service being provided. In order to assess whether ESG considerations are relevant to the investment services being provided by the EU sub-manager, however, there may be a need to look at the US manager's investment objectives and whether there is an underlying push from investors in the direction of ESG. If that is the case, ESG considerations would arguably be relevant to the provision of services by the UK sub-manager to the US management company.

Organisational Reforms for Investment Firms: Key Takeaways

- A key point is that any firm required to comply with the organisational requirements would need to ensure that there is a sufficient understanding and knowledge base amongst its staff of the firm's ESG policy, and potentially of ESG considerations more generally where these are key to the firm's trading or investment strategy.
- The new risk management requirements also highlight the importance of taking into account the risk that an investment's value may reduce as a result of sustainability-related factors. In order for the risk management requirements to be implemented effectively, the proposals would require the firm's compliance function, internal audit function, management body and senior management to consider sustainability risk in their fulfilling their respective duties.
- The reference to sustainability in connection with conflicts of interest requirements signals a growing concern by regulators that, as ESG factors become a more important factor in investors' investment decisions, financial instruments could be missold as, say, "green" products when in fact there is no genuine evidence that they are being used to fund environmentally sustainable projects. This emphasises the need for effective due diligence and monitoring by investment firms in relation to ESG labelled products, and underlines the need for asset managers and other financial institutions to ensure that they are receiving reliable data on these products.

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DISCLOSURE REQUIREMENTS

Draft legal reform: Proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks ("Disclosure Regulation")

Key impact of new disclosure rules	
Proposed requirement	Pursuant to the draft Disclosure Regulation, AIFMs, UCITS ManCos and investment firms that provide portfolio management services ("in-scope firms") will be required to: (a) include disclosures on sustainability risks in their pre-contractual disclosures; and (b) post sustainability policies on their websites. Please see a summary of each proposed requirement below. ***Sustainability policy*** In-scope firms will be required to publish policies on the integration of sustainability risks into their investment decision-making process on their websites. Investment firms that provide investment advice must also publish a policy on how they integrate a consideration of sustainability risks into their investment advice. ***Pre-contractual disclosures*** In-scope firms must include descriptions of the following in their pre-contractual disclosures: (a) the procedures and conditions that they have applied in integrating sustainability risks into investment decisions; (b) the extent to which sustainability risks are expected to have a "relevant impact" on the returns of financial products made available by the firm; and (c) how the firm's remuneration policies are consistent with the integration of sustainability risks and how they are in line, where relevant, with the sustainable investment target of the financial product. These disclosures are required to be made in the following form: • for UCITS ManCos, they should be included in the relevant UCITS prospectus; • for AIFMs, they should be included in the disclosures that are currently required to be made under Article 23 of the AIFMD. These Article 23 disclosures, which would ordinarily cover issues such as the investment strategy and objectives of the AIF, will often appear in the AIF's offering documents; and • for investment firms, they should be included in the general information required to be provided to clients prior to the provision of investment services pursuant to Article 24 of MiFID II[14]. ***Disclosures relating to sustainable investments*** The draft rules also contemplate that certain additional transparency requirements will

[14] See Article 24(4) of MiFID II.

	apply to "sustainable investment" products (see "How Can Asset Managers Assess the ESG Profile of Potential Investment Opportunities?" below – these additional requirements would likely only be relevant to fund managers seeking to structure a product with a specific "sustainable investment" label[15]).
Impact on EU Asset Managers	The proposed disclosure requirements will apply directly to EU AIFMs, UCITS ManCos and investment firms providing portfolio management services (i.e. MiFID authorised sub-managers or firms performing single managed account services). Managers of qualifying venture capital funds and social entrepreneurship funds will also be within scope.
Impact on non-EU Asset Managers	Where a non-EU manager has a UCITS in its structure, it may need to be prepared to assist the UCITS ManCo with making the required disclosures (e.g. by providing data on how the US ManCo incorporates sustainability factors into investment decisions). In addition, MiFID authorised EU sub-managers of non-EU investment managers will be required to publish a sustainability policy on their website, setting out how the sub-manager's investment strategy addresses sustainability risks. Where non-EU investment managers market funds to EEA investors under the AIFMD regime, based on the current drafting it appears that they would need to comply with the pre-contractual disclosure requirements mentioned above. This is because the requirement would sit within Article 23 of the AIFMD, which applies to any AIFM that markets its funds to EEA investors under national marketing regimes permitted by AIFMD, regardless of whether the manager is established in the EEA or in a non-EEA jurisdiction. It is possible, however, that future guidance could narrow the scope of this requirement.

Disclosure Requirements: Key Takeaways

- As noted in the introduction to this briefing (see "Timing"), the Disclosure Regulation is set to be subject to a phase-in period, which should give firms some time to prepare for its application.
- Once it has been phased in, there will likely be a market move towards some level of standardisation in ESG-related disclosures, and, over time, non-EU investors may even begin to request similar levels of disclosure from asset managers.
- A key concern for asset managers caught by the scope of the Regulation is likely to be the potential for inadvertent misrepresentations around the ESG profile of fund shares (e.g. because monitoring of the ESG profile of the fund's underlying investments has failed to pick up sustainability issues with underlying corporates). In addition, the text of the Disclosure Regulation proposes including an assessment of the likely impact of sustainability risks on the returns of financial products caught by the regime. This could be a rather subjective analysis, which is a concern in the case of public disclosures to potential investors. However, the proposals do also leave open the possibility of providing a reasoned explanation for why sustainability risks are simply not relevant to the services being provided.
- To date, it has become increasingly common for asset managers to publish ESG policies and other disclosures, largely in response to investor demand. However, it remains to be seen whether the relatively high level disclosures that are currently being made will be sufficiently granular for the purposes of the Disclosure Regulation; this will likely only become apparent once we begin to see copies of the draft regulatory technical standards necessary to implement the Disclosure Regulation.

[15] Note that there is a question as to how this categorisation would sit beside the EU's "Ecolabel" proposals, which are set to apply to certain retail-focused funds.

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PRODUCT GOVERNANCE REFORMS

Draft legal reform: ESMA Final Report on technical advice to the European Commission on integrating sustainability risks and factors in MiFID II

Key impact of product governance reforms	
Proposed requirement	Pursuant to MiFID II product governance rules, when EU banks or investment firms sell or "distribute" financial instruments (including shares in funds) to their clients, they need to establish what the "target market" for those financial instruments should be. In order to undertake this target market assessment, these EU distributors will generally contact the asset manager for clarification on what the asset manager (aka the "manufacturer" of the fund shares) believes to be the intended target market. Pursuant to the ESG reforms, EU distributors will need to define target markets by reference to their ESG preferences[16] "where relevant" (i.e. their preferences for environmentally sustainable investments, social investments or good governance investments). In practice, and depending on the approach that is taken to determining when ESG preferences are relevant to determining the target market, this is likely to mean that EU dealer banks and other distributors will require information from asset managers on the ESG "profile" of their fund shares, to enable them to identify whether they are distributing those shares in line with the ESG preferences of the target market.
Impact on EU Asset Managers	European distributors of fund shares will need to define the target market for those fund shares by reference to ESG preferences where they consider ESG to be a relevant criterion in setting the target market. EU asset managers, as "manufacturers" of the fund shares for product governance purposes, may therefore be asked to make new target market disclosures focusing on the ESG profile of their fund shares. In certain more limited cases, EU managers may be directly subject to the new product governance rules (i.e. where they sell fund shares directly to investors which they treat as "clients" for the purposes of the MiFID regime).
Impact on non-EU Asset Managers	As above, European distributors of non-EU managers' fund shares will need to define the target market for those fund shares by reference to investors' ESG preferences where they consider those preferences to be relevant in setting the target market for those shares. Non-EU asset managers, as "manufacturers" of fund shares for the purposes of the product governance rules, may therefore be asked to make new target market disclosures focusing on the ESG profile of their fund shares. This may prove trickier for non-EU managers who are outside scope of the ESG reforms to the AIFMD and UCITS regimes, and who may not, therefore, be considering the ESG profile of their fund shares in the same way or using the same taxonomy as EU managers.

16 We note that the ESMA Guidelines on MiFID II product governance requirements do already contemplate that a product may be designed to achieve specific investment objectives such as “green investment” or “ethical investment”; however, the EU's ESG proposals appear to go well beyond this existing acknowledgement.

Product Governance: Key Takeaways

- Since the introduction of MiFID II in 2018, European distributors have been requesting that asset managers provide product governance data in relation to the intended target market for their fund shares (generally in a standardised format such as the EFAMA European MiFID Template). Product governance questions posed to managers generally focus on matters such as the intended class of investor, their knowledge and experience, and (depending on the category of fund), the target market's ability to bear losses, their risk tolerance and their objectives and needs. The ESG profile of investors with whom the fund shares are compatible seems likely to be added to this list following implementation of ESMA's proposed reforms, although it will be open to EU distributors (and also to investment managers as "manufacturers") to determine that this criterion is simply not relevant to the ultimate target market.

- A key question for the market will be how the term "where relevant" should be interpreted in the context of assessing end clients' ESG preferences, given that this will determine when asset managers are required to provide data on the ESG profile of their funds.

- ESMA appears to have left this terminology deliberately vague during this initial phase of the reform project. For example, in response to concerns that applying the new standards only "where relevant" could lead to divergent interpretations, ESMA noted that "the amendments to the MiFID delegated acts are currently just a first step of a more extensive project", and that this more flexible approach is "meant as a starting point" which "allows market participants to accommodate themselves to ESG-requirements in the context of Product Governance".[17] This leaves open the possibility that setting target markets by reference to ESG criteria could become mandatory at some stage in the future.

- There is also a question around who should take the lead in determining whether ESG considerations are relevant to the target market determination (i.e. the distributor or the asset manager as manufacturer). It should in theory be open to the manufacturer to simply note in its responses to distributors that ESG considerations are not relevant to setting the target market for distribution of fund shares. However, if such an approach was adopted on a widespread basis, it might receive pushback from EU distributors. In addition, the new suitability requirements described below (which will require EU banks etc. to make individual enquiries in relation to their clients' ESG preferences) will create a clear incentive for both manufacturers and distributors to consider what disclosures they can reasonably make around ESG factors.

[17] See page 19 of the ESMA Final Report.

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SUITABILITY

Draft legal reform: Delegated Regulation amending Delegated Regulation (EU) 2017/565 as regards the integration of ESG considerations and preferences into investment advice and portfolio management

<table>
<tr><th colspan="2">Key impact of suitability reforms</th></tr>
<tr><td>Proposed requirement</td><td>Pursuant to Article 25 of MiFID II, when providing investment advice or portfolio management services, EU investment firms and banks are required to obtain information from each of their clients regarding:

(a) the client's knowledge and experience in the relevant investment field (albeit that assumptions can be made on this point for professional clients);

(b) the client's financial situation, including its ability to bear losses; and

(c) the client's investment objectives, including its risk tolerance.

Based on this information, the bank or investment firm will assess which products are suitable for its client. However, under the current regime, the information sought by firms about their clients' investment objectives will generally relate to financial objectives, while non-financial objectives, such as ESG preferences, are more rarely addressed. The European Commission's reforms to the MiFID II regime therefore aim to build an assessment of each client's ESG preferences into the suitability test. Firms undertaking a suitability test will, for example, need to incorporate the following steps into the initial process of onboarding a client:

• firms should disclose, where relevant, information on the ESG characteristics of each financial product offered to clients before providing investment services;

• firms providing portfolio management services should explain how their client's ESG preferences are taken into account when selecting financial instruments for the client's portfolio; and

• firms providing investment advice should explain how the client's ESG preferences are taken into account in the selection process used to recommend financial products.</td></tr>
<tr><td>Impact on EU Asset Managers</td><td>The primary impact for asset managers will likely be that where their fund shares are sold to end clients on an advised basis, or where they are selected for inclusion in an end client's portfolio, the end client's ESG preferences will need to have been taken into account in connection with:

(a) an EU investment adviser's decision to recommend the fund shares to a client; or

(b) an EU portfolio manager's decision to include the fund shares in a client's investment portfolio.

The obligation to assess suitability will also apply directly to EU AIFMs with top-up permissions enabling them to perform investment advice or single managed account services. Any MiFID authorised firms in the manager's group may also need to comply with the new requirements depending on the services they offer.</td></tr>
<tr><td>Impact on non-EU Asset Managers</td><td>As above, the primary impact for non-EU managers of these rules will be that where their fund shares are sold to EU investors on an advised basis, or where they are selected for inclusion in an EU investor's portfolio, that EU investor's ESG preferences will need to have been taken into account in relation to the selection of the fund shares. As with the product governance reforms, this may require EU investment firms and banks to seek ESG-related</td></tr>
</table>

	data from non-EU managers in relation to their funds, and this data may need to be presented in a manner that fits with the new EU taxonomy currently being developed. Any EU sub-managers to US or other non-EU investment managers may also need to ensure that they understand the ESG preferences of their manager and that they take those preferences into account when providing portfolio management or investment advice services to the investment manager, as part of their general obligation to retain adequate and up-to-date information about their client.

Suitability Reforms: Key Takeaways

- This suitability test is intended to be more targeted than the more general product governance test described above, given that it will need to be undertaken at the level of each individual client on a case-by-case basis. This requirement to consider ESG factors at an individual client level appears to have arisen from a concern by the European Commission that only a minority of clients proactively raise ESG issues during the advisory process, and that there is currently a limited understanding amongst clients around the impact of ESG factors on risk and performance[18].
- This means that any firms providing portfolio management or investment advice services will need to introduce questions in their suitability assessments that will help identify to each client's ESG preferences alongside their financial objectives, and that any recommended investment strategy will need to take both criteria into account in some way.
- As noted above, the practical outcome for asset managers will likely be an increase in due diligence by EU distributors of their fund shares in relation to the ESG profile of the funds. ESG disclosures by asset managers should, however, be approached in a methodical way in order to limit the potential for any suggestions of mischaracterisation or misrepresentation on the manager's part.

[18] See Explanatory Memorandum to the draft text.

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HOW CAN ASSET MANAGERS ASSESS THE ESG PROFILE OF POTENTIAL INVESTMENT OPPORTUNITIES?

A key area of focus for asset managers following implementation of the EU's ESG reforms will be the question of access to high quality, reliable data on the ESG profile of investments. This will be a particular concern for those managers which hold their funds out as having a positive ESG impact, in order to avoid any potential suggestion of misrepresentation, but even those managers which assert that their strategy has a net "neutral" ESG impact will need to ensure that this is backed up by the necessary data.

There are already a proliferation of firms in the market offering access to ESG data, but these data providers are frequently themselves unregulated, and the market for wide-ranging ESG data is still in some respects in its infancy. However, in addition to data sources and categorisations that have been in use for some time, there are a number of new regulatory classifications and data sources contemplated by the EU's ESG reforms that should in theory assist managers with understanding the ESG impact of a range of investments (summarised below). Unfortunately, at this stage, although these classifications and data sources will likely only account for a portion of the market; there will still be questions around how firms are able to effectively assess and gather information on the ESG profile of securities in smaller, unrated or non-EU companies.

Sustainable investment categorisation

At present, there are certain market-led standards governing when products will be considered "green" for example (see, for example, ICMA's Green Bond Principles). However, the EU's proposed regulatory reforms would create a new, regulation-driven "sustainable investment" label, which would be applied to:

(i) investments in an economic activity that contributes to an environmental objective (as set out in the Taxonomy Regulation); and

(ii) investments in an economic activity that contribute to a social objective (e.g. tackling inequality, fostering social cohesion, social integration and labour relations, or investments in disadvantaged communities).

In each case, the investment may not harm some other ESG objective, and the investee company in question must demonstrate good governance practices. This proposed categorisation may prove to be a helpful tool for asset managers seeking to track which EU investments are truly "sustainable" in nature.

Credit ratings

ESMA has proposed new guidelines on ESG disclosure requirements for Credit Ratings Agencies ("**CRAs**"). Although these guidelines do not purport to build a consideration of ESG into the issuance of credit ratings (i.e. given that ESG factors will not always have a bearing on a CRA's credit assessment), they do aim to increase transparency around whether ESG factors are a key underlying element of the credit rating. So, for example, where ESG factors have been taken into account by a CRA, the CRA will need to indicate how ESG considerations have been factored into its rating, and whether relevant factor or factors are related to Environmental, Social or Governance considerations.

EU Ecolabel

The European Commission has recently launched an initiative to develop and EU Ecolabel for retail financial products (including UCITS and AIFs offered to retail investors), which is likely to focus primarily on environmental sustainability. Given that the proposals are still at a preliminary stage, it is still unclear what universe of products could qualify for the label, or what the take-up is likely to be.

Green loans

At present, there are certain market-driven standards governing "green loans" (e.g. the LMA Green Loan Principles and the Sustainability Linked Loan Principles). Although the EU has not yet proposed any specific standards relating to the loan market, the new standards around "Green Projects" (described below) and the EU taxonomy may well affect how managers who engage in direct lending think about this area.

EU Green Bonds

The EU Technical Expert Group on Sustainable Finance has produced a report proposing an "EU Green Bond Standard"[19], which is intended to be a voluntary code applying to any type of listed or unlisted bond or other capital market debt instrument issued by an EU or international issuer. Pursuant to the proposed Standard, any proceeds from the sale of EU green bonds (or an amount equivalent to such proceeds) would need to be used to finance or refinance "Green Projects" (i.e. projects contributing substantially to at least one of the environmental objectives set out in the EU Taxonomy Regulation) in order to be classed as an EU Green Bond. In addition, an accredited "Verifier" would need to verify the alignment of the bond issuance with the EU Green Bond Standard.

The EU Green Bond Standard seems likely to supplant the ICMA Green Bond Principles, which are currently considered to set market-standard criteria for green bonds. There is a suggestion in the proposed EU standard that issuers will be required to periodically report on the use of proceeds from the issuance, and ongoing environmental impact (supported by quantitative metrics). This proposal would provide some market discipline in an area where issuers are not at present subject to particularly rigorous constraints around use of proceeds etc.

ESG Benchmarks

Proposed amendments to the Benchmarks Regulation will result in the creation of two new categories of benchmark, which are designed to reflect portfolios of assets with lower carbon emissions than standard benchmarks. Recent drafts of the Regulation suggest that these benchmarks will take the following forms:

- an 'EU Paris-aligned Benchmark', where the benchmark portfolio's carbon emissions are aligned with the long-term global warming target of the Paris Climate Agreement; and
- an "EU Climate Transition Benchmark", where the underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a "decarbonisation trajectory" towards reducing carbon emissions.

These new benchmarks should do the job of tracking whether securities included in the benchmarks are truly "green" in nature, and will sit alongside existing sustainability linked benchmarks such as FTSE4Good.

Guidelines on reporting climate-relation information

At present, the non-financial reporting Directive (2014/95/EU) requires large public interest entities with over 500 employees (e.g. listed companies, banks, and insurance companies) to disclose certain non-financial information. The European Commission has recently published a supplement to those guidelines which is intended to assist entities that are subject to the Directive with making disclosures around climate change. The resulting data may form a helpful reference source[20].

Disclosure Regulation

Given that AIFMs, UCITS ManCos and firms providing portfolio management services will in future be required to publish sustainability policies and provide ESG-focused pre-contractual disclosures, there will be substantially more publicly available data from these firms on their ESG strategies. This may be helpful for benchmarking, and for fund of funds managers seeking data on potential investments.

[19] See EU TEG Report on EU Green Bond Standard, dated June 2019.

[20] In addition, the FCA has recently made the point that issuers of securities should already be disclosing the financial implications of climate change on their business where relevant pursuant to existing disclosure obligations (e.g. under the Prospectus Rules and the Disclosure and Transparency Rules).

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