The rising tide of ESG regulation on investment funds

DAVID WALSH examines EU proposals aimed at increasing the use of ESG factors in investment decisions. However, while investor demand continues to grow for investments integrating ESG factors Walsh notes that the availability and access to reliable and accurate ESG metrics and data will also be key in achieving this goal.

There is increasing awareness that material environmental, social and governance (ESG) factors can be tied to a company's long-term growth potential. As such, more and more investors are looking for products that integrate sustainability into the investment process. This places an onus on asset managers to better articulate how they integrate ESG factors into their investment process. In response to this rising demand for ESG products, regulators are taking an active role to ensure that the integration of ESG does not occur to the detriment of investors. This article examines the package of European measures and proposals aimed at ESG investing. However, as also noted, reliable and accurate ESG metrics and data are also key to a sustainable financial services ecosystem.


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Disclosures Regulation

Political agreement was reached this year on new EU legislation which will require UCITS and alternative investment funds managers, irrespective of whether they have any ESG products, to disclose, in quite some detail, how the risks of ESG impacts may affect the value of an investment and about whether and how they take account of longer term ESG impacts (the **Disclosures Regulation**). While ESG was previously an optional add-on for investment firms and funds to consider, the Disclosures Regulation shall ensure it becomes embedded into the regulatory framework. The European Commission has stated that its objective is to explicitly require the integration of sustainability in the investment decision process. Once it enters into force, the rules shall impose obligations on managers of UCITS and alternative investment funds to:

i. systematically consider and integrate sustainability risks and consider adverse sustainability impacts in their processes; and
ii. provide investors with sustainability-related information on the financial products they offer or advise on.

All in-scope entities shall be required to:

- publish information on their policies on the integration of sustainability risks in their investment decision-making process on their websites;
- include information in their remuneration policies on how their remuneration policies are consistent with the integration of sustainability risks; and
- provide "pre-contractual disclosures" to investors relating to the integration of sustainability risks.

The Disclosures Regulation will enter into force on 29 December 2019 and will apply from 10 March 2021.

While the Disclosures Regulation shall be significant for asset managers in terms of compliance, it will take some time before the broader impact on the financial system and the environment can be assessed. In this regard, if negative ESG risks or impacts are disclosed, this still does not prevent funds from offering that particular investment and from investors choosing to invest. In any event, it is clear ESG can no longer be seen as a niche investment strategy as it is relevant to all investments.

ESG products

The continued growth and success of ESG investing depends largely on investor confidence. Where financial products are described as sustainable, this should be based on reliable parameters that are consistently applied both within jurisdictions and across Europe. Without this, not only are investors liable to not be getting what they reasonably believe they are getting, but beyond this, confidence in the implementation of the sustainability agenda runs a significant risk of being undermined. Against this backdrop, there are also new rules under the Disclosures Regulation that apply to managers where the investment fund is (i) promoting environmental or social characteristics; (ii) the investment objective is sustainable investments or (iii) the investment objective is the reduction of carbon emissions. The requirements include the following:

- Pre-contractual disclosures
- Website information
- Financial accounts reporting

There is a clear benefit to having standardised disclosure requirements for ESG which could support investor choices and avoid 'greenwashing' i.e. investors being deceived by misleading or unsubstantiated claims about the environmental benefits of an investment. This should benefit both the industry and investors.

Low-Carbon Benchmark Regulation

A regulation with new financial benchmarks aimed at giving greater information on an investment portfolio's carbon footprint (the '**Low-Carbon Benchmark Regulation**') is in effect from 10 December 2019.

The Low-Carbon Benchmark Regulation creates two new categories of low-carbon benchmarks:

i. a climate-transition benchmark; and
ii. a specialised benchmark which brings investment portfolios in line with the Paris Agreement goal to limit the global temperature increase to 1.5° above pre-industrial levels.

The two new categories are voluntary labels designed to orient the choice of investors who wish to adopt a climate-conscious investment strategy. The climate-transition benchmark will offer a low-carbon alternative to the commonly used benchmarks. The Paris-aligned benchmark will only comprise companies that can demonstrate that they are aligned with a 1.5°C target. The new labels are designed to give additional assurances to avoid greenwashing.

Taxonomy Framework

The European Commission is seeking to establish a framework for a system to determine whether an economic activity contributes to certain environmental objectives and “does no harm” to others i.e. taxonomy, or a “green list”. The taxonomy requirements are intended to introduce a classification system with respect to labels, standards and benchmarks recognizing compliance with environmental standards across the European Union.

The need for a common and reliable taxonomy to be put in place to support the Disclosures Regulation was a persistent theme in the industry lobbying efforts to the European Commission. Industry repeatedly stressed that significant challenges to compliance with the Disclosures Regulation will be presented by the delayed implementation of the proposed taxonomy requirements.

Following months of discussions and disagreements at European level, tentative political agreement was agreed in early December 2019 on a taxonomy regulation. However, the EU sustainable finance taxonomy is going back to the drawing board after representatives from several member states voted to reject the compromise text. While the European Parliament would prefer a strict and wide-ranging taxonomy, certain member states have been pushing for a looser document. Asset managers would also not be allowed to invest in nuclear energy stocks for any fund marketed as a sustainable product. The branding of nuclear energy as an unsustainable investment caused France, which has a large nuclear industry, to lead a group of member states, including the Czech Republic, Poland, Romania, Bulgaria and an abstaining UK, to block the compromise text and demand further negotiations instead.

ESG Data and Metrics

While the above measures have a key role to play in ESG investing, ESG data and measurability is also essential to the growth of ESG investing. ESG data is most often categorized as ‘non-accounting’ information because it captures components important for valuations that are not traditionally reported. ESG data provide insights into these intangibles. In recent months, both Irish and international asset managers have launched smart beta ESG strategies. It appears that this recent rising popularity is driven in part by the availability of better data. The increasing availability of reliable information on a company’s environmental impact and carbon footprint allows for financial providers to populate a portfolio. Both the opportunities and threats of smart beta strategies are linked to the availability and quality of reliable data. For investor confidence and the sustainability of long-term ESG investing, it is crucial that ESG data is both reliable and accurate.

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