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EU Sustainable Finance Package – IEMA

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Why does the EU Sustainable Finance Package matter?

1. New obligations requiring disclosure and management of ESG risks for funds will apply from next March
2. It is going to take time to pull risk management systems up to scratch
3. There is a regulatory standard emerging which seeks to eliminate “greenwashing” once and for all – the “Taxonomy”
4. We are seeing opportunities emerge for funds wanting to achieve Taxonomy eligibility

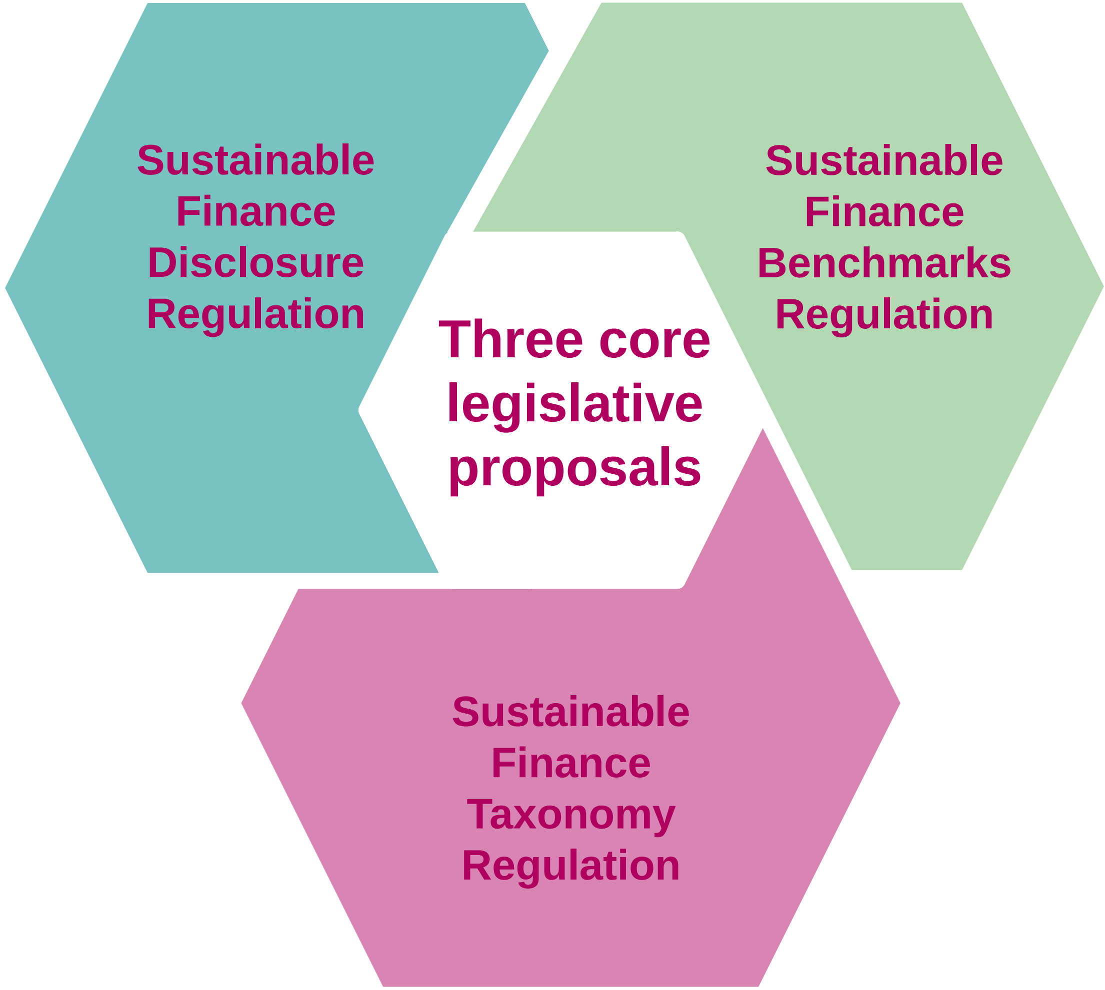
Overview of the EU reforms

EU reforms aimed at regulated firms

Aimed at preventing green-washing, encouraging investments into sustainable activities and managing sustainability risks

Reforms largely apply to UK and EU players – but in same cases have direct or indirect global reach

EU Sustainable Finance Package – Overview



Expected timings

Key Proposals	Expected Timings
SF Disclosure Regulation	Will apply from 10 March 2021
SF Taxonomy Regulation	To be phased in over 2020-22
SF Benchmarks Regulation	Applied from 30 April 2020 for benchmark administrators
MiFID Amendments	Timing still unclear
AIFMD / UCITS Amendments	Timing still unclear

SF Disclosure Regulation – Overview

Entity level obligations

Explain how ESG risks are factored into investment decisions – mandatory

Explain how remuneration policies factor in ESG risks – mandatory

Explain how impacts on ESG matters are built into due diligence – comply or explain

Product level obligations

Explain how ESG risks are likely to impact returns - mandatory

Explain impact of investments on ESG matters – comply or explain

Explain how products are light green – mandatory

Explain how products are dark green – mandatory

How will the SF Disclosure Regulation impact funds?

Investment decision-making and data gathering

- **For all funds** – potential changes to your due diligence, portfolio monitoring and engagement with investee companies
- **For ESG funds only** – potential changes to your due diligence, portfolio monitoring and portfolio construction

Investor relations

- Constraints on the kinds of investor communications funds can make for "non-ESG" funds and ESG funds
- Anticipating investor demands for side letter undertakings (and knowing whether these are driven by regulation or not)
- Anticipating the types of disclosures investors will require

Implications for all funds

Investment decision-making and data - all funds

- **Due diligence** – fund managers will need to assess the likely impacts of sustainability risks on the returns of each of their funds. This assessment will need to be disclosed in pre-contractual disclosures from 10 March 2021

- **Portfolio monitoring**

  - Fund managers will need to disclose the principal adverse impacts of investment decisions on sustainability factors (“**PASI**”) (*16 mandatory environmental indicators, 16 mandatory social indicators, 1 additional environmental indicator and 1 additional social indicator*) **or explain why they don’t consider them**
  - Disclosure to be made on website, at an AIFM-level, in respect of period from 10 March 2021
  - Fund managers may want to assess PASI more thoroughly in advance

- **Engagement with investee companies** – fund managers will need to disclose their actions taken and engagement policies in place in order to avoid or reduce the PASIs identified **or explain why they don’t consider them** from 10 March 2021

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Adverse Sustainability Indicators

Mandatory

Climate and other environment-related indicators

- **Greenhouse gas emissions** (*e.g. carbon emissions / footprint; solid fossil fuel sector exposure etc.*)
- **Energy performance** (*e.g. energy consumption from non-renewable sources etc.*)
- **Biodiversity** (*e.g. deforestation; natural species and protected areas etc.*)
- **Water** (*e.g. exposure to areas of high water stress; untreated discharged waste water etc.*)
- **Waste** (*e.g. hazardous waste ratio; non-recycled waste ratio etc.*)

Social and employee, respect for human rights, anti-corruption and antibribery matters

- **Social and employee matters** (*e.g. gender pay gap; excessive CEO pay ratio; board gender diversity; insufficient whistleblower protection etc.*)
- **Human rights** (*e.g. human rights policy; due diligence; processes / measures to prevent human trafficking; operations / suppliers at significant risk of child labour incidents etc.*)

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Additional

- **Emissions** (*e.g. inorganic pollutants; air pollutants; ozone depletion substances etc.*)
- **Water, waste and material** (*e.g. water management initiatives; sustainable oceans / seas practices etc.*)
- **Green securities** (*i.e. share of securities in investments not certified as 'green'*)

- **Social and employee matters** (*e.g. number of accidents, injuries, fatalities; grievance / complaints handling mechanism; incidents of discrimination; lack of separation of CEO and Chair functions on boards of investee companies etc.*)
- **Social securities** (*i.e. share of securities in investments not certified as 'social'*)

Practical considerations:

- Firms will need to have policies in place to identify, monitor and prioritise PASI
- Data gathering & processing issues
- Stewardship / engagement implications regarding underlying borrowers
- Website disclosures must be made available for 10 years
- Need for proportionality

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Product scoping

Are you dealing with a “non-ESG”, Article 8 or Article 9 fund?

“Non-ESG” funds	**Article 8 funds** (i.e. promotes environmental and/or social characteristics)	**Article 9 funds** (i.e. has sustainable investment as its objective)
Does not make the types of claims set out in the columns to the right	**Claims to take into consideration of binding “sustainability factors”** (i.e. environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters) in investment decisions	**Claims to target “sustainable investments”** (i.e. investments in economic activities that contribute to an environmental objective and/or a social objective)
Investment approach can be subject to some **baseline environmental or social safeguards** without necessarily bringing the fund into scope of Article 8 or 9	Includes • Strategies targeting “best-in-class” • Exclusion strategies based on environmental or social criteria	

Implications for Article 8 and Article 9 funds

Investment decision-making and data – Article 8 and Article 9 funds only

> **Due diligence** – fund managers must have a policy to assess the ESG credentials and good governance practices of your underlying investee companies/borrowers, including with respect to sound management structures, employee relations, staff remuneration and tax compliance

> **Portfolio monitoring** – fund managers will need to monitor the portfolio against a list of "sustainability indicators" used to measure the fund's attainment of its environmental and/or social objective (as applicable) to be disclosed in pre-contractual disclosures and ensure these are monitored throughout the life of the fund (describe on website how they will monitor, and disclose on annual reports the performance against the sustainability indicators)

> **Portfolio construction** – Article 9 funds must exclude companies or borrowers that do "significant harm" to any environmental or social objective (and this will need to be monitored on an ongoing basis). Any portion of an Article 8 fund that invests in "sustainable investments" must do the same.

Implications for fund investors

How will this affect fund’s interactions with investors?

1. In-scope pension funds and insurance companies
2. Regulatory-driven investor demands
3. US ERISA investors
4. Investor comms for “non-ESG” funds
5. Reputational / commercial considerations

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Beyond the Sustainable Finance package

Task Force on Climate-related Financial Disclosures (TCFD)

TCFD-recommended approach to disclosures:

2019 Status Report

> shows current disclosure practice

> encourages alignment with recommendations

Trends

> lack of climate-related financial information

> more disclosure needed on resilience of strategies

> potential disclosure requirements

Best Practice

> TCFD report

> Implementation guidance

> recommendations for financial sector and construction/real estate management and development sector

> banks ahead of most sectors

ESG megatrend – regulatory changes for Corporates

EU Disclosure Regulation

Asset managers and other investors will need to ask corporates much more detailed and broad questions on ESG before providing funding as a regulatory obligation. We anticipate this will start to hit corporates from March of next year, possibly earlier for first movers.
Key deadline: 10 March 2021

EU Taxonomy Regulation

Ambitious corporates may align. Also requires buyside entities and companies that are subject to the NFRD to disclose whether their business activities are "Taxonomy-eligible".
Key deadline: 1 January 2022.

EU Non-Financial Reporting Directive

We expect corporates subject to this regulation will need to disclose in due course against a new EU-wide reporting standard which builds on other more demanding sustainability disclosure standards.
Key deadline: Taxonomy obligations under NFRD 1 January 2022. Rest of NFRD changes estimated end of 2022.

UK FCA Consultation Paper

Consultation paper points to TCFD disclosures becoming mandatory for UK premium listed companies on a comply or explain basis for financial years commencing 1 January 2022.
Key deadline: 1 January 2022

EU Green Deal

The EU Green Deal seeks to achieve net zero emissions in Europe by 2050. Reforms (eg changes to the EU ETS after Brexit) will be designed to incentivise sustainable or "green" investments across all sectors.
Key deadline: From now to 2030

UK Prudential Regulation

Corporates to face more scrutiny from banks when lending over the next ten years as regulators develop new regimes for the assessment and mitigation of climate risk.
Key deadline: UK climate stress test is from mid-2021.

Solving the practical issues

- Interview different data analytics service providers
- Trial and interrogate their services
- Be realistic about what can be achieved
- Combine data analytics with rolling your sleeves up
- Sensible, focused, commercial questions
- Engage external ESG legal advisors to benchmark your policies and procedures against changing legal requirements

EU Taxonomy Regulation

SFTR - what is an environmentally sustainable investment?

It contributes substantially to an environmental objective

Environmental objectives

Minimum social safeguards

DNSH to any of the other environmental objectives

Conducted in compliance with S and G safeguards

Complies with technical screening criteria

Climate change mitigation

Climate change adaption

Sustainable use and protection of water and marine resources

Transition to a circular economy, waste prevention and recycling

Pollution prevention and control

Protection and restoration of biodiversity and ecosystems

1. UN Guiding Principles on Business and Human Rights
2. OECD Guidelines for MNEs
3. ILO Declaration on Rights
4. International Bill of Human Rights

How to manage the challenges and harness the opportunities?

Compliance with Sustainable Finance regime

Linklaters can help you with:

> scoping the impact of rules at a product and entity level;
> validating and drafting any methodology;
> developing your governance and risk management framework;
> building out relevant policies and procedures;
> responding to client requests; and
> preparing and reviewing product level disclosures and reporting.

Reputationally enhancing opportunities

Linklaters can help you:

> establish Taxonomy-eligible or sustainable funds;
> market the sustainability characteristics of your existing funds in a compliant manner.

Manage the ESG data minefield

Linklaters can help you:

> prepare new due diligence templates
> help you to embed ESG factors into your investment processes;
> make recommendations around gathering and interrogating ESG data;
> keep abreast of the shifting landscape on sustainability regulation – expectations are changing more quickly than expected.

Questions