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Asset Managers and the ESG Tsunami: Get ready for the tide of ESG disclosures

Governance and Impact – Part of the Horizon Scanning series

Summary

- The Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation serve as two of the key legislative pillars to the EU's Action Plan on Sustainable Finance. They impose extensive disclosure obligations on financial market participants (including asset managers) and financial advisers within scope at both entity level and product level. Many asset managers will be within scope of the SFDR and non-EU firms marketing products in the EU will also have to take into account the various requirements.
- At entity level, the SFDR will require asset managers to publish: (i) information about their policies on the integration of "sustainability risks" in their investment decision-making process; (ii) the way in which sustainability risks are reflected in their remuneration policy; and (iii) where they take "principal adverse impacts" into account, a statement on their due diligence policies with respect to those impacts.
- At product level, the SFDR will also impose many disclosure requirements. These include, where the asset manager has determined that sustainability risks are relevant to the product, requirements for asset managers to publish a description of the manner in which sustainability risks are integrated in investment decisions and the result of an assessment of the likely impacts of sustainability risks on the returns of such products. Products which promote environmental and/or social characteristics or which have sustainable investments as an objective will require enhanced disclosures.
- The European supervisory authorities are consulting on draft Regulatory Technical Standards (RTS) in relation to the some of the disclosure requirements. In particular, the draft RTS sets out in detail indicators which a firm must report against when meeting their requirements relating to disclosures of "principal adverse impacts", as well as the form and content of required website, pre-contractual, and periodic report disclosures.
- Asset managers face a number of challenges in implementing the regulations. The timeframe to implement any systems and procedures in order to be able to satisfy the disclosure requirements is short. Firms have to grapple with new concepts (such as "principal adverse impacts") introduced by the SFDR, difficulties in reporting against the prescriptive indicators proposed under the associated RTS as well as the lack of widely available, reliable and comparable data from investee companies.
- Under the SFDR, certain disclosure obligations will start applying from 10 March 2021, although indications are that application of the detailed technical standards against which firms must report will be delayed to a later date. Preparation is likely to be extensive – and may include firms taking steps to:
    - review, amend or draft their internal policy on how sustainability risks are considered in their investment processes and reflected in their remuneration policies.
    - analyse the extent to which they consider "principal adverse impacts", whether they fall within the mandatory reporting regime or whether they will voluntarily "opt-in" and report on such impacts.
    - identify the products which promote environmental and/or social characteristics or which have "sustainable investments" objectives.
    - put in place systems and procedures to obtain relevant data from investee companies and to address any data gaps.
    - consider which reporting methodologies to adopt and their approach to calculation of relevant metrics.

Introduction

“2020 has injected steroids into the ESG movement and multiplied the issues that companies must consider.”
(FT.com, Brooke Masters, 14 September 2020)

The interest in sustainable investments remains undiminished despite the immediate focus on crisis management as a result of the COVID-19 pandemic. Indeed, indications are that the COVID-19 crisis has acted as an accelerant in highlighting the importance of environmental, social and governance (ESG) factors as concerns relating to the resilience of company supply chains, treatment of workforces as well as the human costs of the pandemic surface to the forefront. Although the data remains contested, there is some evidence to suggest that ESG-focused funds have outperformed during this crisis. Momentum among investors is growing accordingly. A recent report published by Morningstar showed a net amount of $71.1 billion was invested globally in funds which marketed themselves as following ESG principles (with $54.6 billion in Europe alone) between April and June 2020, pushing assets under management in these products to a new high of just over $1 trillion [1].

In any event, shifts in investor expectations mean that asset managers cannot ignore the increasing demand not just for ESG-focused products but also for asset managers to have regard to ESG factors at every step of the investment chain. A number of asset owners and institutional investors such as pension funds are demanding that any mandate given to asset managers require them to consider ESG issues in their management of those assets. Given their role managing large swathes of investor assets, it is perhaps unsurprising that much of the recent regulatory developments are aimed at financial market participants such as asset managers.

This briefing discusses the regulatory developments for asset managers in the ESG arena, with a focus on the Disclosure Regulation and the Taxonomy Regulation, and considers some of the issues and challenges they may face in light of the growing regulation in the area of sustainable investments.

Background and overview

ESG matters have been and continue to be on the agenda of many regulators and governments as well as international organisations, resulting in a plethora or codes, standards and frameworks to galvanise both companies and investors to action on this front. UN’s Principles for Responsible Investment (“**PRI**”), for example, commits signatories to incorporating ESG issues into investment analysis and decision-making processes (PRI 1), and requires signatories to seek appropriate disclosure on ESG issues by the entities in which they invest (PRI 3). The EU, in particular, has been seeking to be a global leader at moving sustainable investment objectives to the core of its financial system, and has pro-actively taken measures to re-orient capital flows to sustainable investments through mandatory regulation. This has culminated in the adoption of its Action Plan on Sustainable Finance published in 2018. It is interesting to note that the recently published Global Investors for Sustainable Development (GISD) report[2] setting out recommendations to harmonise and scale sustainable finance contains specific measures addressed to the European Commission in recognition of Europe’s leadership on these issues.

To implement the Action Plan, the EC has adopted a “multi-pronged” approach, which includes three key pieces of legislation, all of which would have far-reaching implications on “financial market participants” as well as “financial advisers”, including asset managers (MiFID II investment

[1] Morningstar Global Sustainable Funds Flow Report, data as at June 2020

[2] Global Alliance for Sustainable Development report: ‘Renewed, Recharged and Reinforced: Urgent Actions to Harmonize and Scale Sustainable Finance’ (July 2020). GISD is a group of 30 private sector CEOs established by the UN to provide private sector input on the UN’s Strategy for Financing the 2030 Agenda for Sustainable Development. The report makes 64 recommendations, 42 of which are of global relevance and the rest of which are aimed specifically at the European Commission.

firms which provide portfolio management, AIFMs and UCITS management companies are all in scope):

- The Disclosure Regulation[3] (also known as the sustainable finance disclosure regulation ("**SFDR**")) imposes a host of transparency requirements on asset managers in order to facilitate the integration of ESG factors into their risk processes as well as investment decisions and approaches.
- The Taxonomy Regulation[4] establishes a general framework for a unified EU classification system (taxonomy) of environmentally sustainable economic activities.
- The Low Carbon Benchmark Regulation[5] creates two new EU climate benchmarks (the EU Climate Transition Benchmark and the EU Paris-aligned Benchmark) and introduces minimum standards applicable to those benchmarks in order to address the risk of potentially illegitimate claims being made about the low-carbon nature of various indices and provide investors with better information on the carbon footprint of their investments.

In addition, amendments are also being proposed to the UCITS Directive, AIFMD and MiFID II in order to facilitate the incorporation by firms which fall within scope (including AIFMs, UCITS management companies, and investment firms which conduct business under a MiFID licence) of sustainability risks into their systems and processes. The amendments are set out in delegated regulations which (at the time of writing) remain in draft form.

Appendix 1 sets out the main disclosure requirements of the Disclosure Regulation (and Taxonomy Regulation) and Appendix 2 sets out the timeline for implementation of these requirements.

Disclosure Regulation (SFDR)

"The industry has been intensely engaged on the development of SFDR and recognises the sea-change this piece of regulation could bring."

The Investment Association: Response to EU Consultation on Renewed Sustainable Finance Strategy (August 2020)

Perhaps of most significance to asset managers is the SFDR which is intended to drive asset managers towards integrating "sustainability risks" into their investment decision-making processes by requiring them to make certain disclosures both at "entity" (firm) level and at product level.

At the entity level, asset management firms are required to publish information on their websites about their policies on the integration of "sustainability risks" in their investment decision-making process. This extends to their remuneration policies, and firms will be required to disclose the way in which sustainability risks are reflected in their remuneration policy.

The Regulation also introduces the concept of "principal adverse impacts", obliging firms to consider the "principal adverse impacts" of their investment decisions on "sustainability factors" (that is, ESG matters, as well as respect for human rights and anti-corruption and anti-bribery matters) or to explain why they have not done so. Where firms do take these impacts into account, they must integrate procedures for considering such impacts in their due diligence processes and publish a statement (again, on their website) on their due diligence policies with respect to those impacts (an "**Impact Statement**"). The statement must be updated annually to provide investors with updated information covering the preceding "reference period". Firms must report by 30 June

[3] Regulation (EU) 2019/2088 of the European Parliament and Council (27 November 2019)

[4] Regulation (EU) 2020/852 of the European Parliament and Council (18 June 2020)

[5] Regulation (EU) 2019/2089 of the European Parliament and Council (27 November 2019)

of each year on the reference period covering the period from 1 January to 31 December of the preceding year.

All firms are required to report on a "comply or explain" basis whether they do consider such impacts from 10 March 2021 (although the initial statement to be published in March 2021 does not need include an assessment but simply disclose the policies in place to assess such impacts). From 30 June 2021, firms with (on average over a financial year) more than 500 employees (or firms which are the parent of a group meeting this criteria) must comply and publish the relevant statement – there is no option for them to opt out and explain their reasons for non-compliance.

The information that must be disclosed in an Impact Statement is wide-ranging, and includes:

- details on how principal adverse impacts are identified and prioritised;
- a description of the principal adverse impacts and of any actions taken or planned in relation to those impacts;
- brief summaries of engagement policies; and
- reference to any adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting.

There is an element of proportionality since firms can take into account their size, nature and scale of their activities and the types of financial products they make available.

At the product level, the Regulation will also require a myriad of disclosures. Among other things, asset managers will have to disclose in pre-contractual documentation (i.e. in information memoranda or prospectuses) for all products:

- where the asset manager has determined that sustainability risks are relevant to the product, a description of the manner in which sustainability risks are integrated in investment decisions and the result of an assessment of the likely impacts of sustainability risks on the returns of such products;
- otherwise, a clear and concise explanation of the reasons why sustainability risks are not relevant; and
- (by 30 December 2022) for each product where a firm considers "principal adverse impacts", a clear and reasoned explanation of whether and how the product considers such impacts on sustainability factors.

There are additional obligations requiring asset managers to provide certain specific and enhanced sustainability-related information in relation to any of their financial products which: (i) promote "environmental or social characteristics" (an "Article 8" product); or (ii) have "sustainable investment as their objective" (an "Article 9" product).

While the SFDR sets out the main disclosure requirements, much of the technical detail on content, methodology and presentation of the disclosure items will be contained in regulatory technical standards (RTS). The European Supervisory Authorities (ESAs) have been tasked with drafting the relevant technical details. In this respect, the ESAs have, on 23 April 2020, published a consultation on the first of a series of draft RTS which specify in more detail on how the disclosure rules would apply in practice. The draft RTS broadly covers two areas:

- ***At entity level***: the RTS includes details relating to the requirement to disclose "principal adverse impacts on sustainability factors", including detailed indicators for environmental and social sustainability factors. The RTS also includes a proposed template for the disclosure, setting out the mandatory information that is required, and the order in which the information must be presented, as well as the form of statement to be published where adverse impacts of investment decisions are not considered under the SFDR.
- ***At product level***: the RTS provides detail on the proposed form of pre-contractual, website and periodic product disclosures, as they apply to products with "environmental or social characteristics"

or with "sustainable investment objectives". This includes further detail on the requirements regarding how such products comply with the "do not significantly harm" principle from the SFDR in relation to the principal adverse impact indicators in the draft RTS.

To demonstrate just how extensive and detailed the information required to be provided is, the RTS sets out 32 different "adverse impact" indicators that must be included in the Impact Statement (as well as additional indicators) and will require a firm to assess the impacts by reporting against those 32 indicators through a template form.

Taxonomy Regulation

The Taxonomy Regulation introduces a classification system of "environmentally sustainable" activities, and sets out the criteria for determining whether a particular economic activity constitutes an environmentally sustainable activity. This is meant to provide clarity to investors and facilitate their assessment of a financial product's (such as a fund) environmental credentials. The introduction of a standardised system to classify products is also intended to prevent "greenwashing" by asset managers, ensuring that products are properly labelled as green or sustainable.

In summary, the Taxonomy Regulation sets out six environmental objectives:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a "circular" economy;
- Pollution prevention and control; and
- Protection and restoration of biodiversity and ecosystems.

An economic activity shall qualify as environmentally sustainable if it:

(i) ***contributes substantially*** to one or more of these economic objectives;

(ii) ***does not significantly harm*** any of the environmental objectives;

(iii) is carried out in compliance with certain ***minimum safeguards*** (i.e. in accordance with OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights); and

(iv) complies with ***technical screening criteria*** that have been established by the Commission.

The Regulation sets out further criteria with respect to determining whether the economic activity "contributes substantially" to the relevant economic objective, what constitutes "significant harm", and the minimum safeguards that must be complied with. With respect to what constitutes "significant harm", Article 17 of the Taxonomy Regulation sets out certain activities that will always be considered to cause significant harm in relation to each of the environmental objective, for example, where the activity leads to significant greenhouse gas emissions. Significantly, in assessing whether the activity causes significant harm, both the environmental impact of the activity itself and the environmental impact of the products and services provided by that activity throughout their life cycle need to be taken into account.

The Taxonomy Regulation also amends the Disclosure Regulation by requiring additional disclosures for certain types of financial products offered by asset managers, specifically those that are marketed as having environmental characteristics or as contributing towards one of the environmental objectives set out in the Taxonomy Regulation. In particular, the disclosure requirements in the Taxonomy Regulation is focussed on disclosing the level of alignment with activities that are considered environmentally sustainable under the taxonomy.

Issues for asset managers

Which firms are in scope?

The SFDR applies to "financial market participants", which includes within its definition AIFMs, UCITS management companies, investment

firms which provide portfolio management, and credit institutions which provide portfolio management. Many asset managers will be caught within the scope of the SFDR, including third country/non-EU firms marketing funds in the EU. The Regulation does not explicitly distinguish between EU and non-EU fund managers, nor between EU and non-EU financial advisers. While it is not clear from the legislation itself, the European Commission is expecting that non-EU fund managers marketing their funds in the EU under the national private placement regimes will have to add, when relevant, pre-contractual and periodic information to the AIFMD required disclosures that are made to EU regulators and investors[6]. It should be noted that the Regulation imposes obligations on asset managers pursuing any strategy, not only those which (only) market products with ESG characteristics or which promote themselves as following an ESG-friendly investment strategy.

Brexit implications

Whether or not the UK will follow suit in implementing equivalent legislation obliging UK asset managers to make similar disclosures remains an open question. While both the SFDR and the Taxonomy Regulation are already in force, the main obligations apply only after the expiry of the Brexit implementation period. As only EU legislation which are in force and apply immediately prior to IP Completion Date (11pm on 31 December 2020) are "on-shored" as UK domestic law, the relevant provisions will not automatically form part of UK law (as EU retained law), unless the UK voluntarily chooses to implement them.

However, the UK has published its Green Finance Strategy where it has stated its commitment to "match the ambition" of the EU's action plan on sustainable finance. The FCA's recent consultation proposing that UK premium-listed companies be required to make climate-related disclosures based on the TCFD recommendations is an indication of UK's seriousness of intent "in aligning private sector financial flows with clean, sustainable and resilient growth". However, acknowledging the challenge posed by the granular content requirements set out in the technical standards promulgated by the EU, the UK may take a different approach to disclosure. Nonetheless, whatever the UK's final position, given the scope of the European proposals, asset managers marketing funds in the EU will need to take heed of the requirements. In any case, with the growth in inflows into ESG products (in particular, among European investors), asset managers may find themselves voluntarily aligning with the requirements in order to access the growing investor base.

Practical challenges in implementation

Under the SFDR, certain substantive obligations will apply from 10 March 2021. While it has been reported that application of the detailed RTS has been delayed to a later date[7], firms would still have to comply with the high level requirements from 10 March 2021. The time for implementation of systems and procedures to ensure firms are able to report against, and comply with, their disclosure obligations at both entity and product level is tight. Firms will not want to be on the back-foot when the various disclosure obligations start applying, but the operational challenge of implementing compliant systems cannot be overstated.

The SFDR assumes that firms have in place policies relating to the integration of sustainability risks in their investment decision-making process and, where applicable, the consideration of principal adverse impacts. To the extent that an asset manager have not put in place (or at least formalise) such policies, in the run-up to the application of the Regulation, they will need to take a number of preparatory steps, for example, to:

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[6] See FAQ about the work of the European Commission on Sustainable Finance on EU Taxonomy and EU Green Bond Standard (published 10 June 2020).

[7] Both the German (BVI) and Italian (Assogestioni) fund management trade associations have reportedly received letters from the Commission stating that the regulatory technical standards "will become applicable at a later stage" (the date has not been specified although 1 January 2022 is likely) in order to provide firms time for implementation of the detailed requirements.

- amend or draft their internal policy on how sustainability risks are considered in the investment process;
- amend their remuneration policies to ensure consistency with the consideration of sustainability risks; and
- analyse the extent to which they consider “principal adverse impacts”, whether they fall within the mandatory reporting regime, or whether they will voluntarily “opt-in” and report on such impacts.

While many asset managers already have existing policies in relation to their approach to ESG matters, the extent to which these policies are applied throughout their investment processes and frameworks will need to be reviewed. This may translate into operational changes as they seek to ensure that their operational processes are indeed aligned with what they disclose.

Further, while the SFDR itself relates only to disclosure obligations, the proposed amendments to, for example, AIFMD, will require the AIFM to take sustainability risks into account when implementing its internal structures and decision-making procedures, task and responsibility allocation, reporting lines, internal control and compliance and documentation procedures. This is a board level concern: amendments to the UCITS Directive and AIFMD will mean that the governing body will be responsible for the integration of sustainability risks in any function for which they are responsible (including valuation, oversight of investment strategy approval, compliance function, monitoring of the risk policy, and the remuneration policy).

The requirement to disclose how a firm’s remuneration policies are “consistent with the integration of sustainability risks” also raises questions. It is difficult to construct a remuneration policy and pay structure that reflects consideration of “sustainability risks” across the board – how will different portfolio managers demonstrate that they have considered ESG factors in their investment decisions? How will such considerations factor in the measurement of performance targets that usually form the basis of compensation packages? While a “one size fits all” approach is unlikely to be appropriate (nor is it likely that investors or other stakeholders would expect such an approach), it is likely that any policy will necessarily be high level. It is difficult to see, even with disclosure of policies, how investors would be able to gain sufficient transparency to assess how any policy is translated into the actual determination of remuneration levels for management and employees. Having said that, it should be noted that a number of firms already explicitly align certain aspects of their remuneration policies with ESG considerations[8].

Principal adverse impacts

One of the most significant requirements under the SFDR is for asset managers to assess and report to investors on any “principal adverse impacts” of investment decisions on sustainability factors through the publication of an Impact Statement at both entity and product level. Although this applies on a “comply or explain” basis: (i) large asset managers (those with, or the parent of a group with, on average, more than 500 employees over a financial year) will have to publish an Impact Statement; and (ii) smaller firms which do not voluntarily “opt-in” must still give clear reasons why they do not consider such adverse impacts, including information as to whether and when they intend to consider such adverse impacts. The expected trajectory certainly seems to be for all firms eventually to comply.

Recital 20 of the Disclosure Regulation defines principal adverse impacts as “the impacts of investment decisions and advice that result in negative effects on sustainability factors”. Compare this with the concept of sustainability risks which is defined as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment”. The concept of “principal adverse

[8] Insight Investment, for example, expects their credit analysts’ to consider ESG research in their analysis of all companies within their investment universe and links this to the analysts’ performance appraisals which form the basis for any awarding of bonuses.

impact" relates to the impact of a decision to invest in an underlying investee company itself – as such an asset manager would have to go beyond just considering ESG issues as a risk management tool, but would have to consider what adverse impact a particular investee company's business may have on ESG matters. This may influence the decision to invest and how they choose to allocate capital in the first place.

As an example, an asset manager considering an investment in an energy company will have to analyse not just the financial risks posed by climate change on the value of any investment in the company (sustainability risks) - such as the risk of the investment becoming a "stranded asset" - but also the extent to which the underlying activities of that energy company may themselves have a negative impact on the environment, for example if its activities produce greenhouse gas emissions that contribute towards climate change (principal adverse impact).

As shown in the draft RTS relating to the content requirements of the Impact Statement, EU regulators are expecting asset managers to gather very granular data in respect of investee companies. As noted, the RTS sets out different "indicators" against which firms must report – with firms being required to report, in respect of each reference period, against a core set of (32) "mandatory" indicators and at least one additional "environmental" indicator and one additional "social" indicator.

The mandatory indicators are those that will ***always*** lead to principal adverse impacts of investment decisions on sustainability factors, irrespective of the result of the assessment by the asset manager while the additional indicators are optional sets used to identify, assess and prioritise additional principal adverse impacts. Even where an indicator is irrelevant to a particular investment, disclosure against the indicator is mandatory, although the ESAs have made it clear that a firm can disclose a value of zero against the indicator and provide an explanation as to why it is irrelevant. Asset managers will have to implement a framework, among other things, to:

- determine their approach to obtaining relevant ESG data about underlying investee companies;
- work out the methodology and calculation of the relevant values and metrics for each indicator; and
- consider how they will address any potential information gaps (see below on lack of available data).

A number of other concerns have been raised: one, the prescriptive nature of the RTS relating to the reporting of "principal adverse impacts" and level of detail required by the mandatory indicators do not take into account the elements of proportionality and materiality which the SFDR itself envisages; and two, the lack of alignment or clear link between the proposed indicators for "principal adverse impacts" under the SFDR and the "do not significantly harm" principle under the Taxonomy Regulation.

Marketing and disclosure at product level

Firms will also have to review the products they are offering and identify those for which sustainability risks are relevant, as well as those that are marketed as promoting "environmental and social characteristics" or which have "sustainable investments" as their objective, and make the relevant disclosures accordingly. For products for which sustainability risks are not considered relevant, the asset manager still needs to provide an explanation as to why it considers that sustainability risks are not relevant. Again, the exercise that needs to be done in order to identify and then to make appropriate disclosures in existing and new products, in particular in relation to those products that are promoted as having "ESG" characteristics, would be extensive.

Identification of the relevant products (and therefore working out which requirements apply) is complicated by the potentially ambiguous scope of Article 8 and Article 9 SFDR and the fact that the SFDR and Taxonomy Regulation are not entirely aligned. By way of illustration, as "*sustainable investments*" is defined under the SFDR without reference to the Taxonomy Regulation, a financial product may have "sustainable investments" as its objective (and

fall within scope of Article 9 SFDR) even if its portfolio is fully or partly composed of investments which are not Taxonomy-compliant (i.e. which are not invested in "*environmentally sustainable economic activities*" as defined under the Taxonomy Regulation).

Asset managers are also required to disclose in pre-contractual documentation the result of the assessment of "*likely* impact of sustainability risks on returns" where such risks are considered relevant to the product. This would presumably require some form of scenario analysis, the quantification of the risks posed by those scenarios, the likelihood of those risks materialising, and how they may impact the returns of each product. While the definition of sustainability risks has a built in materiality qualification since it only relates to events or conditions that could cause a "material impact" on the financial performance of an investment product, it will be down to the asset manager to assess those risks which will have a material impact. As with any forward-looking information, disclosure brings with it liability concerns. Clear explanation of methodologies used in the assessment, disclosure of assumptions made, and appropriate use of disclaimers would all need to be carefully considered.

Further disclosure obligations introduced under the Taxonomy Regulation will require asset managers which offer financial products that have environmentally sustainable objectives, or that promote environmental characteristics to disclose how, and to what extent, the underlying investments support economic activities that are aligned with the EU Taxonomy. This includes disclosures on the environmental objective(s) to which the underlying investments contribute, and the proportion of investments that are aligned with the EU Taxonomy. However, without full transparency from companies on the extent to which taxonomy-aligned activities contribute to their revenues and capital expenditures, it will prove challenging to precisely measure the extent to which portfolios (especially those which include non-EU companies) are so aligned.

Lack of availability of data and reliable metrics

As numerous commentators have already noted, the lack of availability, and comparability, of relevant ESG data from investee companies is a major stumbling block to implementation, making the disclosure exercise fraught with difficulty. Certainly, there are many initiatives to address this data gap and the lack of standardisation. The Taxonomy Regulation will impose requirements on companies of a certain size to disclose information on how and to what extent its activities are associated with "environmentally sustainable" activities[9]. In the UK, listed companies are being required to make climate-related disclosures in line with TCFD recommendations, albeit on a "comply or explain" basis. In addition, the five global organizations (CDP, CDSB, GRI, SASB, IIRC[10]), whose frameworks, standards and platforms guide the majority of sustainability and integrated reporting, recently announced their intention to work together to achieve a comprehensive reporting system for sustainability disclosures. None of the current disclosure obligations imposed on investee companies require third party assurance or audit, raising concerns over the reliability of any data even if provided by investee companies. While the expectation is that this should become less of a concern over time as ESG matters become a growing feature of a company's corporate reporting, as it stands, there remains a lack of widely available and comparable audited information which would facilitate the ability of asset managers to comply with their obligations.

The draft RTS does acknowledge this situation as it envisages that in cases where the data is not readily available, financial market participants can use "best efforts" to obtain information from investee companies and, where information

[9] Article 8 of the Taxonomy Regulation. It is estimated that around 6000 large companies and groups across EU are within scope.

[10] CDP (formerly Carbon Disclosure Project), CDSB, (Climate Disclosure Standards Board), GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board), IIRC (International Integrated Reporting Council).

cannot be obtained despite such best efforts, they are to use best efforts to assess the adverse impacts (based on reasonable assumptions, research and third party data). Details of how they have used their "best efforts" in this respect must be disclosed. Ultimately though, it remains the responsibility of the asset manager to ensure the accuracy of disclosures made in respect of a financial product.

On a more fundamental level, while there are some established and auditable metrics in relation to environmental matters – such as measurements relating to greenhouse gas emissions – there are many other matters, especially those falling within the social and governance sphere, which are difficult to quantify. As discovered by various asset managers which manage ESG-branded funds invested in Booho.com, an over-reliance on some form of ESG scoring systems could lead to perverse outcomes as a company's record, for example, on supply-chain practices, cannot always be adequately captured through an aggregated scoring system. Certain issues simply require substantial research involving on-the-ground engagement and diligence of investee companies, which may stretch the resources of many asset managers.

Limits of disclosure

Disclosure is, of course, simply one step in facilitating investors' assessment of a firm's ESG credentials. As noted by commentators, there is no clear benchmark for what ESG integration means in practice, and asset managers may take any number of approaches in integrating ESG issues in their investment decisions. These may range from a minimal form of "negative screening", which simply involves the exclusion of companies which do not comply with certain international standards or which hail from certain "sin" sectors (like tobacco and arms manufacturers), to requiring managers as a matter of policy to conduct ESG research and consider ESG factors in portfolio construction and to actively engage with investee companies on such matters (either through dedicated ESG teams or otherwise) throughout its investment process. Investors will have to undertake a more detailed review to understand a firm's disclosed methodology and approach when determining the extent to which an asset manager takes ESG factors into consideration, how its policies are put into practice, and how that impacts its investment decisions. Others have commented that integration alone is insufficient without sustained stewardship and engagement with investee companies, although it should be the case that a robust policy should address these as well.

Conclusion

Nonetheless, the push towards mandatory disclosure should, in and of itself, drive changes. As noted in the GISD report, disclosures are "*a means toward motivating action on sustainability and re-aligning investment flows towards [our goals].*[11]" The disclosure requirements can therefore be seen as a means to push asset managers towards demonstrating and committing to actual tangible action with regards to ESG matters at both the operational and investment decision level. Public disclosure will inevitably invite scrutiny. Asset managers will have to be prepared for their policies, but also their actions (especially given the ability for these to be measured against their disclosed policies), to withstand robust scrutiny from increasingly vocal clients as well as from other interest groups.

The far-reaching obligations under SFDR and Taxonomy Regulation demonstrate the EU's commitment to re-orienting capital flows to sustainable investments and to reducing the risk of firms relegating ESG integration into a box-ticking "greenwashing" exercise. Asset managers will need to brace themselves for the incoming tide of regulation.

[11] GISD report: 'Renewed, Recharged and Reinforced: Urgent Actions to Harmonize and Scale Sustainable Finance' (July 2020), page 5

Appendix 1: Disclosure requirements under the Disclosure Regulation and the Taxonomy Regulation

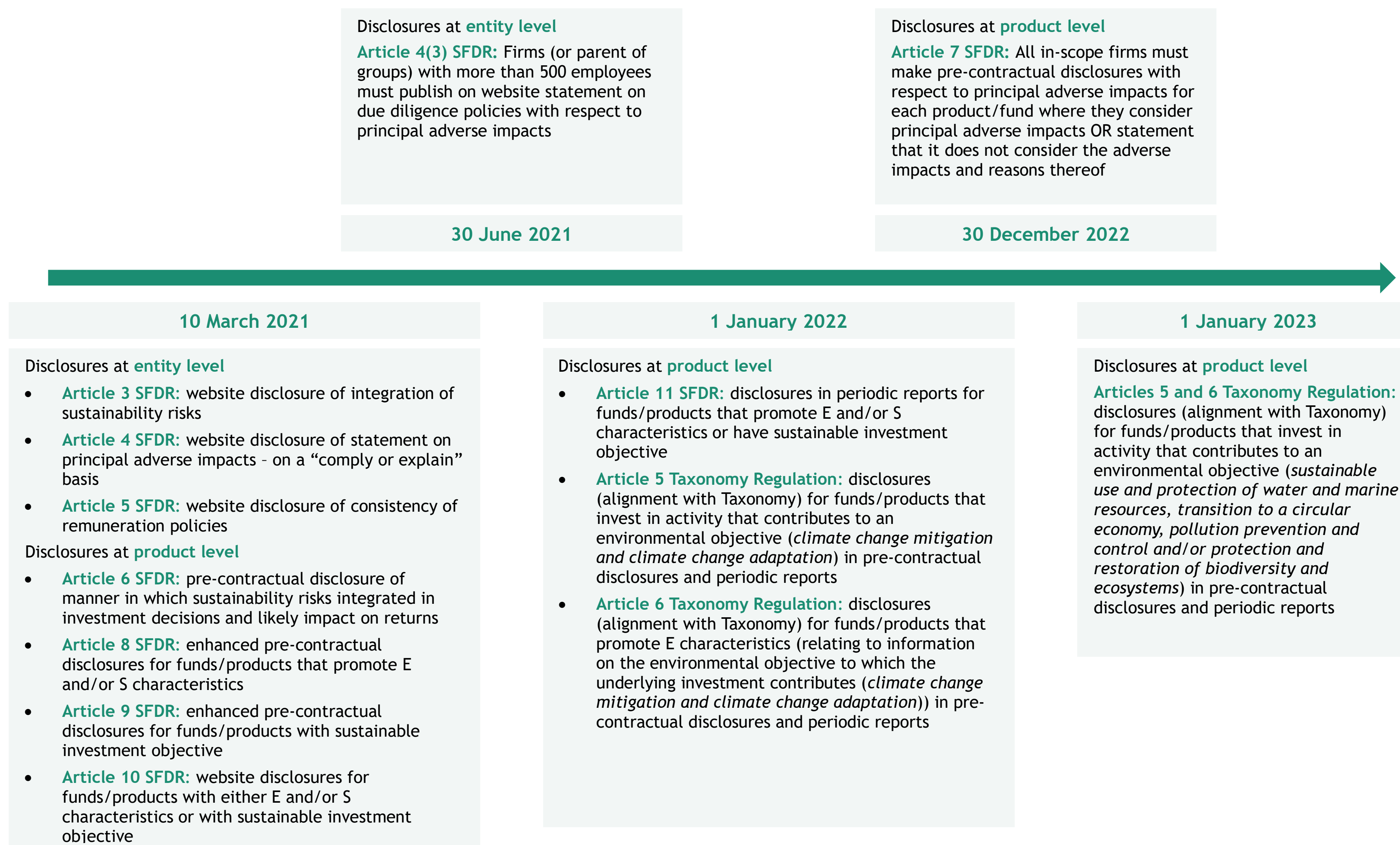
Disclosure requirement	Disclosure channel	Reference	Comments
At Entity level			
Information about policies on the integration of sustainability risks in the investment decision-making process	Website	Article 3 SFDR	
Information on due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors		Article 4 SFDR	This is applied on a "comply or explain" basis so firms that do not consider "principal adverse impacts" do not have publish a statement on their respective due diligence policies with respect to such impacts. However, they must still publish an explanation setting our clear reasons why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts. From 30 June 2021, firms (or parents of groups) with, on average, more than 500 employees must publish the relevant statement and do not have the option of explaining why they do not do so.
Information on how remuneration policies are consistent with integration of sustainability risks		Article 5 SFDR	
At Product level			
All products			
Description of manner in which sustainability risks are integrated in investment decisions	Pre-contractual disclosure	Article 6 SFDR	
Results of assessment of the likely impacts of sustainability risks on the returns of the product			
Where sustainability risks are not considered relevant, an explanation why they are not relevant to the product			

Disclosure requirement	Disclosure channel	Reference	Comments
Where the asset manager considers principal adverse impacts: • an explanation of whether and how the product considers principal adverse impacts on sustainability factors; • a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed in the relevant periodic reports relating to the product	Pre-contractual disclosure Periodic reports	Article 7 SFDR	This requirement applies from 30 December 2022.
Where the asset manager does not consider principal adverse impacts, statement that the firm does not consider the adverse impacts of investment decisions on sustainability factors and reasons why.	Pre-contractual disclosure		
Enhanced Disclosures: Products promoting environmental ("E") and/or social ("S") characteristics			
Description of the environment or social characteristics	Website	Article 10 SFDR	
Information on methodologies used to measure and monitor the environmental and social characteristics			
Information referred to in the pre-contractual disclosures (see below) and periodic reports (see below) for those products			
Information on how those characteristics are met	Pre-contractual disclosure	Article 8 SFDR	
If an index is used, information on whether and how the index is consistent with those characteristics			
A description of the extent to which environmental or social characteristics are met	Periodic report	Article 11 SFDR	
Further requirements imposed by the Taxonomy Regulation:	Pre-contractual disclosure Periodic reports	Article 6 Taxonomy Regulation	The disclosure requirements apply from 1 January 2022 in relation to the "climate change mitigation and "climate change adaptation" environmental objectives and from 1 January 2023 in relation to

Disclosure requirement	Disclosure channel	Reference	Comments
• If the product promotes environmental characteristics, information on the environmental objective(s) to which the underlying investment contributes • a description of how and to what extent the investments underlying the product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation			the rest of the environmental objectives set out in the Taxonomy Regulation. Disclosures must be accompanied by the following statement: *"The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities."*
Enhanced Disclosures: Products which have sustainable investments as their objective			
A description of the sustainable investment objective	Website	Article 10 SFDR	
Information on the methodologies used to measure the environmental or social characteristics or the impact of the sustainable investments selected for the product			
Information referred to in the pre-contractual disclosures (see below) and periodic reports (see below) for those products			
If a designated index is used as a reference benchmark: • information on how the designated index is aligned with that objective • an explanation as to why and how the designated index aligned with that objective differs from a broad market index	Pre-contractual disclosure	Article 9 SFDR	
If no index is used, an explanation of how that objective is to be attained			

Disclosure requirement	Disclosure channel	Reference	Comments
A description of the overall sustainability-related impact of the product by means of relevant sustainability indicators; **OR** Where a designated index is used as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index	Periodic report	Article 11 SFDR	
• Further requirements imposed by the Taxonomy Regulation: • If the product invests in an activity that contributes to an environmental objective, information on the environmental objective(s) to which the underlying investment contributes • a description of how and to what extent the investments underlying the product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation	Pre-contractual disclosure Periodic report	Article 5 Taxonomy Regulation	The disclosure requirements apply from 1 January 2022 in relation to the “climate change mitigation and “climate change adaptation” environmental objectives and from 1 January 2023 in relation to the rest of the environmental objectives set out in the Taxonomy Regulation.

Appendix 2: Timeline for Implementation (as set out in the Regulations)



If you would like further information about this topic, please speak to your usual Slaughter and May contact.

Jeff Twentyman
T +44 (0)20 7090 3476
E jeff.twentyman@slaughterandmay.com

Nilufer von Bismarck
T +44 (0)20 7090 3186
E nilufer.vonBismarck@slaughterandmay.com

Jan Putnis
T +44 (0)20 7090 3211
E jan.putnis@slaughterandmay.com

Jonathan Marks
T +44 (0)20 7090 3056
E jonathan.marks@slaughterandmay.com

Paul Dickson
T +44 (0)20 7090 3424
E paul.dickson@slaughterandmay.com

Nick Pacheco
T +44 (0)20 7090 3143
E nicholas.pacheco@slaughterandmay.com

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