Sustainable Finance and Investment Funds

March 2020

2019 saw the climate crisis and sustainability enter the mainstream globally, with governments and regulators prioritising sustainability in their agendas. Significant investment will be required to drive the decarbonisation agenda and the financial system has an important role to play in directing investment towards achieving sustainability targets. The European Commission launched its Sustainable Finance Action Plan in March 2018, including three legislative proposals aimed at: creating an EU sustainability taxonomy; requiring disclosures relating to environmental, social and governance factors; and the creation of low carbon and positive carbon impact benchmarks.

The European Commission ("**Commission**") Action Plan on Financing Sustainable Growth ("**Action Plan**") sets out objectives and key actions to promote a reorientation of private capital flows towards sustainable investments. This note focuses on the elements of the Action Plan relevant to investment funds (undertakings for collective investment in transferable securities ("**UCITS**") and alternative investment funds ("**AIFs**")) and their managers (UCITS management companies and alternative investment fund managers ("**AIFMs**")).

Action Plan Objectives

- Reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth
- Manage financial risk stemming from climate change, natural disasters, environmental degradation and social issues
- Foster transparency and long-termism in financial and economic activity

Action Plan Key Actions

- Establish a common language for sustainable finance
- Create standards and labels for green financial products
- Clarify institutional investors' and asset managers' duties to ensure they consider environmental, social and governance ("**ESG**") issues in their investment decision process
- Incorporate sustainability in prudential requirements
- Strengthen sustainability disclosure and improve accounting rule-making

In order to achieve the objectives set out in the Action Plan, a number of legislative proposals have been progressed, including the following legislative measures of particular relevance to investment funds:

- a regulation on disclosures relating to sustainable investments and sustainability risks (the "**Disclosures Regulation**")
- a regulation on the establishment of a framework or taxonomy to facilitate sustainable investment (the "**Taxonomy Regulation**"); and
- a regulation on EU Climate Transition benchmarks and EU Paris-aligned benchmarks (the "**Low Carbon Benchmarks Regulation**").

Each of these is considered in greater detail below.

Disclosures Regulation

The Disclosures Regulation requires AIFMs and UCITS management companies (amongst others, but for the purposes of this note, we focus on investment funds and their managers) to consider and disclose in a consistent and harmonised manner how ESG factors are adopted in their decision making processes. It aims to harmonise disclosure standards among EU member states to facilitate the comparability of different financial products and services. Many of the provisions of the Disclosures Regulation apply to all asset managers, whether or not they have an express ESG or sustainability focus. The Disclosures Regulation applies different requirements and implementation timeframes in respect of disclosures on websites, in prospectuses and in periodic reports.

What are sustainable investments?

Disclosure Obligations Applicable to All Funds

Website

Sustainability risk policies	Information about their policies on the integration of sustainability risks in the investment decision-making process.
Adverse sustainability impacts	Publish and maintain on website: ■ a statement on due diligence policies regarding the principal adverse impacts of investment decisions on sustainability factors; or ■ clear reasons why they do not consider the adverse impacts of investment decisions on sustainability factors.*
Remuneration policies	Include in remuneration policies information on how those policies are consistent with the integration of sustainability risks and publish this information on website.

Prospectus Disclosures

Sustainability risks and sustainable investments	Firms must disclose: ■ the manner in which sustainability risks are integrated into their investment decisions; ■ the results of assessments of the likely impacts of sustainability risks on the returns of the financial products they make available; and ■ where the manager considers principal adverse impacts of investment decisions on sustainability factors, whether, and if so how, each financial product considers principal adverse impacts on sustainability factors.**

Marketing communications must not contradict any information disclosed under the Disclosures Regulation.

* From **30 June 2021**, financial market participants with more than 500 employees or which are parent undertakings of large groups with more than 500 employees must publish and maintain on their websites a statement of their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors.

** This requirement applies from **30 December 2022**.

Additional Disclosure Requirements for Expressly ESG Focused Products

Products promoting environmental and social characteristics	Prospectus should disclose: ■ information on how those characteristics are met; ■ where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics; and ■ information as to where the methodology used for the calculation of the reference index can be found.
Products that have sustainable investment as their objective	Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the following will need to be included in the prospectus: ■ information on how the designated index is aligned with the objective; ■ an explanation as to why and how the designated index aligned with that objective differs to a broad market index; and ■ information as to where the methodology used for the calculation of the reference index can be found. Where no index has been designated, pre-contractual disclosures will include an explanation of how the sustainable investment objective is to be attained.
Products promoting environmental and social characteristics and products that have sustainable investment as their objective	Website to provide the following information: ■ a description of the environmental or social characteristics or the sustainable investment objective; ■ 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, screening criteria for the underlying assets; and ■ the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product. Periodic reports to include the following information: ■ the extent to which environmental and social characteristics are met; ■ the impact of sustainable investments by means of relevant sustainability indicators; and ■ where an index has been designated as a reference benchmark, a comparison will be needed between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.

The European Supervisory Authorities ("**ESAs**") will develop by **30 December 2020** draft technical standards to specify the details of the presentation and content of information to be provided to investors in respect of the sustainability indicators in relation to adverse impacts on the climate and other environment-related adverse impacts. The ESAs will develop by **30 December 2021** further draft technical standards in respect of sustainability indicators in relation to adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

Sustainable investments are defined in the Disclosures Regulation as any of the following:

- investments in economic activity that contributes to an environmental objective;
- investments in economic activity that contributes to a social objective and in particular an investment that contributes to tackling inequality, an investment fostering social cohesion, social integration or labour relations; and
- investments in human capital or economically or socially disadvantaged communities;

provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

In contrast, while the Disclosures Regulation applies different requirements to sustainable investments and products which promote environmental or social characteristics, it does not include a specific definition of what is meant by a product which promotes environmental or social characteristics, nor does it clarify how managers should distinguish between such products and sustainable investments.

When will the Disclosures Regulation apply?

The main provisions of the Disclosures Regulation will apply from **10 March 2021**. The requirements relating to disclosures in the periodic reports of ESG-focused products are stated to apply from **1 January 2022**, which would appear to suggest that reports published after that date (as opposed to reports relating to periods starting on or after that date) should include the required disclosures, but this may be clarified in the technical standards.

The Taxonomy Regulation

The proposal to create a sustainability taxonomy was devised to provide market clarity on what economic activities should be considered "sustainable". To date, a fragmented approach has been adopted by EU member states to this issue, giving rise to a range of interpretations as to what may be considered to be a sustainable investment. The proposal is also designed to prevent "greenwashing", or the marketing of financial products as "green" which do not in fact meet basic environmental or sustainability standards in order to garner a competitive advantage over other products.

The Taxonomy Regulation aims to develop a taxonomy for climate change and environmentally sustainable activities so that the classification system can be used with respect to labels, standards and benchmarks recognising compliance with environmental standards across the EU. Standardising the concept of environmentally sustainable investment across the EU is expected to facilitate investment in environmentally sustainable economic activities, both nationally and in more than one EU country, and enable economic operators to attract investment from abroad more easily.

Importantly, the Taxonomy Regulation does not establish a label for sustainable financial products. It sets out criteria for determining if an activity (not a company or asset) is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives.

Environmental Objectives

Climate change mitigation	**Transition to a circular economy (including waste prevention and recycling)**
Climate change adaptation	**Pollution prevention and control**
Sustainable use and protection of water and marine resources	**Protection of healthy ecosystems**

The Commission will have the power to adopt delegated acts to determine the technical screening criteria for determining conditions under which a financial product might be considered to contribute to these objectives. The technical screening criteria must consider for example, conclusive scientific evidence. They should strive not to distort competition in the market. The Commission established the Technical Expert Group on Sustainable Finance ("**TEG**") in July 2018, which assists the Commission in developing the unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low carbon indices and metrics for climate-related disclosure. The TEG published its final report on 9 March 2020. The TEG report sets out recommendations on the design of the taxonomy, guidance for market participants and recommendations for the Platform on Sustainable Finance to be established under the Taxonomy Regulation.

Scope

The Taxonomy Regulation applies to a broad range of financial market participants, defined to include AIFMs, UCITS management companies, and financial products (including AIFs and UCITS).

For the most part, the Taxonomy Regulation will be relevant to asset managers who make available a financial product, such as an investment fund, which either: (a) has an objective of environmentally sustainable investment; or (b) "promotes environmental characteristics". However, even managers of out-of-scope financial products will need to make the negative disclosure set out below confirming that the product is out of scope of the regulation.

When will the Taxonomy Regulation apply?

Political agreement on the Taxonomy Regulation was reached in December 2019 and the agreed text was published on 18 December 2019.

The Taxonomy Regulation will apply, with respect to activities that substantially contribute to climate change mitigation and adaptation, by **1 January 2022**. The regulation will apply with respect to activities that substantially contribute to the other environmental objectives by **1 January 2023**.

Interaction with the Disclosures Regulation

The Taxonomy Regulation is closely linked to the Disclosures Regulation. While the Taxonomy Regulation provides a common language for firms and investors to identify which economic activities are "environmentally sustainable", it also includes supplemental disclosure obligations to those set out in the Disclosures Regulation.

Together, these regulations will require firms to indicate the way and the extent to which the criteria for environmentally sustainable economic activities have been used to determine the environmental sustainability of the investment. The Disclosures Regulation includes within "sustainable investments" investments that pursue environmental objectives that, among others, should comprise investments into "environmentally sustainable economic activities" within the meaning of the Taxonomy Regulation.

What additional disclosures are required by the Taxonomy Regulation?

The Disclosures Regulation and the Taxonomy Regulation provide for different transparency requirements for: (a) financial products with sustainable investment as their objective; and (b) financial products which promote, among other characteristics, environmental or social characteristics).

Where a financial product has "sustainable investment" as its objective within the meaning of the Disclosures Regulation, the information to be disclosed in the prospectus and annual report must include:

- information on the environmental objective or environmental objectives 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 invested in environmentally sustainable activities. This description must specify the share of investments in environmentally sustainable economic activities, including details on the respective proportions of enabling and transition activities, as a percentage of all investments underlying the financial product.

Where a financial product "promotes environmental characteristics", the prospectus and annual report should include the following statement:

"The "do no significant harm" principle is applied only for the investments underlying the product that take into account the EU criteria for environmentally sustainable investments.

The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable investments."

Where a financial product is not: (a) a financial product with sustainable investment as its objective; or (b) a financial product that promotes, among other characteristics, environmental or social characteristics within the meaning of the Disclosures Regulation, the prospectus and annual return must include this statement:

"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments."

Disclosures by Investee Undertakings

One of the potential challenges identified by industry in relation to the fulfilment of the Action Plan's objectives is the lack of reliable and comparable ESG data from investee companies. The Taxonomy Regulation includes provisions regarding the transparency of undertakings that come within the scope of the Non-Financial Reporting Directive ("**NFRD**"), which would require large companies (public interest entities with more than 500 employees) and parent undertakings of large groups with more than 500 employees subject to the EU Accounting Directive (Directive 2013/34/EU) to include in their non-financial statement, or consolidated non-financial statement, information on how and to what extent the company's activities are associated with environmentally sustainable economic activities. The Commission will publish the detailed disclosure requirements by **1 June 2021** and the requirements will apply from **30 June 2021**.

Low Carbon Benchmarks Regulation

The Low Carbon Benchmarks Regulation amends the existing EU Benchmark Regulation by introducing two new types of benchmarks:

- EU Climate Transition benchmarks; and
- EU Paris-aligned benchmarks.

In addition to the introduction of these new benchmarks, the amendments require benchmark administrators to update all benchmark statements (excluding those relating to interest rate and currency benchmarks) by **30 April 2020** to include "...how ESG factors are reflected in each benchmark ...". For benchmarks that do not pursue ESG objectives, it will be sufficient "... to clearly state in the benchmark statement that they do not pursue such objectives". Benchmark administrators that pursue ESG objectives will be required to publish key elements of their methodologies. The Commission will adopt delegated acts to provide further detail on the minimum standards for each of the new benchmarks and the requirements applicable to benchmark administrators. Administrators of significant benchmarks ie, benchmarks that are above a certain threshold in terms of usage, will be required to disclose the degree of "Paris alignment" of those benchmarks and must endeavour to provide a Transition benchmark by **1 January 2022**. The Low Carbon Benchmarks Regulation entered into force on **10 December 2019**.

Related Developments

The European Securities and Markets Authority ("**ESMA**") has submitted two final reports to the Commission containing technical advice on possible amendments to the existing level 2 measures under the UCITS Directive, the Alternative Investment Fund Managers Directive ("**AIFMD**") and the Markets in Financial Instruments Directive ("**MiFID II**"). The proposed amendments would seek to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes. The Commission is currently considering ESMA's reports and will use them as the basis for future proposals.

As part of its Action Plan, the Commission is also considering expanding the EU Ecolabel concept to financial products. EU Ecolabels already apply to many household goods, which identify the energy efficiency performance of the product. It is proposed that with an effective taxonomy in place, Ecolabels could be assigned to determine the greenness of financial products. The technical report of the Commission regarding the EU Ecolabel criteria has found that investment funds are particularly suited to this type of assessment. In order to create awareness, increase investment, and enhance investor trust, the EU Ecolabel logo would be clearly identifiable on any prospectus or promotional material.

Next Steps

As outlined above, the various legislative measures contained with the Action Plan will apply from different dates. The priority in 2020 will be making the business and policy decisions required in relation to how sustainability impacts on investment processes so that these decisions can then be disclosed under the requirements of the Disclosures Regulation and the Taxonomy Regulation. Firms will need to consider what approach they will take to the "comply or explain" decisions, identify which products have an express sustainability focus, implement the required policies and consider the process for making the necessary disclosures.

Commentary

The timeframe for implementation of the Action Plan, while understandable from a political perspective, will be particularly onerous for funds and their managers, as well as their regulators, to meet. In particular, it will be important to see draft technical standards in relatively final form and related advice in early course so that financial market participants have the necessary information and guidance to prepare their implementation plans. While the provisions regarding disclosures by investee companies contained in the Taxonomy Regulation are to be welcomed, these provisions are unlikely to fully address industry concerns regarding data availability, reliance on third party data providers, insufficient transparency of the methodologies used, the consolidation of the industry and the cost of data.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at **www.matheson.com**.

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Timeline of Key Dates

Benchmarks Regulation
30 April 2020
Benchmark administrators to update benchmark statements regarding ESG factors

Disclosures Regulation
30 December 2020
ESAs to prepare draft technical standards on disclosures to investors in relation to adverse impacts on the climate and other environment-related adverse impacts

Disclosures Regulation
10 March 2021
Application date of most provisions (pre-contractual and website requirements) of the Disclosures Regulation

Taxonomy Regulation
30 June 2021
Financial market participants with more than 500 employees or which are parent undertakings of large groups with more than 500 employees must publish and maintain on their websites a statement of their due diligence processes with respect to the principal adverse impacts of investmentdecisions on sustainability factors

Disclosures Regulation
30 December 2021
ESAs to prepare draft technical standards on disclosures to investors in relation to adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery

Disclosures Regulation
1 January 2022
Application date of requirements relating to periodic reports of ESG-focused products

Taxonomy Regulation
1 January 2022
Application date in respect of activities that substantially contribute to climate change mitigation and adaptation

Taxonomy Regulation
1 June 2022
ESAs to prepare draft technical standards on activities that substantially contribute to environmental objectives other than climate change mitigation and adaptation (water, circular economy, pollution, biodiversity)

Disclosures Regulation
30 December 2022
Where the manager considers principal adverse impacts of investment decisions on sustainability factors, prospectus to disclose whether, and if so how, each financial product considers principal adverse impacts on sustainability factors

Taxonomy Regulation
1 January 2023
Application date in respect of activities that substantially contribute to environmental objectives other than climate change mitigation and adaptation