ALLEN & OVERY

GREAT FUND INSIGHTS

ESG and SFDR regulatory developments for fund and asset managers

Up to date as of 7 December 2020

1. Introduction

The European Commission and other bodies continue to press ahead with an ambitious Environmental, Social and Governance (**ESG**) sustainability agenda, with a number of further initiatives in the pipeline. This Great Fund Insights briefing gives a summary of what is proposed and relevant next steps.

2. Key developments

Subject	Summary	Timing and next steps (if any)
Sustainable Finance Disclosure Regulation (**SFDR**) – Delay to Level 2	The European Commission has confirmed a delay to its proposed Level 2 measures for the SFDR[1], but has stated that the Level 1 requirements will come into force as originally proposed from 10 March 2021. In the absence of Level 2 measures, firms will still be required to comply with the SFDR's "high level and principle-based requirements" from 10 March 2021. Various firms in the industry are now considering whether they will still seek to comply as much as possible with the European Commission's draft Level 2 requirements on a "reasonable endeavours" basis (although possibly ignoring the template), on the assumption that the final version may be largely unchanged from the draft on which the European Commission consulted. However, the preferred position remains unclear.	SFDR (Level 1) will begin to apply from 10 March 2021. Periodic reporting will be required from 1 January 2022. Some of the additional requirements added to the SFDR by the Taxonomy Regulation will begin to apply from 1 January 2022, while other additional requirements in relation to certain environmental objectives will only begin to apply from 1 January 2023[2]. The European Commission has not clarified when its finalised Level 2 requirements will begin to apply, although there has been talk of January 2022. Thus, the European Commission is likely to finalise its Level 2 measures by the beginning of 2022.
SFDR – UK implementation (or not)	For planning purposes, a lot of UK firms are continuing to proceed on the assumption that SFDR will be implemented in the UK post-Brexit. This had previously seemed likely[3], but as the end of the implementation period approaches, it is looking increasingly uncertain. Even if that is not the case, however: – EU firms that delegate to the UK are likely to look to the UK team to help them comply with EU SFDR. It is therefore likely to remain front and centre for many UK asset managers; – Certain large institutions may wish to contractually require their UK portfolio managers to comply with EU SFDR, even if it does not apply as a matter of law; and – there is a risk the European Commission will consider EU SFDR to apply to UK and other third-country firms doing business cross-border into the EU (eg selling funds, or providing portfolio management or advisory services), although this is unclear[4].	
AIFMD Review – ESMA proposals	In a letter dated 18 August 2020[5], ESMA suggested various changes to AIFMD, including an update to the current AIFMD reporting template to include fields on ESG. This would be done to increase transparency on environmental impacts and social and governance matters, "in line with [the] "EU Commission action plan on sustainable finance"[6] and ESMA-developed "Strategy on sustainable finance"[7]. ESMA also considers that it will assist local regulators in their monitoring – although precisely what they would be monitoring is unclear. ESMA has also requested a mandate to develop technical standards.	Unclear, although see below

AIFMD Review – European Commission Public Consultation	The European Commission is now formally consulting on AIFMD[8]. The consultation includes a significant section on "Sustainability/ESG", including the following types of questions: – Should AIFMs quantify sustainability risks? – Should an AIFM's investment decision-making process include potential principal adverse sustainability impacts? – Should adverse impacts on sustainability factors be integrated in the quantification of sustainability risks? – Should AIFMs, when making investment decisions, be required to take account of sustainability-related impacts beyond what is currently required by EU law (eg environmental pollution and degradation, climate change, social impacts, human rights violations); ie. alongside the interests and preferences of investors? – Should the EU taxonomy play a role when AIFMs are making investment decisions; in particular regarding sustainability factors? – Should other sustainability-related requirements or international principles beyond those in SFDR be considered by AIFMs when making investment decisions? Another question is whether the AIFMR supervisory reporting template should provide a more comprehensive portfolio breakdown; in particular, to require more details on sustainability-related information, eg risk exposure and/or impacts	The European Commission's consultation closes on 29 January 2021. If the European Commission decides to propose changes to the existing legislation, these are unlikely to be published until mid-2021.
EBA	The European Banking Authority (**EBA**) has published a Discussion Paper on ESG risk management and supervision[9]. This has been issued to set out a comprehensive proposal as to how ESG factors and ESG risks could be included in the regulatory and supervisory framework for credit institutions and investment firms. The paper identifies common definitions of ESG risks (building on the EU taxonomy) and gives a summary of current evaluation methods. It also focuses on the risks to which firms are exposed via the impact of ESG factors on counterparties, especially as regards climate change. The paper provides recommendations as to how ESG risks can be incorporated into business strategies, governance and risk management. It suggests that this could be done by evaluating the long-term resilience of business models, setting ESG risk-related objectives, engaging with customers, and considering the development of sustainable products. The paper also discusses how existing supervisory processes could be revised to enable supervisors to understand the longer-term impact of ESG risks, and proposes to enhance existing supervisory reviews to include ESG factors. Please ask us if you would like a copy of our separate briefing on this.	The consultation runs until 3 February 2021.
Changes to UCITS, AIFMD, and MiFID II for ESG	On 8 June 2020, the European Commission launched a consultation on proposed changes to the UCITS[10], AIFMD[11] and MiFID II[12] regimes for ESG. Among other things, this included an express requirement to integrate sustainability risks into firms' processes, to consider the principal adverse impacts of investment decisions on sustainability factors within the due diligence process, incorporate ESG in product governance, and capture a client's ESG preferences before providing advice or portfolio management.	The consultation closed on 6 July 2020. While the legislative timetable remains unclear, it is possible that the proposed changes could apply from Q4 2021.
Financial Data Exchange Templates (**FinDatEx**)	FinDatEx is a joint structure established by representatives of the EU financial services sector to support the development and use of standardised technical templates to facilitate the exchange of data between stakeholders in the application of EU financial markets legislation. On 24 June 2020, FinDatEx announced that it had created a new working group and initiated a review of its European MiFID Template (**EMT**) for the integration of ESG target market criteria[13], as required by the European Commission's proposed changes to the MiFID II regime (see above).	Once the revised draft version of the EMT has been prepared, FinDatEx will publish it on its website for public consultation. Based on previous timetables, the revised draft version of the EMT should be ready by the first half of 2021.

Taxonomy Regulation	On 5 November 2020, ESMA published a consultation paper entitled “Draft advice to European Commission under Article 8 of the Taxonomy Regulation”[14]. In addition to consulting on various matters relating to firms subject to NFRD, section 4 concerns asset managers and deals with a specific question posed to ESMA, namely how asset managers that report under NFRD should disclose how their activities are directed at funding environmentally sustainable economic activities. ESMA proposes (in the context of this question) to interpret an asset manager’s activities to be the investments of the investment funds that they manage, as these are used to fund underlying economic activities of investee companies. In the context of the Article 8 obligation, ESMA believes that asset managers merit a framework for reporting how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable. Please refer to our client bulletin for more information on what asset and fund managers need to know about the Taxonomy Regulation.	The consultation runs until 4 December 2020. ESMA is required to finalise its advice by the end of February 2021.
SRD II and stewardship	Among other things, SRDII imposed a “comply or explain” approach for asset and fund managers as regards an SRDII compliant engagement policy. It also imposed a requirement to publicly disclose on an annual basis how its engagement policy has been implemented (plus other prescribed requirements), and to make certain annual disclosures to certain institutional clients and fund shareholders. Note also that, in October 2019, the FCA published its revamped Stewardship Code 2020 (UK)[15], setting out good stewardship practice for asset managers, asset owners and service providers. The UK Financial Reporting Council (**FRC**) will evaluate reports submitted to it against its assessment framework, and those that meet the reporting expectations will be listed as signatories to the Code.	In force since June 2019. Unless they have decided to “opt out”, firms should be putting an SRDII compliant engagement policy on their websites. Annual disclosures are likely to begin to be made from January 2021. The new code has applied from 1 January 2020. Asset managers and service providers must submit their final reports to the FRC by 31 March 2021 to be considered (30 April 2021 for asset owners).
AMF, France	Mindful of the increasing number of funds integrating ESG criteria, the AMF has published a policy document setting out its expectations in relation to the provision of information to investors in the context of funds incorporating such criteria.[16] A key goal is to ensure “the proportionality between the reality of non-financial (ESG) criteria taken into account in the fund’s asset management and the prominence and explanation of such criteria in investor communications”. The policy is not applicable to French-domiciled collective investment products which are only marketed abroad and whose subscription and acquisition of units or shares are reserved for non-French-resident investors.	The policy applied immediately for the creation of collective investment products, products modifications and notification of cross-border marketing of a foreign-based UCITS. For products in existence as at 11 March 2020, the policy must be complied with by 10 March 2021 at the latest. In relation to the creation of collective investment products, products modification and notifications to the AMF of cross-border marketing of a foreign based UCITS between 12 March 20202 and 22 July 2020, the policy must be complied with from 30 September 2020 at the latest.

IOSCO	The International Organization of Securities Commissions (**IOSCO**) launched a sustainable finance network in October 2018, and has been progressing a programme of work since that date including building upon previous IOSCO initiatives in this area. This work has included publishing a report in April 2020 on sustainable finance[17], covering asset and fund management, among other sectors. IOSCO is also establishing a Board-level Sustainability Task Force. One of its key aims is to improve sustainability-related disclosures made by issuers and asset managers; in particular, it will identify and develop categories of disclosure which are material for investors ("decision useful"). It will also prepare case studies and an analysis on transparency, investor protection, greenwashing and other relevant issues.	Ongoing
UK industry guidance – Responsible Investment	In the UK, the Investment Association has issued guidance to its member firms "Fund Communication of Responsible Investment"[18]. This follows its "Responsible Investment Framework"[19], published in November 2019. The association has also reminded firms of the FCA guidance titled "The description of fund objectives and investment policies" (February 2019), published as part of Policy Statement (**PS**) 19/4:[20] "**Non-financial objectives** 29. Sometimes funds set out non-financial objectives, for example environmental or social objectives, or state that they are aiming to achieve a non-financial return. We expect, if a fund has such objectives, that it will set them out in its prospectus and its KIID/KID. 30. Where a fund sets out objectives such as these, it must do so in a way that is fair, clear and not misleading. Firms that set out non-financial objectives for a fund should be clear about how they will measure whether those objectives are being met, and should provide ongoing information to investors."	NA
UK TCFD-aligned disclosures for asset managers & pension schemes	The FCA has indicated an intention to consult on implementing client-focused TCFD-aligned disclosures for asset managers and contract-based pension schemes in H1 2021.[21] The FCA commented that: "Institutional and retail investors increasingly demand information on how their asset managers take climate into account in their investment decisions, and the outcomes they achieve." In terms of SFDR, the letter does not make clear on its face whether their proposal would be a substitute for SFDR or something added on top.	Consultation H1 Rules finalised – end 2021 New obligations in force in 2022 (possibly on a phased basis)

3. Technical point for UK firms – UK SFDR

SFDR came into force prior to Brexit, but for the most part[22], it does not begin to apply until after the end of the implementation period (31 December 2020). It therefore does not form part of the "retained EU law" after 31 December under the EU (Withdrawal) Act 2018 (as amended) (**EUWA**). This is because the EUWA will not onshore provisions that, despite being in force before the end of the implementation period, will not apply until a date that falls after the end of the implementation period.

The upshot? SFDR will **not** automatically form part of UK law following Brexit because those provision which do **not** yet apply will not be onshored and those that apply already will be repealed. There has been a suggestion that the UK will separately consult in due course if it decides to "onshore" SFDR (or alternatively, introduce something bespoke for the UK). If so, this is likely to involve a reasonable timeline for consultation and implementation, suggesting a much longer timeline than March 2021.

References

[1] See https://www.esma.europa.eu/sites/default/files/library/eba_bs_2020_633_letter_to_the_esas_on_sfdr.pdf

[2] See Art 28(2) of the Taxonomy Regulation – for example, only financial products that contribute to or promote either (a) climate change mitigation or (b) climate change adaptation will have additional requirements added to the SFDR by the Taxonomy Regulation from 1 January 2022. Financial products that contribute to or promote the other four objectives in Art 9(c)-(f) of the Taxonomy Regulation will only have additional requirements added to the SFDR by the Taxonomy Regulation from 1 January 2023.

[3] See HM Treasury paper titled "Financial Services (Implementation of Legislation) Bill Updated Policy Note" (February 2019) at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/780759/FS__IoL__Bill_Revised_Policy_Note_web__2_.pdf

[4] This is not clear, but is possible based on views stated by the European Commission in relation to the Taxonomy Regulation, which draws on the same defined terms and concepts: Q: "What extra-territorial reach will the Taxonomy Regulation have? What will be its effect on non-EU companies? And on EU companies' activities located outside the EU? • A: The disclosure obligations for financial market participants in the Taxonomy Regulation apply to anyone offering financial products in the EU, regardless of where the manufacturer of such products is based. … This approach is not different to other … financial product disclosure obligations already in place in the EU. [Possibly this is a reference to PRIIPs, which also has extra-territorial reach."] See https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en.pdf

[5] https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf

[6] https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en

[7] https://www.esma.europa.eu/sites/default/files/library/esma22-105-1052_sustainable_finance_strategy.pdf

[8] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/2020-aifmd-review-consultation-document_en.pdf

[9] https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Discussions/2021/Discussion%20Paper%20on%20management%20and%20supervision%20of%20ESG%20risks%20for%20credit%20institutions%20and%20investment%20firms/935496/2020-11-02%20%20ESG%20Discussion%20Paper.pdf

[10] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11959-Integration-of-sustainability-risks-and-factors-for-undertakings-for-collective-investment-in-transferable-securities-

[11] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11960-Integration-of-sustainability-risks-and-factors-related-to-alternative-investment-fund-managers-

[12] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017-565- and https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive-EU-2017-593-

[13] https://findatex.eu/news/40/findatex-launches-work-on-esg-target-market

[14] https://www.esma.europa.eu/press-news/consultations/consultation-paper-draft-advice-ec-under-article-8-taxonomy-regulation

[15] https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf

[16] https://www.amf-france.org/sites/default/files/doctrine/Position/Information%20to%20be%20provided%20by%20collective%20investment%20schemes%20incorporating%20non-financial%20approaches.pdf

[17] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf

[18] https://www.theia.org/sites/default/files/2020-10/Sustainable%20Finance%20Regulatory%20Overview%20Oct%202020.pdf

[19] https://www.theia.org/sites/default/files/2019-11/20191118-iaresponsibleinvestmentframework.pdf

[20] https://www.fca.org.uk/publication/policy/ps19-04.pdf

[21] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/923327/fca-letter-climate-related-financial-disclosures-sept-2020.pdf

[22] Most of the provisions of SFDR only apply from 10 March 2021 (and some only apply from 1 January 2022); ie. after the end of the implementation period. There are a small number of exceptions, however, namely articles 4(6) and (7), 8(3), 9(5), 10(2), 11(4) and 13(2) which empowered the ESAs to make technical standards. These were expressly repealed by UK SI 2020/628, being one of HM Treasury's Brexit related statutory instruments. See The Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020 https://www.legislation.gov.uk/uksi/2020/628/pdfs/uksi_20200628_en.pdf (see page 16). See also the Securities Financing Transactions, Securitisation and Miscellaneous Amendments (EU Exit) Regulations 2020 https://www.legislation.gov.uk/ukdsi/2020/9780348213614/pdfs/ukdsi_9780348213614_en.pdf (see page 40), which dealt with additional provisions added to SFDR by the Taxonomy Regulation.