



The New ESG Framework: Integration of Sustainability Risks

Introduction

In its Action Plan: Financing Sustainable Growth which it published in 2018, the European Commission noted that one of its key aims was to manage “*financial risks stemming from climate change, resource depletion, environmental degradation and social risks*”¹. In this, the third in our series of client briefings on the implications of the ESG framework for fund management companies² and funds, we consider the new obligations imposed on management companies under the SDFR which will require them to disclose to investors how they consider not only financial risks associated with an investment but also their policy on how they integrate sustainability risks into their investment decision-making process. We also outline proposed changes to the UCITS and AIFMD framework which were published in June 2020 under which management companies may be explicitly required to integrate sustainability risks into their investment decision processes, organisational structure and risk management systems.

It is worth highlighting at the outset that each of the obligations discussed below will apply to all management companies, regardless of whether or not they manage ESG funds.

SDFR: Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

Sustainability Risk: An environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of an investment.

¹ https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

² All references to “management company” in this briefing should be construed as including self-managed UCITS funds and internally managed alternative investment funds.

What is meant by “sustainability risk”?

Sustainability risk is defined under the SDFR 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*”. It is therefore concerned with the risk that the value of an investment could be materially negatively impacted as a result of environmental or social risks. It is also worth noting that such risks need only be considered where they could have a material negative effect on the value of the relevant investment.

Integration of sustainability risks into investment decision-making processes

Website Disclosures

In discharging their duties to act in the best interests of investors of the funds under management, management companies have typically been concerned with assessing and monitoring the financial risks associated with the investments acquired by funds which they manage.

However from 10 March 2021 onwards, all management companies will be required to provide information on their websites about their policies on the integration of sustainability risks into the investment decision-making process. In practice, this will require portfolio management teams and risk teams within management companies to assess how sustainability risks are integrated into the investment decision-making process applicable to each fund under management and to update due diligence policies accordingly. Information on such policies must then be disclosed on the management company’s website by the applicable deadline of 10 March 2021.

Prospectus Disclosures

The prospectus of each fund under management must also provide information on the manner in which sustainability risks are integrated into the investment decision-making processes. In addition to this, management companies must also conduct an assessment of the likely impact of sustainability risks on the return of the relevant fund. While information on the results of this assessment does not need to be disclosed on the management company’s website, it will need to be disclosed in the prospectus of the relevant fund by the same date.

Where the assessment leads to the conclusion that sustainability risk is relevant, the prospectus should be revised to disclose the extent to which such sustainability risks may impact the performance of the relevant fund. While the SDFR itself is not prescriptive on how such information is presented to investors and prospective investors in the fund’s prospectus, the recitals to the SDFR suggest that this information can be presented in either qualitative or quantitative terms.

If it is the case that the management company concludes that sustainability risks are not relevant in the case of a particular fund, the prospectus of that fund should be updated to explain to investors why this is the case.

The objective of these disclosure requirements is to allow investors and prospective investors to be able to understand their exposure to sustainability risk as a result of investing in a particular fund and to encourage them to take into account the impact of sustainability risks when assessing the performance of their investment over time.

Given the deadline of 10 March 2021 for publication of revised prospectuses, it would be prudent for management companies to implement a project plan at this juncture, particularly in light of the fact that the proposed amendments to the prospectus will need to be reviewed not only by the management company but also by the board of directors of the relevant fund and that UCITS and RIAIF prospectuses will require prior review by the Central Bank of Ireland³.

Implications for delegation arrangements

For those management companies which delegate investment decision-making responsibilities to delegate investment managers, they may wish to consider amendments to the relevant investment management agreement in place in order to oblige the delegate investment manager to provide such assistance, information and documentation as is necessary as to allow the management company to comply with its obligations under the ESG framework.

Integration of sustainability risks into remuneration structure

Under the SDFR, all management companies (regardless of whether or not they manage ESG funds) will be required to revise their remuneration policy to explain how this policy is consistent with the integration of sustainability risks. The expectation of the legislators is that the remuneration structure put in place by management companies is such that it is linked to risk-adjusted performance and does not encourage excessive risk-taking with respect to sustainability risks. The SDFR does not set down any prescriptive measures on how this information should be imparted to investors or prospective investors however the recitals to the SDFR suggest that it can be presented in either qualitative or quantitative terms.

³ Article 6 of the SDFR provides that relevant disclosures must be included in the “disclosures referred to in Article 23(1) of Directive 2011/61/EU”. The disclosure obligations set down in Article 23 apply to an AIFM in respect of “each of the EU AIFs that they manage and for each of the AIFs that they market in the Union”. As a result, it would appear (subject to any further clarification being issued by the European Commission or the ESAs) that the prospectus disclosure requirements set down under the SDFR will be imposed on any AIFM which manages an EU fund or which markets a non-EU fund within the EEA under the national private placement regime.

Given the deadline of 10 March 2021 for disclosing this information on their websites, management companies should now conduct an assessment on how sustainability risks are integrated into their remuneration structure and revise their remuneration policies as necessary.

Action to be taken by 10 March 2021

- Revision of relevant policies to disclose how sustainability risks are integrated into investment decision-making processes
- Update website to provide information on these policies
- Assessment of likely impact of sustainability risks on the returns of the relevant fund
- Revision of fund prospectus to provide information on how sustainability risks are integrated into the investment decision-making process and the likely impact of sustainability risks on the return of the relevant fund or explain why sustainability risks are not deemed to be relevant
- Revision to management company's remuneration policy and revision of website disclosure providing investors with information on this policy

Proposed changes to the UCITS and AIFMD frameworks on integration of sustainability risk⁴

Under proposed amendments to the UCITS and AIFMD legislative frameworks published in June 2020, management companies will be explicitly required to integrate sustainability risks in the investment decision-making processes. The objective of the draft legislation is, similar to that of SDFR, “to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth”. Noting that the existing legislative frameworks do not explicitly refer to sustainability risks, the European Commission notes that “it is necessary to clarify that processes, systems and internal controls of management companies reflect sustainability risks, and that technical capacity and knowledge is necessary to analyse those risks”.

The European Commission has given interested stakeholders until 6 July 2020 to provide feedback.

Under the current proposals, the obligations would apply 12 months after the date on which the legislation is published in the Official Journal. An overview of the proposed requirements which will be imposed on management companies is provided in the table below.

⁴ The European Commission has also proposed changes to the product governance rules imposed on investment firms under MiFID II. Under the draft legislation, product manufacturers will be required to take into account sustainability preferences in the product oversight and governance process, including considering sustainability preferences when specifying the type of client whose needs, characteristics and objectives the relevant fund (or other financial instrument) is compatible with. Similar requirements are also imposed on distributors licenced under MiFID II.

Impacted Area	Obligation
Due Diligence on Investments (Sustainability Risks)	Management companies must assess all relevant sustainability risks when conducting due diligence on investments
Due Diligence on Investments (Principal Adverse Sustainability Impacts)	Larger management companies (and those who choose to voluntarily comply with the principal adverse impact reporting obligation under the SDFR) must take into account principal adverse impact of investments on sustainability factors ⁵ .
Conflicts of Interest	Management companies must identify conflicts of interest which arise as a result of the integration of sustainability risks in processes, systems and controls.
Risk Management Policy	Assessment and management of exposure to sustainability risks must be incorporated into the risk management policy and procedures of the management company.
Organisational Requirements	Sustainability risk must be taken into account in the organisational structure of the management company and the management company.
Resources	Management companies must retain the necessary resources and expertise required for the integration of sustainability risks

We will keep readers updated on the progress of the proposed amendments to the UCITS and AIFMD legislative frameworks.

⁵ This provision has been included to ensure consistency with the SDFR under which management companies with an average of more than 500 employees (or other management companies who consider principal adverse impacts voluntarily) must disclose information on their due diligence policies on how they take the principal adverse impact of investments on sustainability factors. This in effect requires such management companies to revise their due diligence policies to address same. This obligation to do so is now implemented into the UCITS and AIFMD frameworks under the draft legislation. For further information on principal adverse impact reporting, please refer to our separate [client briefing](#) on the topic.

Conclusion

The suite of legislative measures relating to the integration of sustainability risk as outlined above are evidence of the European Commission's commitment to the "greening" of the financial sector as a key component in its action plan to achieve a climate-neutral EU by 2050. Enhanced transparency to investors in the form of website and prospectus disclosures to allow them to better understand their exposure to sustainability risks is also intended to help re-direct private monies into more sustainable investments. Given the significant obligations imposed on fund management companies relating to integration of sustainability risk under the new ESG framework, we would recommend that these entities to implement project plans now to ensure that they are in a position to comply with applicable obligations set down under the SDFR by 10 March 2021.

If you require any further assistance with implementing appropriate arrangements under the ESG framework, please contact your usual contact in the Dillon Eustace Asset Management and Investment Funds Team.

Dillon Eustace
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Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.



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