Sustainability Regulation in the European Financial Services Sector

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Investors are increasingly demanding a greater focus on sustainability and responsible investment from their asset managers, and the private funds sector is certainly no exception. In Europe, regulators are following suit, and new rules that will affect most private funds that want to raise money in Europe have now taken shape.

In May 2018, the European Commission proposed a package of measures on sustainable finance, which, as we reported at the time, included a requirement for asset managers (including private equity and venture capital fund managers) to take sustainability risks into account in their investment decision-making, and to explain to investors how they do so. It also included a proposal for a taxonomy (a classification system) to determine whether an economic activity is environmentally sustainable and a proposal for a new category of low and positive carbon benchmarks. These measures formed part of the Commission's broader attempts to meet the goals set by the Paris Agreement on Climate Change.

Sustainability Regulation

One year later, the European Parliament has published agreed text on the disclosures to be given by firms on the integration of sustainable investments and sustainability risks in their investment process (the "Regulation"), while work on the other initiatives is ongoing. "Sustainable investments" are broadly conceived as investments in an economic activity that contribute to an environmental or social objective, with the additional proviso that the investment follows good governance practices.

The Regulation will apply to a broad range of "financial market participants", including alternative investment fund managers ("AIFMs"), firms authorised under the Markets in Financial Instruments Directive ("MiFID") to provide portfolio management, and managers of EuVECA and EuSEF[1] funds. "Financial advisers" (including firms authorised under MiFID to give investment advice) are also in scope. Insurers that provide investment products, manufacturers of individual pension products (including

[1] EuVECA and EuSEF funds are funds established under the European Venture Capital Fund and European Social Enterprise Fund Regulations.

those not regulated at the EU level) and occupational pension schemes are also subject to the Regulation.

As we reported last year, the scope of the Regulation widened during the legislative process. The Regulation originally applied primarily to managers that pursue a sustainable strategy. It now applies to all firms.

The Regulation is not explicit as to whether it applies to "incoming" non-EEA managers, including US fund managers, when marketing their funds in EU states under available national private placement regimes, but it seems likely that Member States will apply it in practice to such managers (and the use of the generic term "AIFM" in the Regulation certainly facilitates application of the Regulation to non-EU AIFMs).

Impact on Fund Managers—Incorporation of Sustainability Risks into Investment Decision-Making Process. The Regulation seeks to ensure that fund managers incorporate "sustainability risks" into their investment decision-making process. "Sustainability risk" means an environmental, social or governance event that could negatively affect the value of an investment. It means consideration of, for instance, an environmental factor in the investment decision-making process to the extent it affects the value (or volatility) of the investment—but it does not require a manager to consider sustainability factors that have no impact on the investment's value. There is no qualification as to whether a sustainability risk should be material, although managers will need in practice to determine the materiality and relevance of sustainability risks to the value of the investments they make, as well as the availability of data on the impact of sustainability risks on value.

The Regulation requires managers to publish information on their policies on the integration of sustainability risks in their investment decision-making process on their website. Managers are not required to publish the whole policy, but can do so if they wish.

The Regulation introduces the separate concept of "principal adverse impact of investment decisions on sustainability factors". This only applies to firms that consider the "adverse" impact of their investment decisions on "sustainability factors", such as the environment, in their investment process—even if they do not affect the value of an investment. This is framed as a disclosure obligation at the "entity" level, encompassing the whole firm's approach to sustainability factors in its investment decisions. Firms that do commit to consider sustainability factors more widely must publish information on their website on how their due diligence policies incorporate these factors. Information to be given will include the priority given to various sustainability factors, actions taken to address the factors and adherence to responsible business conduct codes. Firms that do not consider such factors will need to explain that this is the case, give clear reasons for not doing so and indicate if and when they intend to consider such factors. However, large firms (including firms that exceed an average number of 500 employees during their financial year) cannot benefit from the "comply or explain" route—they must publish a statement on their website on how they consider sustainability factors more widely in their investment due diligence.

The degree to which AIFMs will need to change their investment approach for existing (as opposed to new) funds is unclear, although it is likely that firms will in practice focus on the application to new products. In helpful acknowledgement of the proportionality principle, the Regulation acknowledges that the degree to which due diligence incorporates sustainability factors should take account of the firm's size, nature and scale of activities. The applicability of sustainability factors to a firm will depend on the firm's investment strategies, with the possibility for some firms to make quite high-level disclosure, particularly if they consider that their strategy does not necessarily accommodate the consideration of sustainability factors.

Firms must make similar disclosures in relation to given financial products, including funds, at the "pre-contract" stage (for AIFMs, as part of the disclosures usually given to investors in the fund's PPM). Here, the obligation is to disclose whether a financial product considers principal adverse impacts on sustainability factors—so large firms that must publish the disclosure at the entity level are not necessarily required to follow through with disclosure at the product level, such as where they conclude that the product does not lend itself to the application of sustainability factors.

Many private fund managers do not make any information available on their funds on their website, other than to approved investors behind a "firewall". Although the Regulation requires product-level disclosure to appear on websites, it appears that firms in practice can continue to make this information available only to approved investors. By contrast, firm-level disclosures on the consideration of sustainability risks on websites will likely be required to be made public—highlighted by Evert van Walsum of ESMA in a speech given on 13 May 2019, in which he referred to "Public disclosure of so-called 'principal adverse impacts' of investment decisions on sustainability factors, such as environmental and social matters (which apply to market participants on a comply or explain basis, except for companies with more than 500 employees for which the obligation is mandatory)."

As the Regulation notes, standardised disclosure will allow "end-investors" to make better informed investment decisions and compare investment products on a like-for-like basis more easily. It may also reduce the need for managers to complete separate investor due diligence questionnaires.

Impact on Investors. As noted above, insurers that provide investment products (and firms, other than very small firms, that provide advice on those products) are in scope and must comply with the rules in a similar manner to fund managers. Likewise, the Regulation applies to manufacturers of individual pension products (including those regulated at the national law level and the forthcoming pan-European Personal Pension Product) and occupational pension schemes (other than schemes with fewer than 15 members). From a private equity perspective, certain types of investors, such as occupational pension schemes, are in scope, suggesting a significant future bias in their investment policies towards sustainable investing. There is a separate EU workstream to consider the integration of sustainability risks in the Solvency II Directive that governs EU insurers.

Impact on Financial Advisers. The Regulation has similar obligations for "financial advisers", which include firms authorised under MiFID to give investment advice. As for managers, financial advisers must publish information on how they integrate risks in their investment advice on their website, and publish information as to whether they more widely take into account the "adverse" impact of their investment decisions on "sustainability factors" in their investment advice (regardless of whether their clients have expressed a preference for sustainable investments). Very small investment advisers (that employ fewer than three persons) are exempt.

Products with Sustainable Investment as Objective. The Regulation introduces additional disclosure obligations where a financial product has sustainable investment as its objective. There will be prescribed and consistent disclosure standards on how these objectives are met, the methodologies used to assess achievement of the objectives and rules to ensure the consistency of any index used as a benchmark with the objectives. These are, in part, designed to prevent "greenwashing" (which the European Commission describes as "unsubstantiated or misleading claims about sustainability characteristics and benefits of an investment product"). The details of the disclosure will be in forthcoming regulatory technical standards.

Remuneration Policies. As an add-on to existing remuneration rules, firms in scope of the Regulation must include in their remuneration policies (applicable to their staff) information on how their policies (in terms of incentives and avoidance of conflicts of interest) are consistent with the manner in which they take into account sustainability risks, and publish that information on their website. This provision is not as prescriptive as earlier versions, and does not, for instance, tie remuneration awards to the firm's overall sustainability achievements.

Separate changes to MiFID and the AIFM Directive

In a separate workstream, the European Commission has proposed changes to Delegated Regulations under MiFID to require investment firms to ask their clients about their preferences concerning sustainability issues and to take any such preferences into account when advising their clients.

In addition, the European Securities and Markets Agency ("ESMA") has recently published technical advice to the Commission on how sustainability risks should be incorporated into the AIFM Directive's ("AIFMD") organisational requirements (and separate advice in relation to MiFID organizational requirements). AIFMs will be required to take into account sustainability risks in their procedures for internal decision-making and resolving conflicts of interest, and will have to ensure that their senior management are responsible for taking into account sustainability risks (although firms are not required to designate a single senior person as responsible). Of relevance to private equity is that AIFMs must, where required to consider the "adverse" impact of their investment decisions on "sustainability factors" under the Regulation (as to which, see below), develop engagement strategies (such as the use of voting rights to influence a company's strategy) to apply sustainability factors at investee companies. The proportionality principle—that takes account of a firm's size, scale and nature of its activities—applies to these new requirements.

Significantly, ESMA said that it has received calls for a compulsory taxonomy on the meaning of environmental, social and governance factors making up sustainable investments—given the possibility of investors being misled by incorrect or inconsistent use of these terms. While such a taxonomy is beyond its remit, ESMA will nonetheless include the calls for a taxonomy in its final report to the Commission, with the potential for the Commission to engage ESMA in this project at a later date. Separately, the Regulation requires the EU regulatory authorities to develop rules on the content, methodologies and presentation of information in relation to certain aspects of the disclosures required on the consideration of sustainability risks in their investment processes, although it is unknown how detailed these rules will be.

Timing

As a next step, the European Council will adopt the proposed Regulation. The Regulation will enter into force 20 days after it is published in the Official Journal of the EU but then apply 15 months from the date of publication, giving firms sufficient time to implement any new due diligence requirements and make the new disclosures. The Regulation is not likely to be effective until the beginning of 2021, at the earliest.

The obligation for large firms to publish a statement on their website on how they consider sustainability factors more widely in their investment due diligence enters into force 18 months after the Regulation enters into force. The obligation to make the related disclosure for each product also has delayed application (three years after entry into force).

It is likely that the application date of the separate changes to MiFID and the AIFM Directive will be aligned to the application date of the Regulation.

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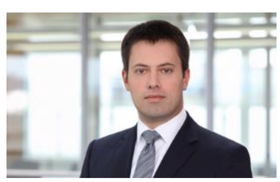

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