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European Union Further Refines Its Sustainable Investment Regulations

Ezra Zahabi, partner with Akin Gump's London office, discusses the state of ESG investing in Europe, including the latest EU regulations, how the new laws will effect the post-Brexit UK, and where she sees ESG investing going in the future.

CCBJ: Please share some background about what led up to the new regulations around environmental, social and corporate governance (ESG) investing in the EU and when they will come into effect.

Ezra Zahabi: The background for the new rules in the EU comes from the United Nations Framework Convention on Climate Change, which is an international framework for dealing with climate change. More recently the Paris Agreement committed the signatories to using their best efforts to further the objectives of keeping a global temperature rise this century below 2 degrees Celsius (3.6 degrees Fahrenheit) above pre-industrial levels. Those two big international conventions have given rise to more specific initiatives, including the EU's Sustainable Finance Action Plan and the European Green Deal.

These initiatives seek to transition the European economy to a more resource-efficient and sustainable economic model and to build a financial system that is capable of supporting sustainable growth. One of the key elements of these initiatives is finding mechanisms within the financial markets to organically guide capital flows to more sustainable sectors and to change market behavior through drivers like investor pressure. A cornerstone to the successful redirection of capital flows is transparency, so the new ESG disclosure requirements form one of the key steps toward achieving that recalibration.

What are the new requirements?

There are two new European regulations that are specifically focused on ESG investing. These complement and build on other ESG focused requirements, including the 2019 revised Shareholder Rights Directive (SRD), which requires investment managers and certain institutional investors to publicly report on their shareholder engagement and voting behavior. The two new regulations are the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation. The SFDR basically introduces a new regime of disclosures around ESG issues for investment managers and other "financial market participants." That includes occupational pension schemes, investment advisors, and other kinds of institutional investors and asset managers.

Investment managers and other institutional investors will be required to disclose information about how they approach ESG in their investment process. Investment managers will need to publish statements describing their approach to ESG and how they incorporate sustainability risks in their investment process. Flowing from that disclosure, other disclosure requirements will provide further information on the manager's ESG approach. Many of those requirements apply on a "comply or explain" basis. So the focus of the ESG disclosure requirements is really to get large investors to show how they approach ESG issues and how they integrate sustainability risks into their investment decision-making processes. Once they've described that, they then have to decide whether to comply or explain in further disclosures. In contrast to some existing disclosures, these disclosures are likely to be relatively granular, which is necessary for the disclosure to be meaningful, so in practice the disclosure will need to be relevant to the specific asset class and market.

The terminology in the regulation is pretty dense, however, managers can elect to specify whether or not their investment processes take into consideration the negative impacts of their investment decisions on the environment, social equality or other areas.

The ESG disclosures are phrased to require disclosure of the impact of investments on “sustainability factors.” This is a really broad concept which encompasses environmental matters, social and employee matters, respect for human rights, anticorruption and anti-bribery matters. So when managers disclose their ESG approach, they have to think carefully what they are saying about what the manager really factors in the investment process and how these various considerations actually manifest.

What that really means is that if managers state they are taking into account the ESG impact of their investments, they will need to produce and assess data about their portfolio and its impact on the ESG issues they have identified as relevant to the manager. So, for instance, let’s say a portfolio is heavily invested in the energy sector in enterprises focused on extracting and processing fossil fuels. The manager needs to have data on the basis of which it can assess the portfolio against highly prescribed key performance indicators such as carbon footprint, deforestation etc. in order to express the impact of its investment decisions on sustainability factors.

The secondary legislation that sets out the granular disclosure requirements has been delayed but when it takes effect, managers will need to disclose against some 50 key performance indicators or data fields, more than 30 of those being mandatory. The secondary legislation sets out formulae and very detailed definitions of certain concepts.

The granularity and quantitative nature of the disclosures require managers to have adequate due diligence policies

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and data frameworks that take into consideration the negative impacts of investment decisions on sustainability, and allow them to disclose in a way that's consistent with the EU regulations. There is a great deal of work involved in upgrading internal processes to allow for the same.

The ESG concept under the SFDR is really broad. However, in practice, this first wave of disclosure is more focused on climate change and environmental issues. The Taxonomy Regulation chiefly focuses on environmental issues but it provides a potential framework also for the social and governance issues. The focus at the moment is very much on the environmental issues and on climate change in particular.

Under the SFDR, the high-level disclosure obligations will take effect on March 10, 2021. In regard to the secondary legislation, there has been concern in the markets in Europe about the ability of investors and asset managers to comply with the new super-prescribed, granular disclosure standard. The effective date of the secondary legislation has been postponed and it won't take effect until after 2021.

Because ESG and climate awareness have been on the political agenda for a long time – especially among European investment managers who have been subject to various domestic regulations that require them to take climate change into consideration – many managers have integrated ESG concerns into their vernacular when dealing with investors. They demonstrate an understanding of ESG issues, and they've indicated that they may have an interest in ESG policy, but really, when it comes down to it, many of those managers are, at heart, value investors. So they may talk about ESG, and may even genuinely take it into consideration, but nevertheless it's not actually fully integrated into their due diligence or decision-making processes. So another key concern for the European Commission has been to address what they see as "greenwashing" in the financial markets, meaning the promotion of financial products where, if you scratch below the surface and look beyond the marketing talk around ESG, it becomes clear that the strategy is really just value investing.

Some managers will need to consider and comply with additional disclosure requirements for the so-called "light green" or "Article 8" products, which are distinct from the "dark green" products that truly have sustainable investments as the investment objective. I think most managers know whether they're actually in dark green territory, but some will need to determine whether their products are being sold as "promoting sustainable characteristics" such as to require additional disclosure. The regulatory goal is to standardize disclosure to enable meaningful comparison and require managers to disclose in their pre-contractual documentation how exactly they're achieving the ESG objectives they state they are committed to. So if a manager is promoting empowering women entrepreneurs or green energy or any other sustainability factors, it has to explain what it is actually doing in order to achieve the characteristics that it is promoting. Similarly, if there are reference benchmarks, like certain indices, for example, there will be various tools that institutional investors and investment managers can use to analyze their investment decision-making process

and to pull out the necessary information to assess whether something is sustainable or not. It's expected that the "light green" and "dark green" disclosure will be standardized in prescribed format.

That's quite a bit to consider. How will all of this impact financial institutions?

One of the key questions is really about performance. There's some concern that a greater push toward sustainable investment might result in poor overall short-term performance, which might be a problem for certain institutional investors.

Another potential effect is that many managers are going to be pushed into a space where they really need to think about how they make their investment decisions at a much more granular level. I think that many managers – even the ones who think that they have ESG within the scope of their investment horizon in some way – are not necessarily prepared for these new regulations. So there's going to be a need for the senior management at these financial firms to really think about what the firm is actually doing, how far are they willing to go, what they are really going to change if they want to state in their disclosures that they do consider ESG impacts. They will need to engage with investors to understand what their expectations are now and where they think the asset managers and leaders are going in the future. Where are they going to be in terms of practices and disclosures in five year's time or in 10 year's time?

We expect there is going to be more engagement with investors on ESG matters and investors' expectations, which will find its way into the due diligence questionnaires in an increasingly detailed way. There will likely be periodic reporting requirements on ESG performance going forward, and so there's going to be a push for increased transparency in these areas.

As a practical matter, in the short term, it may be about how firms can comply in order to make sure they're not in breach of their legal obligations. But in the longer term, I think it's really about engaging with investors and understanding how they're expecting managers to approach ESG and what information they will want to see. And that part of the process, the longer term, is likely to involve things that are currently talked about more than done in actual practice – things like potential tax benefits or other sorts of financial incentives around investing in

sustainable sectors, quite possibly combined with some form of potential financial penalties.

How does Brexit play into this?

The United Kingdom stands apart from the EU now, but it also has climate change action high on its political agenda. The UK is an active member of the Financial Stability Board and has already been discussing the role of the financial sector and financial markets in mitigating the adverse impacts of climate change. The UK also has its own Green Finance Strategy, and it is expected that all large asset owners, as well as all large issuers, are going to be required to report in line with the Task Force on Climate-Related Financial Disclosures. This basically means that financial accounts will have to include climate-related financial disclosures.

In the UK, I think the agenda is probably more about ensuring that the companies and the issuers – i.e., the investee companies – produce and disclose adequate information to make sustainable investing a meaningful exercise. Contrary to expectation earlier in the year, the UK will not implement the SFDR on March 10. I think that it was largely thought that the UK would implement the EU framework, since the UK and EU financial markets are highly interlinked and it will be tremendously onerous to have two separate disclosure regimes, especially if they are very similar but not identical.

In any case, the UK is going to have its own regime, which it has stated will be closely aligned with the SFDR. It is unlikely to be identical to the SFDR, and the devil may well be in the detail there. The longer-term hope is that once the political dust of the UK's withdrawal from the EU

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settles, there will be some kind of an equivalency decision or a substitutive compliance mechanism. I think there is a good chance that some arrangement will be agreed between the EU and the UK by which if compliance with one set of rules satisfies compliance with the other, because trying to produce two sets very similar but not identical disclosures will just double the work.

The UK Financial Conduct Authority is expected to put out a consultation paper on the new disclosure requirements in the first half of 2021, with the final rules available at the end of 2021. The new regime is expected to become effective in 2022, a slightly later timescale than SFDR.

Where do you think the ESG space overall is going from here?

There's going to be significant movement, especially around development of investment research and rating tools that allow investment decisions to be made in a way that's objectively justifiable, verifiable and consistent. The development of these tools will also make compliance and integration of ESG considerations in the investment process more affordable and manageable for asset managers. Some firms may have already developed their own proprietary technology around ESG, but for those that haven't, they will be reliant on prepackaged solutions. They may seek to modify them, but they'll need some external tools to actually implement ESG considerations in a systematic and a cohesive way within their internal decision-making processes.

I think the other big thing to think about is investor engagement, which I think will be a longer-term process and a longer-term dialogue between asset managers and investors, in terms of addressing the standards that are absolutely worthwhile and worthy of committing energy and resources to. Also, there are potentially conversations to be had about concerns that both managers and investors may have around the shorter-term performance of assets.

There are also concerns, of course, that these regulations will limit a manager's ability to create exposures to investing in companies that are not deemed to be sustainable as defined by the new framework – I mean, that's the ultimate policy objective of the rules. The goal, really, is that change in the corporate sector, in terms of the commercial practices of companies on the ground, can be driven by the drying up of available capital, unless they change their unsustainable practices. So, part of the concern is that there is going to be more active shareholder engagement on matters relating to ESG. While issuers may not all welcome this unequivocally, it is unlikely to come as a surprise as they have been grappling with these issues for some time. ■

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