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ESG Disclosures: Guiding Principles and Best Practices for Investment Managers

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Whether preparing or reviewing Environmental, Social, and Governance (ESG) disclosures for compliance with regulatory requirements in the EU, the United Kingdom (UK) or the United States (US), or for alignment with ESG best practices more broadly in response to investor demand, investment managers and their funds should consider certain guiding principles and best practices.

In the EU, the advice[1] provided by the Securities and Markets Stakeholder Group[2] ("EU Stakeholder Group") to the European Supervisory Authorities[3] (ESAs) on the draft ESG disclosure templates[4] under the Sustainable Finance Disclosure Regulation (SFDR) highlights a number of guiding principles and best practices, which are relevant irrespective of whether an investment manager or its funds are subject to the SFDR.

The Task Force on Climate-related Financial Disclosures (TCFD) Recommendations, on which the UK disclosures regime will be based, also include seven fundamental principles "to help achieve high-quality and decision-useful disclosures that enable users to understand the impact of climate change."[5] Similar guiding principles were also echoed by the Financial Conduct Authority's (FCA) Director of Strategy in his speech on sustainable investments, during which he also stated that "immediate areas of focus are the SFDR and the EU's Taxonomy for sustainable activities."[6]

In the US, the ESG Sub-committee of the Securities and Exchange Commission's (SEC) Asset Management Advisory Committee[7] reviewed current ESG practices for investment products in the US and proposed a number of recommendations to the SEC on the "best practices to enhance ESG investment product disclosure."[8]

We outline below some of these guiding principles and best practices, as derived from the respective stakeholders groups and insights from regulators. The various guiding principles and recommendations deal with disclosure requirements and practices from the broad perspective of both sophisticated as well as retail investors. However, investment managers that only focus on providing funds or investment services to professional investors will find that at least some, if not all, of the principles may be applied in relation to professional investors.

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Guiding Principles and Best Practices

At a high level, investment managers should consider the following guiding principles and best practices for the purposes of preparing and drafting effective ESG disclosures or in the review of their existing disclosures and practices:

- **Including essential information only**: Investors should be provided with all of the essential information in one document, if possible, and such information should not be lengthy or repetitive. Investment managers should consider the length of any ESG-focused disclosures in light of their current disclosure requirements to avoid unnecessary duplication and an information overload for investors. The content of the disclosures should be "relevant" as well as "specific and complete."[9] Related to this is also ensuring that the disclosures are made in a timely manner.[10]
- **Prominently displaying a summary of key information**: Any granular information about a fund or portfolio should be provided in the body of the disclosures and should be preceded by a summary of the key information placed at the start of the document to facilitate decision making for less sophisticated investors. The EU Stakeholder Group recommends the use of drop-down menus or hyperlinks to give investors the option to read the sections they find most interesting without overloading them with information.
- **Ensuring consistency in communications**: In the words of the FCA's Director of Strategy, "firms should ensure their communications are 'clear, fair and not misleading'. What we don't expect to see is firms exaggerating their products' green credentials. That's 'greenwashing' and misleads investors."[11] Simil arly, the TCFD's principles for effective disclosure state that disclosure should be "clear, balanced and understandable."[12] The disclosures should also be consistent across all marketing material and communications in whatever form, whether on a manager's website or in precontractual documentation. In practice, this means that a manager should ensure that its approach to ESG is consistent both in the detailed drafting of the disclosures as well as in its approach to ESG more broadly within the firm to ensure that it is compliant with the FCA's fundamental principles on client communications. In addition, "disclosure should be consistent over time" and not simply around the time the relevant communications have been made.[13]
- **Standardising the disclosures**: Disclosures should be standardised to the extent possible to facilitate comparability.[14] If a manager is not subject to a requirement to use the templates prescribed by the SFDR, it should nonetheless standardise the manner in which it provides disclosures to investors across its own funds and portfolios. This might include drawing upon some of the characteristics in the SFDR or other industry templates to facilitate comparison.
- **Integrating ESG disclosures into existing disclosure requirements**: ESG-related disclosures should be sufficiently integrated into a manager's existing disclosure requirements and documentation (e.g., a private placement memorandum (PPM) for precontractual disclosures or an annual report for periodic disclosures). The need to properly integrate ESG disclosures into existing disclosures is also highlighted by the SEC's advisory ESG Sub-committee, which recommended that "material ESG risks be disclosed in a manner that is consistent with the presentation of other financial disclosures…including integrating ESG

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disclosures into required SEC filings and reports."[15] For optimal integration, a manager should consider:

- **Adequately describing investment objectives and strategies**: A fund should clearly describe its ESG objectives or focus in its investment objectives and in the description of its investment strategies. In the description of the investment objectives, "best practice would be to indicate any specific priorities in these objectives – whether risk/return objectives come above or below social objectives, or are equal priorities, for example."[16] The SEC ESG Sub-committee also adds, "for risk/return objectives, it would be helpful to identify the time horizon over which those objectives are designed to be accomplished."[17] For describing the investment strategies, the Sub-committee has recommended using a specific taxonomy for the purposes of categorising an investment product's strategies.[18]
- **Using an Annex**: Where appropriate, ESG-specific disclosures may be provided by way of an Annex to the standard non-ESG-related information. An Annex allows for greater uniformity, a higher level of standardisation and easier comparison. The Annex format also facilitates updating the information from time to time, such as if appended as a supplement to a PPM.
- **Including cross-references to other relevant disclosures**: Cross-references may be used to ensure that investors consider all material and relevant information prior to making an investment decision. By way of example, an ESG disclosure may provide a link to the non-ESG disclosure requirements where these are not within the same document. For EU retail investors, the EU Stakeholder Group is advocating for the inclusion of ESG disclosures by way of a link in the Packaged Retail and Insurance-based Investment Products (PRIIPs) Key Information Document (KID) ("PRIIPs KID"). However, the use of cross-references or links to other sources of information should not be excessive, nor require an investor to search for the relevant information, or otherwise obscure it in the volume of general information provided. The disclosure itself should at least provide some substantive information (e.g., in summary form), and any cross-references or links to other information should be to the exact place where that information may be found. Any links should be maintained over time to ensure that investors do not find broken links where information is no longer available.
- **Dedicated section in Annual Reports**: For ongoing disclosures, an investment manager may consider the inclusion of a new "Sustainability Discussion and Analysis" (SD&A) section within its annual report to investors. The inclusion was considered "reasonable middle ground between those who favor mandatory disclosure" of ESG information and "those who remain skeptical of whether such information is decision-useful for investors" in recent commentary by certain members of the SEC.[19] Within the SD&A section, a manager would "identify and explain the three sustainability issues most significant to their operations."[20]

- **Correctly using graphs, images and colours**: The use of graphs and images in disclosures for ESG-focused products is encouraged where these contribute to making a disclosure document "lighter, shorter and easier to understand," particularly for less sophisticated investors.[21] However, investment managers should consider whether the use of images or icons in connection with ESG disclosures might be confusing or misleading. For example, the EU Stakeholder Group has commented on situations where the proper use of colours may prove helpful for investors to easily distinguish between different types of data, but may also be misleading if the colours are not used carefully (e.g., using shades of green to disclose portions of an investment portfolio that are not ESG-focused).[22]

- **Using labels and meaningfully complying with industry codes**: ESG labels are one way of demonstrating that a fund or other financial product meets certain objective standards or criteria. In the EU, harmonised ESG labelling is being introduced through the Taxonomy Regulation[23], which establishes an EU-wide classification system for the purposes of identifying the degree to which economic activities can be considered environmentally sustainable. In the US, the SEC ESG Sub-committee is recommending "alignment with the taxonomy developed by the ICI ESG Working Group," which has developed a taxonomy for categorising ESG investment strategies.[24] To avoid "greenwashing,"[25] the use of ESG labels or commitments to adhere to industry standards should only be made if there is a meaningful commitment to comply or adhere to those standards.
- **Using explanatory notes where necessary**: The use of explanatory notes in disclosures may be helpful for less sophisticated investors to understand the concepts used in ESG disclosures. Whilst this may be of less importance for sophisticated investors familiar with EU ESG disclosures, defining certain terms and concepts derived from EU legislation may be helpful for non-EU investors, given the very distinct meanings attributed to such terms by EU Regulations such as the SFDR and the Taxonomy Regulation.
- **Clearly distinguishing between types of ESG products and/or investments within a portfolio**: This principle is generally relevant where a manager offers one or more funds with different types of ESG credentials, or if the investments within a particular fund's portfolio have different types of ESG credentials. The important point here is that fund-specific disclosures should be sufficiently clear for an investor to understand the type of ESG characteristics (if any) of a particular fund and, if applicable, the level of investments within the portfolio that will have an ESG focus by reference to the composition of the entirety of the investment portfolio.
- **Using online and other types of electronic disclosures with consideration**: The EU Stakeholder Group advocates the use of online disclosures and templates as a means of simplifying the manner in which information is disclosed to investors. Equally, the EU Stakeholder Group states that consideration should be given to investors that may prefer receiving hard copies of the documents, such as by ensuring that printer-friendly versions are available for those who would like them printed.
- **Other considerations**: The drafting of ESG disclosures is not an end in itself, but rather is one of various considerations in a manager's approach to ESG. Other considerations include:
  - **Data quality**: The information used and disclosed to investors should be reliable.[26] The FCA is concerned that investee companies' ESG disclosures are "often incomplete and difficult to compare across companies" and that, as a result, managers are relying on ESG ratings issued by rating agencies in order to evaluate investment opportunities.[27] In this regard, the FCA warns against the mechanistic reliance on ratings "without a detailed understanding of the

methodologies the providers apply and careful consideration of whether they are fit for purpose."[28] A manager should carry out its own due diligence on the quality of any available ESG data, such as ESG ratings, in relation to a particular investment opportunity. The FCA recommends that firms "understand their source and derivation [of ESG data], and articulate clearly and accessibly how it is used."[29]

– **Product design**: The name of a fund and the description of its investment objectives and policies should be set out clearly and accurately in order to avoid creating false expectations for investors about the fund or portfolio's actual holdings. In the words of the FCA, "including some words in a product's name or stated objective – 'green', 'ESG', 'impact', 'climate' – may create expectations" that are not met.[30] Similar considerations are being discussed in the US, which led to the inclusion of ESG in the SEC's "Request for Comments on Fund Names" earlier this year to address potentially misleading fund names.[31]

  A product's investment strategy should set out clearly how its sustainability objectives will be met, including by expressly describing any investment restrictions. According to the FCA, this includes describing any screening criteria, the anticipated portfolio holdings, the fund's approach to stewardship and the action the manager intends to take in the event that an investee company fails to meet its desired milestones.[32]

– **Ongoing performance reporting and disclosures**: The FCA stated that best practice requires a manager to periodically report to investors on the fund or portfolio's performance against the set sustainability objectives in a manner that is "quantifiable and measurable," so that an investor can understand whether the stated objectives have been achieved.[33] As such, the sustainability objectives disclosed to investors should be verifiable and objective.[34] In addition, ongoing performance reporting should be made on a timely basis (e.g., by inclusion of such information in the annual report to investors). The SEC ESG Sub-committee has suggested that "a best practice would be to explain how the product achieved its top objectives, and, ideally, how these are estimated to have contributed to return."[35]

[1] Advice to the ESAs: SMSG advice on the ESAs' Survey on templates for Environmental and/or Social financial products under SFDR, 23 October 2020 (See here).

[2] The Securities and Markets Stakeholders Group (SMSG) is a group of stakeholders (comprised of EU industry representatives and other financial market participants, investors, academics and others) established pursuant to Article 37 of EU Regulation (EU) No. 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority). The Group was set up "to help facilitate consultation with stakeholders in areas relevant to the tasks of the Authority." The Group is consulted on the drafting of regulatory technical standards, implementing technical standards, guidelines and recommendations under EU legislation. It was set up to facilitate consultation between ESMA, its Board of Supervisors and EU stakeholders, on ESMA's areas of responsibility and to provide technical advice on its policy development. The Group's mission is to help ensure that stakeholders can contribute to the formulation of policy from an early stage.

[3] The ESAs are, collectively, the European Banking Authority (EBA), ESMA and the European Insurance and Occupational Pensions Authority (EIOPA).

[4] The ESAs published a survey on 21 September 2020 seeking public feedback on presentational aspects of product templates, pursuant to Article 8(3), Article 9(5) and Article 11(4) of SFDR. The survey closed on 16 October 2020 (See here).

[5] Recommendations of the Task Force on Climate-related Financial Disclosures, Final Report, June 2017 (See here).

[6] Building trust in sustainable investments, Speech by Richard Monks, FCA Director of Strategy, delivered at the SRI Services and Partners 'Good Money Week' panel discussion, published on 23 November 2020 (See here).

[7] The Asset Management Advisory Committee (AMAC) established a sub-committee to review matters concerning ESG investment products and make recommendations regarding these products for consideration by the AMAC. The AMAC was formed to provide the SEC "with diverse perspectives on asset management and related advice and recommendations. Topics the committee may address include trends and developments affecting investors and market participants, the effects of globalisation, and changes in the role of technology and service providers. The committee is comprised of a group of outside experts, including individuals representing the views of retail and institutional investors, small and large funds, intermediaries, and other market participants." (See here).

[8] U.S. Securities and Exchange Commission, Asset Management Advisory Committee, Potential Recommendations of ESG Sub-committee, 1 December 2020 (See here).

[9] Principles 1 and 2 of the Fundament Principles for Effective Disclosure, Section F, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017, (See here).

[10] *Ibid*, Principle 7.

[11] Building trust in sustainable investments, Speech by Richard Monks, FCA Director of Strategy, delivered at the SRI Services and Partners 'Good Money Week' panel discussion, published on 23 November 2020 (See here).

[12] Principle 3 of the Fundament Principles for Effective Disclosure, Section F, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017 (See here).

[13] *Ibid*, Principle 4.

[14] *Ibid*, Principle 5: "Disclosure should be comparable among companies within a sector industry or portfolio".

[15] U.S. Securities and Exchange Commission, Asset Management Advisory Committee, Potential Recommendations of ESG Sub-committee, December 1, 2020 (See here).

[16] *Ibid*.

[17] *Ibid*.

[18] *Ibid*. The SEC ESG Sub-committee has recommended using the Investment Company Institute (ICI) ESG Working Group's taxonomy for categorising investment strategies in one or more of three categories of ESG strategies: Inclusionary Investing, Exclusionary Investing and Impact Investing, as set out in its publication "Funds' Use of ESG Integration and Sustainable Investing Strategies: An Introduction", July 2020. The ICI ESG Working Group is composed of senior executives from ICI member firms and was created to review how funds describe ESG integration and sustainable investing strategies (See here).

[19] Comment: Making Mandatory Sustainability Disclosure a Reality, Rick A. Fleming and Alexandra M. Ledbetter, published on the SEC's website on October 1, 2020 (See here). Rick A. Fleming is the Investor Advocate at the U.S. Securities and Exchange Commission (SEC). Alexandra M. Ledbetter is currently the Senior Corporation Finance Counsel in the SEC's Office of the Investor Advocate, where she serves as Mr. Fleming's principal advisor on issues related to corporate governance and disclosure.

[20] *Ibid*.

[21] Advice to the ESAs: SMSG advice on the ESAs' Survey on templates for Environmental and/or Social financial products under SFDR, 23 October 2020 (See here).

[22] *Ibid*.

[23] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (See here).

[24] U.S. Securities and Exchange Commission, Asset Management Advisory Committee, Potential Recommendations of ESG Sub-committee, 1 December 2020 (See here).

[25] "Greenwashing" is the practice of making misleading claims about the ESG characteristics of an investment fund/portfolio or about the standards and practices adopted or adhered to by an investment manager on ESG matters. The result of greenwashing is making an investment manager or a fund/portfolio appear to be more ESG-friendly than what it truly is.

[26] Principle 6 of the Fundament Principles for Effective Disclosure, Section F, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017 (See here).

[27] Building trust in sustainable investments, Speech by Richard Monks, FCA Director of Strategy, delivered at the SRI Services and Partners 'Good Money Week' panel discussion, published on 23 November 2020 (See here).

[28] *Ibid*.

[29] *Ibid*.

[30] *Ibid*.

[31] U.S. Securities and Exchange Commission, Request for Comments on Fund Names, Release Nos. IC–33809; File No. S7-04-20, 2 March 2020 (See here).

[32] Building trust in sustainable investments, Speech by Richard Monks, FCA Director of Strategy, delivered at the SRI Services and Partners 'Good Money Week' panel discussion, published on 23 November 2020 (See here).

[33] *Ibid*.

[34] Principle 6 of the Fundament Principles for Effective Disclosure, Section F, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017 (See here).

[35] U.S. Securities and Exchange Commission, Asset Management Advisory Committee, Potential Recommendations of ESG Sub-committee, 1 December 2020 (See here).

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