The New ESG Framework: Principal Adverse Impact Reporting

Introduction

In this, the first in our series of client briefings on the new ESG framework, we consider the obligation imposed on "financial market participants" under Regulation (EU) 2019/2088 (the "**SDFR**") to assess and report to investors on any principal adverse impacts of investment decisions on sustainability factors[1].

> "*Greening the financial sector is a first step to make investments flow in the right direction, so it serves the transition to a carbon neutral economy"*
>
> Sipra Pietikaienen, Lead Negotiator for the Environment Committee of the European Parliament, December 2019

In their Joint Consultation Paper on ESG Disclosures ("**Consultation Paper**") published in April, the ESAs[2] set down how they propose "financial market participants" inform investors about the consideration of sustainability factors in the investment decision-making and advisory processes. The proposals outlined in the Consultation Paper have gained much attention from many

[1] Sustainability factors are defined under the SDFR as environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters
[2] The ESAs comprise of the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)

stakeholders in the financial services sector due to the proposed obligations on financial market participants to disclose very granular ESG data in respect of investee companies to investors.[3]

The "principal adverse impact statement" is intended to show investors and prospective investors how investment decisions made by a financial market participant have or may have adverse impacts on sustainability factors relating to (i) climate and the environment and (ii) social and employee matters, respect for human rights, anti-corruption and anti-bribery matters. By proposing to require all relevant financial market participants to report against the same indicators and to use a template form of principal adverse impact statement, policy makers are hoping to encourage investors to compare the approaches to sustainable investment taken by different financial market participants so that they make more informed investment decisions. The ESAs believe that this in turn should help to redirect capital flows towards sustainable investment.

Scope of the obligations

UCITS management companies and AIFMs (including self-managed UCITS funds and internally–managed AIFs) constitute "financial market participants" (hereinafter referred to collectively as "**management companies**") under the SDFR. This obligation is imposed on all management companies, regardless of whether or not they manage "ESG funds"[4][5][6].

Larger management companies (defined as those with an average number of 500 employees or which are parent undertakings of a large group which has an average number of 500 employees) must comply with the disclosure obligations outlined below. However, management companies with less than an average of 500 employees can either choose to comply with this disclosure obligation or alternatively explain to investors why they do not consider adverse impacts of investment decisions on sustainability factors.

[3] Management companies may wish to provide their feedback on the draft regulatory technical standards before the consultation process closes on 1 September 2020. Feedback can be submitted via ESMA's webpage accessible from https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules
[4]ESG funds are those funds which either (i) promote environmental or social characteristics or (ii) have sustainable investments or reduction in carbon emissions as their objectives
[5] The term "AIFM" under the SDFR relies on the definition of "AIFM" used in Directive 2011/61/EU. We await further guidance as regards any impact of these obligations on non-EU AIFMs.
[6] It should be noted that this briefing focuses solely on the obligations of management companies under the SDFR and does not focus on other "financial market participants" such as investment firms providing portfolio management services to clients etc

What is a "principal adverse impact statement"?

It is a statement which must be published by in scope management companies which describes their due diligence policies on how they take the principal adverse impacts which investee companies have on sustainability factors into account when making investment decisions.

Where relevant, it must be published on the website of the management company by 10 March 2021.

The management company must provide information on how it identifies and prioritises "principal adverse" sustainability impacts and indicators, how it engages with investee companies on sustainability-related matters and the extent to which it adheres to responsible business conduct codes and internationally recognised standards for due diligence and reporting. As noted above, under the ESA proposals a template framework document must be used when preparing a principal adverse impacts statement. [7]

As a result, management companies will need to work with key stakeholders to revise their due diligence policies and internal processes to address these matters in advance of 10 March 2021.

When does the management company assess "principal adverse impacts" of investments on sustainability factors?

Each in-scope management company will be required to update its statement annually to provide investors with information on the principal adverse impact of its investment decision-making process on sustainability factors during the preceding "reference period". The Consultation Paper proposes that all management companies must report in respect of the same reference period which will cover the period from 1 January to 31 December of the preceding year, again to ensure the comparability of different funds or other financial products. In addition, the ESAs have proposed that comparisons against previous

[7] This template statement is currently set down in Annex 1 to the draft regulatory technical standards contained in Part 4 of the Consultation Paper

reference periods should be reported in the updated statement in order to show investors the progress made towards reducing the principal adverse impacts of investment decisions on environmental and societal factors during that period.

It is worth noting that management companies will not be required to include an assessment of the principal adverse impacts of investment decisions on sustainability factors in the statement published on their management companies on 10 March 2021 (the statement published on 10 March 2021 addressing primarily the due diligence policies in place to assess and prioritise principal adverse impacts on sustainability factors).

Under current proposals, in-scope management companies will be required to report on such assessment for the first time in the revised statement which must be published on their website by 30 June 2022.

How does the management company assess “principal adverse impacts” of investments on sustainability factors?

In order to ensure that investors will be able to compare the impact that the investment decisions taken by different management companies have or may have on sustainability factors, management companies must describe the “principal adverse impacts” using common reference points or “indicators” which will be set down in legislation.

Under the Consultation Paper, the ESAs have proposed that indicators are divided into “mandatory” indicators and “additional” indicators. Management companies will be required to report, in respect of each reference period, against all “mandatory” indicators and at least one additional “environmental” indicator and one additional “social” indicator.

The ESA have proposed that very specific indicators be used to report to investors on how investments have had a principal adverse impact on sustainability factors.

By way of example only, “environmental” mandatory indicators include reporting on the “*total energy consumption from non-renewable sources and share of non-renewable energy consumption*” by investee companies and the “*share of investments in entities without a deforestation policy*”. Proposed “social” mandatory indicators include the "*average gender pay gap of investee companies*" and "*share of investee companies without policies on the protection of whistleblowers*".

By way of example only, additional "environmental" indicators include "*investing in companies without carbon emission reduction initiatives*" while additional "social" indicators include "*reporting on the number of incidents of discrimination reported in investee companies"*.

Given the granular nature of the information to be reported in the principal adverse impacts statement, some management companies are understandably concerned about the ability to obtain relevant data from underlying investee companies which may be required if the management company is to comply with its disclosure obligations under the SDFR.

The ESAs recognise the challenges faced by management companies in obtaining the relevant ESG related data. In the Preliminary Impact Assessments in the Consultation Paper, they note that they are aware that "i*t may not be straightforward to assess the adverse impact of an investment decision due to the lack of reported data on a particular indicator. Nevertheless, the ESAs are convinced that the situation is improving, as evidenced by the growing share of ESG data provided by data providers."*

Helpfully large EU public interest entities with more than 500 employees will be required to report under the Non-Financial Reporting Directive[8] on how and to what extent their activities are associated with economic activities which qualify as environmentally sustainable under the Taxonomy Regulation. However given proposed timelines, it is likely that this information will only be published from 2023 onwards, resulting in a gap in available information for a period of time. In addition, such entities will not be required to report on the impact of their activities using social indicators. Challenges may also arise in obtaining relevant information in respect of non-EU investee companies or other EU investee companies which are not subject to any mandatory sustainability disclosure obligations (such as those set down in the Non-Financial Reporting Directive).

The recitals to the draft regulatory technical standards set down in the Consultation Paper outline a number of different ways in which financial market participants can gather data which is not included in the financial statements of, or otherwise routinely reported by, the investee company, such as through

[8] Directive 2014/34/EU

direct engagement with investee companies, using external market research providers or internal financial analysts and specialists in the area of sustainable investments.

However many financial market participants remain concerned about the significant gap between the level and type of information currently provided by investee companies on sustainability matters and the information which they will need in order to comply with their legal obligations as proposed under the draft regulatory technical standards as well as the associated cost implications of such compliance.

Obligations imposed on management companies which do not publish a principal adverse impacts statement

Smaller management companies which choose not to publish a principal adverse impacts statement must disclose on their website that they do not consider adverse impacts of their investment decisions on sustainability factors and the clear reasons for this. Investors should be informed, where relevant, whether and when the relevant management company intends to consider such adverse impacts. Under the ESA proposals, such management companies will be required to create a section on their website entitled "No Consideration of Sustainability Adverse Impacts". If enacted as currently proposed, this may encourage smaller management companies to opt-in to the full disclosure regime in order to avoid any potentially negative implications associated with publishing a statement on their website that they do not consider the adverse impact of investment decisions on sustainability factors.

Prospectus Disclosures

With effect from 30 December 2022, the prospectuses of funds under management must disclose how the relevant fund considers principal adverse impacts on sustainability factors in the investment decision-making process and a statement that further information on this matter is available from the relevant website. Where the management company does not consider principal adverse impacts as part of the investment decision making process applicable to the relevant fund, the prospectus of that fund should disclose that the management company does not take these matters into account and the reasons for this.

Action to be taken

While we are unlikely to have finalised regulatory technical standards until the end of 2020, we would suggest that management companies initiate their review process in the coming months with a view to being in a position to publish a principal adverse impact statement on their websites by 10 March 2021. This may include taking actions such as:

- Conducting an analysis as to whether they will fall within the scope of mandatory reporting or will voluntarily “opt-in” to this reporting obligation. For example, management companies which do not fall within the scope of the mandatory reporting regime but which do manage “ESG funds” may choose to “opt-in” in order to demonstrate their commitment to sustainable investing;
- Once this decision has been taken, management companies can, in conjunction with relevant stakeholders, begin to update internal policies and processes to map out how principal adverse impacts on sustainability factors are identified and prioritised within the investment process. This should include identifying the persons responsible for implementing these policies within the management company and considering whether the management company adheres to responsible business codes and internationally recognised standards for due diligence and reporting.*
- Monitoring the progress of the draft regulatory technical standards as these will incorporate the finalised template statement to be used for the website disclosure as well as setting down the indicators which must be used to assess the principal adverse impacts of investment decisions taken by the management company on sustainability factors;
- Giving consideration to implementing a framework to analyse how the management company will obtain relevant ESG data about underlying investee companies so that they can report against relevant indicators in respect of reference periods and identify any data challenges which are likely to arise;
- Reviewing existing contractual arrangements in place with delegate investment managers to consider whether any amendments are required to oblige them 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;
- For those smaller management companies which choose to “opt-out” of the relevant reporting regime, statement for disclosure on their website outlining why they do not consider the adverse impact of investment decisions on sustainability factors and, where relevant, whether and if so, when, they intend to consider same.

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* Recital 12 to the SDFR advises that financial market participants should consider the OECD Due Diligence Guidance for Responsible Business Conduct and the United Nations-supported Principles for Responsible Investment.

Despite the fact that management companies are unlikely to have finalised regulatory technical standards until the end of this year, given the onerous nature of the principal adverse impact reporting regime and the very tight timeframe for compliance once the regulatory technical standards are finalised, we are advising clients to engage early and carry out as much groundwork as possible between now and the end of the year to ensure that they can comply in full with their obligations come 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. Please also look out for the next in our series of briefings on the new ESG framework in which we consider the disclosure obligations which will apply in respect of ESG funds.

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