The New ESG Framework: Disclosure Obligations Imposed on ESG Funds

Introduction

Disclosure to investors is a key cornerstone of the SDFR with a clear distinction being drawn between the information to be provided to investors of "ESG funds" and to investors in non-ESG funds. In this, the second in our series of client briefings on the implications of the ESG framework for fund management companies[1] and funds, we consider the types of disclosures which the ESAs have proposed be provided to investors and prospective investors of ESG funds and the implications for both the management company and the board of directors of the relevant fund arising from this[2].

While all EU funds and non-EU AIFs which are marketed within the EU will be required to update their prospectuses by 10 March 2021 to provide investors with information on how sustainability risks are taken into account in the investment-decision making process applicable to the relevant fund[3], investors in ESG funds must be provided with significant additional information both prior to investing in the fund and during the life of

ESG funds comprise of

- Funds which promote environmental or social characteristics (although not exclusively) and which invest in companies that follow good governance practices ("**Article 8 funds**"); and
- Funds which have either sustainable investment or reduction in carbon emissions as their objective ("**Article 9 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.

Taxonomy Regulation: Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment.

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[1] All references to "management company" in this briefing should be construed as including self-managed UCITS funds and internally managed alternative investment funds.
[2] In our first client briefing on the new ESG framework, which is available here, we consider the principal adverse impact reporting obligations imposed on management companies.
[3] By 30 January 2022, the prospectus of all such funds (regardless of whether ESG funds or not) must be updated to include information on how the management company takes principal adverse impacts of investment decisions on sustainability factors into account.

the investment through periodic reports and information made available on the website of the management company.[4]

In order to determine the scope of disclosure obligations imposed on them under the ESG framework, management companies will therefore need in the first instance to conduct an inventory of funds under management to determine whether any fund constitutes an “ESG fund” and if so, categorise the relevant fund as an “Article 8 fund” or an “Article 9 fund”. Importantly, they will also need determine whether the relevant fund contributes to an environmental objective or promotes environmental characteristics as this category of funds is subject to additional disclosure obligations set down in the Taxonomy Regulation.

Legislative Framework[5]

The SDFR sets down the framework for the disclosure obligations imposed on ESG funds and tasks the ESAs with preparing regulatory technical standards by 30 December 2020[6] which will include more detailed and prescriptive disclosure requirements.

As noted above, the Taxonomy Regulation also imposes additional disclosure obligations on those ESG funds which promote environmental characteristics or contribute to an environmental objective. Those ESG funds which promote only social characteristics or pursue social objectives are not subject to any disclosure obligations under the Taxonomy Regulation.

The ESAs have published a consultation paper containing draft RTS under the SDFR (“**draft RTS**”) with interested parties having until 1 September 2020 to provide feedback on their proposals[7].

It should be noted at the outset that the ESAs have included a series of questions for stakeholders in the Consultation Paper on certain elements of the draft RTS and therefore the finalised regulatory technical standards may vary from the draft RTS. However, the draft RTS do provide some indicators as to the proposed direction of travel on the type of information which will need to be disclosed to investors in ESG funds under the new framework.

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[4] 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*” while Article 11 of the SDFR provides that the relevant disclosures must be disclosed in the annual reports referred to in Article 22 of AIFMD. The disclosure obligations set down in Article 23 and Article 24 of the AIFMD apply to an AIFM in respect of “*each of the EU AIFS that they manage and for each of the AIFSs 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 and periodic report 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.

[5] It is worth noting that the AMF in France published a position paper in March 2020 under which it requires all funds which are authorised for marketing to retail investors (including EU funds registered for sale in France) which indicate in their fund documentation that they pursue ESG investment strategies to include additional disclosures in relevant fund documentation.

[6] Under the SDFR, the ESAs are not required to present the draft technical standards on sustainability indicators to be used in respect of adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters. However, the ESAs have addressed these indicators in the draft RTS published in April 2020.

[7] 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

Objective of Disclosure Obligations

The ESG framework introduces for the first time harmonised disclosure obligations for funds which market themselves as ESG funds with the stated objective of combating "greenwashing"[8].

In addition to providing investors with ESG related information in the prospectus, management companies will be required to expand on these disclosures on their websites to provide investors with access to more detailed information not suitable to be set down in a pre-contractual document such as the prospectus.[9] Separately, the disclosures required to be made in the periodic reports are intended to require the management company to report on the success of the fund in achieving the relevant environmental/social characteristic(s) (in the case of Article 8 funds) or its sustainable investment objective (in the case of Article 9 funds). The legislators are hoping that this disclosure framework will mean that investors in ESG funds with "*all of the information necessary to properly inform end investors about the sustainability-related impact of their investments*"[10].

Under the draft RTS, a specific template will need to be followed when complying with prospectus and periodic report disclosure obligations. These templates were not included in the draft RTS, with the ESA noting that same would be prepared and published separately to the issue of its consultation paper.[11] In practice, this should allow investors to compare the ESG characteristics of financial products and should help to eliminate the uneven playing field for ESG funds within the EU which currently exists as a result of divergent disclosure standards and market-based practices.

Timeframes for Compliance

10 March 2021	• SDFR Prospectus Disclosures for ESG Funds • SDFR Periodic Report Disclosures for ESG Funds • Marketing Communications
1 January 2022	• SDFR Periodic Report Disclosures • Taxonomy Regulation Prospectus Disclosures (for funds which contribute to climate change mitigation and climate change adaptation) • Taxonomy Regulation Periodic Report Disclosures
1 January 2023	• Taxonomy Regulation Prospectus Disclosure (for funds which contribute to remaining four environmental objective

[8] Recital (9) of the draft Taxonomy Regulation describes greenwashing as "*the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards*".
[9] Recital 37 to the draft RTS outlines the purpose of website disclosures and notes as follows: "*Financial market participants should use website disclosures to disclose on specific items, to expand on topics disclosed in a concise way in pre-contractual documents, and to provide further information they deem relevant which will help end-investors better understand the investment strategies offered. Before a contract is closed, financial market participants should inform end-investors about the fact that more product-specific, detailed information can be found on the website and provide them with a link to that information*"
[10] Recital 24 to the SDFR.
[11] The ESAs have asked for feedback in the Consultation Paper on whether such templates should be prepared, what elements should be included and how same should be formatted.

Prospectus Disclosures

The SDFR requires that the prospectus of an “Article 8 fund” includes information on how the environmental/social characteristics being promoted by the fund are met while the prospectus of an “Article 9 fund” must disclose how the objective of sustainable investment is to be achieved. Where either category of fund uses a reference benchmark, additional disclosure is required.

The draft RTS give further colour as to the type of information which may need to be disclosed in the prospectus of any ESG fund. By way of overview, some of the key proposals put forward by the ESAs include:

(i) Use of a mandatory reporting template for the presentation of ESG information in the fund’s prospectus;

(ii) Inclusion of a graph to illustrate (i) the planned proportion of sustainable investments, (ii) other investments which, although not sustainable investments, contribute to the fund promoting environmental/social characteristics or attaining the objective of sustainable investments and (iii) the remainder of the investments. The ESAs propose that the prospectus should also distinguish between the planned proportion of direct holdings in investee companies and all other types of exposure generated to those companies;

(iii) Disclosure of the sustainability indicators used to measure whether or not the fund attains the environmental or social characteristics promoted by the fund/achieves its objective of sustainable investment;

(iv) Disclosure of information on the investment strategy used to attain environmental/social characteristics promoted by the fund or the objective of sustainable investments, including any exclusion policies applied to the investment universe[12]; and

(v) An explanation as to how sustainable investments held by the fund comply with the “Do No Significant Harm” principle.

Website Disclosures

The ESG-related information which must be disclosed in the prospectus of the relevant fund should be “complemented by website disclosure” which is intended to provide investors with meaningful information which is easily accessible which the ESAs believe is not suitable to be included in the prospectus.

[12] In order to prevent greenwashing, the ESAs have proposed that any non-binding criteria used to select underlying assets should not be disclosed in the fund prospectus

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Management companies are required under the SDFR to include on their websites a description of environmental or social characteristics or sustainable investment objective being pursued by the fund[13] as well as information on the methodologies used to monitor and measure the sustainability performance of the underlying investments. The website disclosure must also include the ESG information contained in the prospectus and periodic report of the relevant fund.

While the ESAs have not proposed that the information to be disclosed on the website must follow a template, the draft RTS published by them suggest that very prescriptive information be provided on the management company's website. The proposals include providing information on:

(i) How the management company monitors how the fund complies with the disclosed environmental or social characteristics promoted by the relevant fund or sustainable investment objective being pursued by the relevant fund (including the internal and external controls in place in respect of such monitoring) and the sustainability indicators used during the lifecycle of the fund for such purpose;

(ii) The due diligence carried out on underlying assets of the relevant fund and relevant internal and external controls in place in respect of such due diligence practices;

(iii) The data sources used by the management company to monitor the ESG performance of the underlying assets, the measures taken to ensure data quality and the proportion of data that is estimated. The limitations of methodologies and data sources used should also be disclosed; and

(iv) Where a reference benchmark is used, a hyperlink to the website of the benchmark administrator which provides specific information about that benchmark.

Concept of "Do No Significant Harm

Under the SDFR, in order to constitute a "sustainable investment", an investment cannot significantly harm any of the environmental or social objectives contained in the definition of "sustainable investment". The concept of "Do No Significant Harm" is also a key concept in the Taxonomy Regulation. This regulation requires that in order for an investment to be considered to be environmentally sustainable, it must not only contribute substantially to one or more of the environmental objectives set down in that regulation, but in addition, it cannot significantly harm any of the other environmental objectives. When determining whether or not an investment does "significant harm", the management company must take the indicators used for principal adverse impact reporting (which are set down in Annex I to the draft RTS) into account.

[13] This includes any fund which pursues an objective of reduction of carbon emissions

Periodic Reports

As noted above, the requirement to report on ESG related matters in the periodic reports is intended to ensure that investors are provided with information on the success of the fund in achieving the relevant environmental/social characteristic(s) (in the case of Article 8 funds) or its sustainable investment objective (in the case of Article 9 funds).

The SDFR itself requires that the periodic reports disclose the extent to which environmental or social characteristics have been met or the overall sustainability-related impact of the fund.

This is expanded upon in the draft RTS in which the ESAs propose that the periodic reports include (without limitation) the following information:

(i) The extent to which the fund has met its chosen environmental/social characteristics or sustainable investment objectives using both qualitative and quantitative indicators which are specified in the draft RTS. These include reporting against sustainability indicators used;

(ii) How sustainable investments held during the reporting period have complied with the "Do No Significant Harm" principle;

(iii) An historical comparison between the current reference period and previous reference periods, again presumably to allow end-investors to monitor the relative progress of the management company in ESG related matters;

(iv) Similar to the graph which must be disclosed in the prospectus, the periodic report should include a graph which illustrates (a) the proportion of total investments that are sustainable investments, (b) other investments which although not sustainable investments, contribute to the fund promoting environmental/social characteristics or attaining the objective of sustainable investments and (c) the remainder of the investments for the relevant reporting period. This should allow investors to compare the planned proportion of investment in sustainable investments as disclosed in the prospectus against the actual make-up of the portfolio for the relevant reporting period. The draft RTS propose that the proportion of investments in different sectors and sub-sectors such as fossil fuels sectors should be disclosed and that the periodic reports should distinguish between direct holdings in investee companies and all other types of exposures to those companies during the reporting period;

(v) Where either category of fund uses a reference benchmark, additional disclosure is required; and

(vi) The action taken during the reporting period to attain the environmental/social characteristics or the objective of sustainable investment (including shareholder engagement).

The SDFR provides that the periodic disclosure obligations apply from 1 January 2022. We interpret this as meaning that the relevant ESG disclosures must be included in the periodic reports covering any period beginning on or after 1 January 2022.

Taxonomy Regulation Requirements: Prospectus and Periodic Reports

"Environmental" ESG funds will be required to comply with additional disclosure obligations in both their prospectuses and their periodic reports under the Taxonomy Regulations. These include:

(i) Which environmental objective(s) the investments of the fund contribute;

(ii) How and to what extent the investments of the fund are in economic activities that qualify as environmentally sustainable under Article 3 of Taxonomy Regulation; and

(iii) Proportion of investments in environmentally sustainable economic activities as a percentage of all investments selected for the fund.*

* Article 8 funds must also include a disclaimer that the "Do No Significant Harm" principle only applies to investments which take into account EU criteria for environmentally sustainable economic activities and that the investments underlying the remaining proportion of the fund do not taken into account the EU criteria for environmentally sustainable economic activities.

Marketing Communications

Marketing communications relating to ESG funds will need to be reviewed and where necessary updated before 10 March 2021 to the extent that they contain information which is inconsistent with the disclosures which are required to be made under the SDFR.

Action to be taken by management companies of ESG funds

- Categorise relevant fund as a (i) non-ESG fund, (ii) an Article 8 or (iii) an Article 9 fund as this will determine the specific disclosures to be provided.
- Determine whether the ESG Fund pursues an environmental objective/environmental characteristic. If so, the disclosures required under the Taxonomy Regulation as detailed above will need to be included in the prospectus and periodic reports in due course;
- Track the progress of the draft RTS as these will determine the content of the ESG disclosures to be included in the prospectus, website disclosure and periodic reports;
- Implement a project plan identifying key stakeholders (both within the organisation and including any delegate investment manager appointed by the management company) who will need to implement internal procedures in order to gather and provide relevant information required to allow the management company to comply with its disclosure obligations
- Review existing investment management agreements in place to determine whether same should be updated to address obligations imposed on management companies under the ESG framework;
- Draft prospectus and website disclosures to be prepared and presented to the board of the management company and draft prospectus disclosures to be presented to the board of the relevant fund for their consideration and approval.
- Conduct a review of all marketing materials to ensure that they do not contradict the information disclosed in the prospectus/website disclosure/periodic reports;
- Prospectus disclosures to be filed with and noted by the Central Bank and published on or before 10 March 2021. Website disclosures to be published on or before 10 March 2021;
- Internal processes to be put in place in order for the management company to incorporate relevant ESG disclosures in periodic reports of ESG funds in respect of reporting periods beginning on or after 1 January 2022;
- Revise prospectus and periodic reports disclosure to incorporate additional disclosures required under the Taxonomy Regulation by relevant deadlines (See above for further details).

Implications for the board of directors of externally managed ESG funds

As noted above, the obligations imposed on management companies under the SDFR and, where relevant, the Taxonomy Regulation will necessitate amendments to fund's prospectus as well as additional ESG related disclosures being included in the periodic reports of the relevant funds. Changes may also need to be made to the marketing communications of relevant funds.

The board of directors of externally managed funds should therefore ensure that they obtain all draft disclosures in good time to allow them to consider the proposed amendments to the fund documentation in advance of relevant deadlines.

Conclusion

While the legislative framework has not yet been finalised, it is already very clear that the ESG framework marks a new departure for the type and level of information which will need to be provided to investors of ESG funds from 10 March 2021 onwards.

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 integration of sustainability risk into the operations of EU management companies.

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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