Briefing for Investment Management Clients
26 May 2018

Investment Managers and ESG: Proposed EU Regulations

Background

On 24 May 2018, the European Commission issued a series of proposed regulations aimed at re-positioning ESG considerations at the heart of the financial system.

This legislative programme positively responds to a report published on 31 January 2018 by a High-Level Expert Group (HLEG) to develop an EU strategy on sustainable finance. The HLEG report perceived a need, first, for the financial system to improve its contribution to sustainable growth and, secondly, to strengthen financial stability by incorporating ESG factors into investment decision-making.

This note considers the key provisions of the proposed EU regulations. It will be of particular interest to investment management clients, including UCITS management companies, investment management firms regulated by MiFID II and AIFMs.

Taxonomy and sustainable investment criteria

Presently, there are inconsistencies between Member States as to the criteria to be applied to determine which economic activities qualify as environmentally sustainable. This makes comparing different investment opportunities difficult. The proposed EU regulation “on the establishment of a framework to facilitate sustainable investment” (2018/0178 (COD); COM (2018) 353 final) establishes the basis for the development of an EU taxonomy for ESG, to enable investors to identify which and to what degree economic activities can be considered environmentally-sustainable.

- Under Article 3 of the proposed Regulation, to qualify as environmentally-sustainable, economic activities would have to fulfil all of the following requirements:

    - contribute substantially to at least one of the six environmental objectives laid out in the proposal;

    - not significantly harm any of the other environmental objectives;

    - be carried out in compliance with a number of minimum social and governance safeguards; and

    - comply with specific technical screening criteria, to be established by the Commission through delegated acts.

- The six EU environmental objectives listed in Article 5 of the proposed Regulation are climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control; and protection of healthy ecosystems.

- The application of the operational provisions in the Regulation will be deferred for six months until after the adoption of the relevant technical screening data.

Under Article 4(2) of the proposal Regulation, financial market participants (including AIFMs, UCITS management companies and investment management firms regulated by MiFID II) offering financial products as "environmentally sustainable investments" are subject to disclosure requirements. They are required to disclose information on how and to what extent the criteria for environmentally sustainable economic activities set out in Article 3 are used to determine the environmental sustainability of the investment. Note that the proposed Regulation does not prescribe what to invest in; and it does not penalise other investments.

Transparency
The proposed EU regulation "on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341" (2018/0179(COD); COM(2018) 354 final) establishes harmonised rules on the transparency to be applied by financial market participants (which includes UCITS management companies, AIFMs and investment management firms regulated by MiFID II).

The proposed rules cover all financial products offered and services (individual portfolio management and advice) provided by the above-mentioned entities, "regardless of whether they pursue sustainability investment objectives or not" (Commission FAQs published 24 May 2018).

- Sustainability risk policies. Under Article 3 of the proposed Regulation, financial market participants are required to publish written policies on the integration of sustainability risks in the investment decision-making process on their websites.

- Transparency of the integration of sustainability risks. Under Article 4 of the proposed Regulation, financial market participants shall include descriptions of the following in pre-contractual disclosures:

    - the procedures and conditions applied for integrating sustainability risks in investment decisions;

    - the extent to which sustainability risks are expected to have a relevant impact on the returns of the financial products made available; and

    - how the remuneration policies of financial market participants are consistent with the integration of sustainability risks and are in line, where relevant, with the sustainable investment target of the financial product.

In addition, under Article 5 of the proposed Regulation, where a financial product (such as an AIF or a UCITS) has as its target sustainable investments or investments with similar characteristics, or the reduction in carbon emissions, a financial market participant is subject to additional transparency and disclosure obligations. This includes the disclosure on their websites and in periodical reports of the sustainability or climate impact of their products and portfolios.

Benchmarks
To assist investors to compare the carbon footprint of investments, the proposed EU regulation amending Regulation (EU) 2016/1011 "on low carbon benchmarks and positive carbon impact benchmarks" (2018/0180 (COD); COM(2018) 355 final) introduces new categories of low carbon and positive carbon impact benchmarks against which investment portfolios can be compared.

Amendments to MiFID II

A proposed delegated regulation amending Regulation EU 2017/565 aims to ensure that MiFID II keeps pace with the integration of ESG into the financial system.

- Client ESG preferences. Under the existing MiFID II framework, information regarding the investment objectives of the client generally relates to financial objectives, while non-financial objectives of the client, such as "ESG preferences", are usually not addressed. The amendments to MiFID II, which are now the subject of a public consultation, would require investment firms to ask their clients about their preferences as regards ESG.

- Re-weighting ESG consideration in the selection process. It is proposed that investment firms will provide a description of the factors taken into consideration in the selection process used by the investment firm to recommend financial instruments including, where relevant, ESG considerations.

- Policies and procedures. Investment firms shall have in place, and be able to demonstrate that they have in place, adequate policies and procedures to ensure that they understand the nature, features, including costs, risks of investment services, and financial instruments selected for their clients, including any ESG considerations.

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