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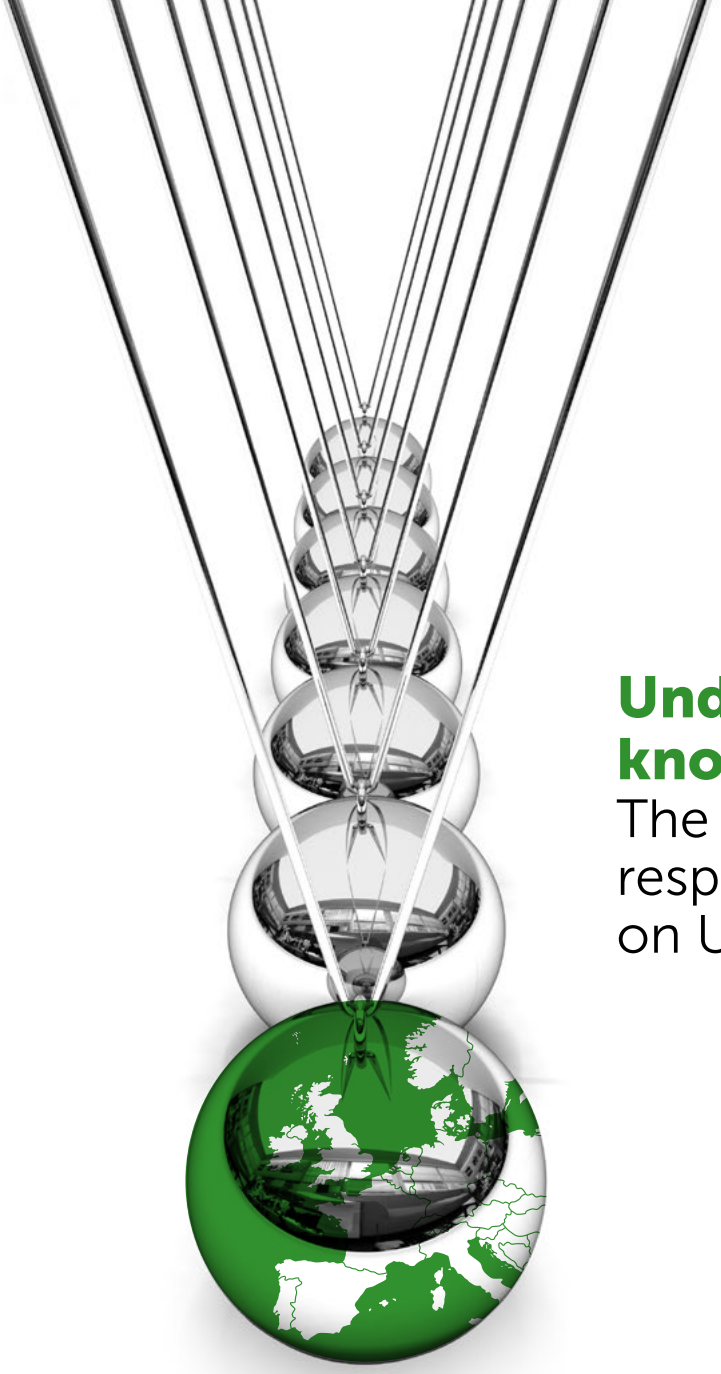

Understanding the knock-on effect

The impact of ESG and responsible investing on UK asset managers

Introduction

Very few issues have attracted the focus, attention and at times controversy, as those relating to environmental, social and governance (ESG) issues.

We are all aware of the impact that campaigns such as those led by Greta Thunberg and Extinction Rebellion have had, as well as the awareness raising of programmes such as David Attenborough's Blue Planet II. Social issues have also become more at the forefront of people's minds with issues such as mental health, modern slavery and equality being hotly debated. The COVID-19 pandemic is only serving to heighten awareness of the key issues facing society. Governance issues such as executive compensation, board composition and diversity are also still highly relevant.

The pace of change and focus on these issues is only going to increase and will present challenges for individuals, businesses and governments alike.

Initiatives on ESG matters are coming thick and fast. Some of these are thought leadership debates whilst other seek to impose obligations on businesses and individuals to speed up the pace of change.

In the financial services space there are a plethora of initiatives, working groups as well as a large body of rules and regulations which will have direct and comprehensive impacts on financial services institutions and the products they manufacture.

As always we remain available to you to assist with your scoping, planning and implementation of any ESG projects and hope that you find this resource helpful.

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Head of Financial Services

Phil Spyropoulos
ESG and Responsible Investing Lead

A world of meaning

There are a wide array of terms of art used in the ESG world and no accepted definitions. We set out below an explanation of some commonly used terms.

Environmental

Issues relating to the quality and functioning of the natural environment and natural systems, such as:

- changes to nitrogen / phosphorus cycles
- greenhouse gas emissions
- biodiversity loss
- renewable energy
- climate change
- energy efficiency
- depletion / pollution of air, water or other resources
- waste management
- ozone depletion
- ocean acidification
- changes in land use

Social

Issues relating to the rights, well-being and interests of people and communities, such as:

- health and access to medicine
- consumer protection
- freedom of association and freedom of expression
- human rights
- child, slave and bonded labour
- activities in conflict zones
- HIV/AIDS
- controversial weapons
- labour standards in the supply chain
- relations with local communities
- diversity
- workplace health and safety
- human capital management and employee relations

Governance

Issues relating to the governance of companies and other investee entities, such as:

- business ethics
- board composition
- skills and independence
- stakeholder interaction
- stakeholder relations
- bribery and corruption
- executive pay
- internal controls and risk management
- shareholder rights
- disclosure of information

Sustainability

Meeting the needs of the present without compromising the ability of future generations to meet theirs. Sometimes used as an analogue for ESG.

Ethical investing

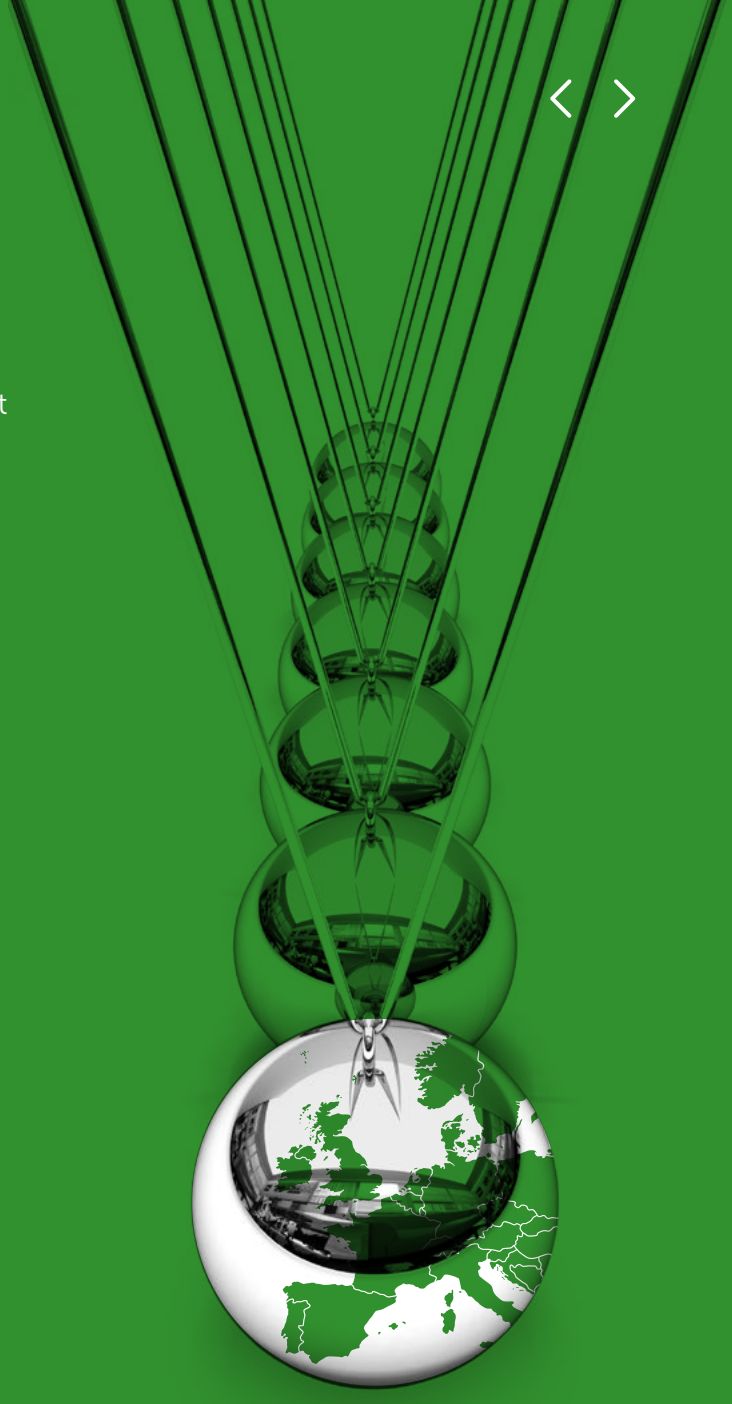
Investing where the main motivation is aligning the portfolio with the ethical values of an organisation - guided by ethical codes, religious beliefs or personal values.

Stewardship

Using influence (e.g. from share ownership) to guide a company's behaviour to create long-term value for shareholders and stakeholders.

Impact investing

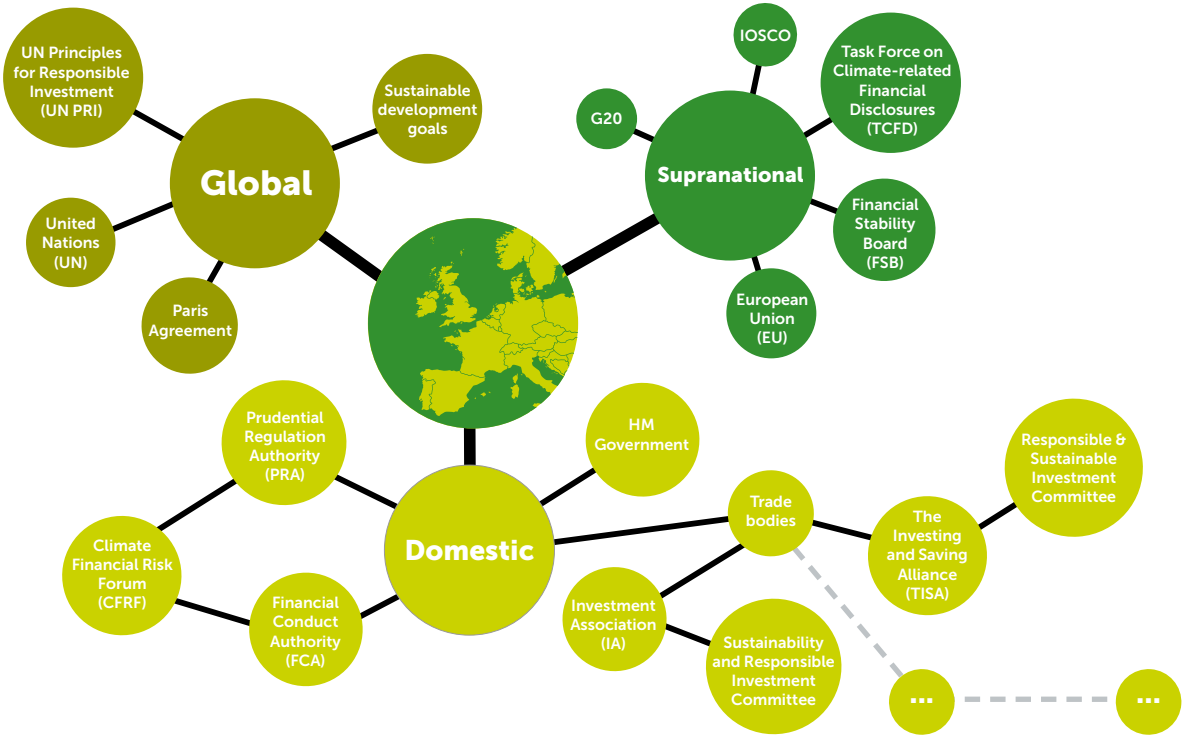
Deploying capital with the intention to generate positive, measurable social and environmental impact alongside a financial return.



Sources of change

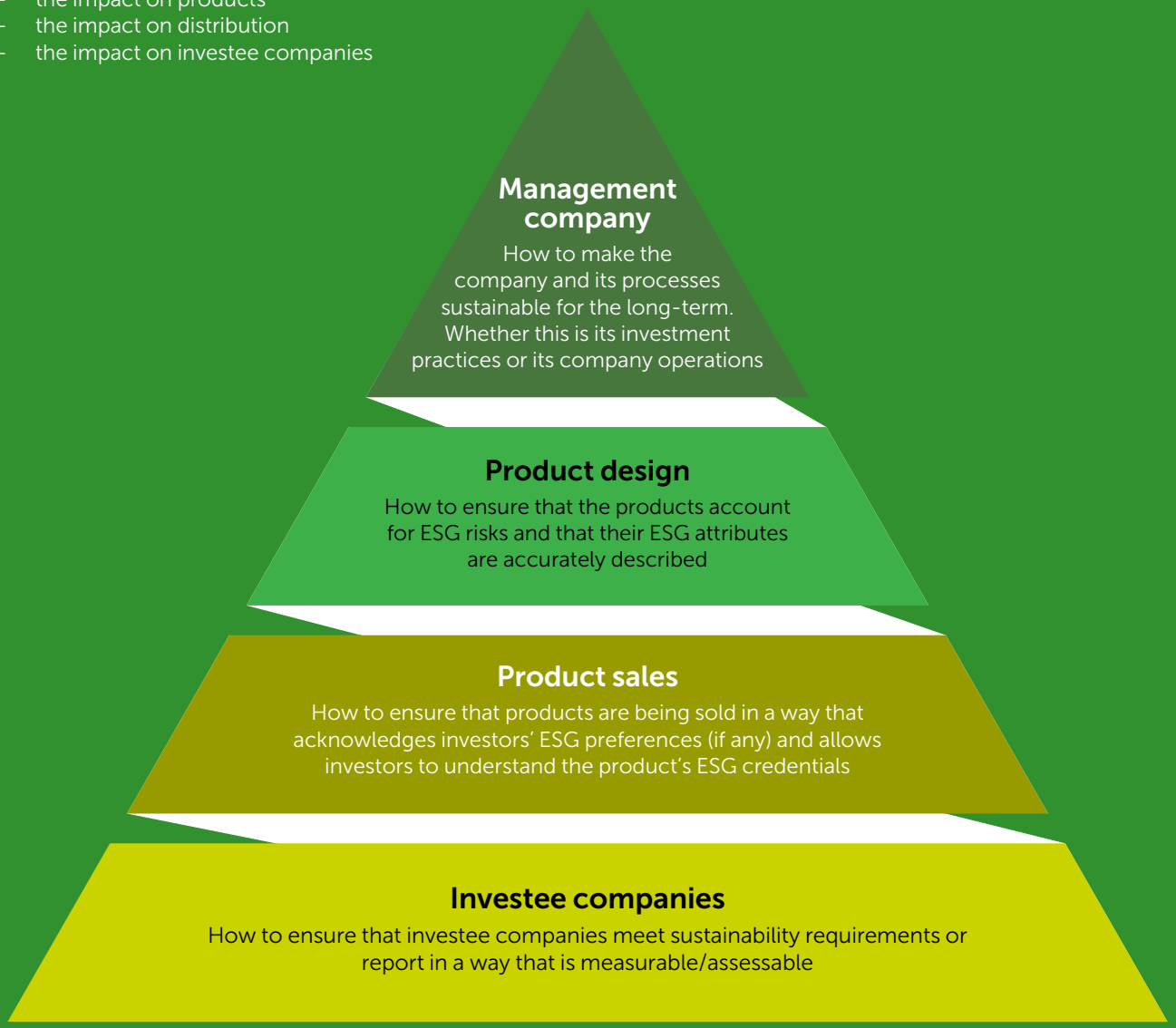
The body of bodies

The impetus for change is coming from all directions. We have set out below some of the players in this space.



With such a huge body of material to identify, absorb impact-assess, we have found it helpful to divide the materials into four key areas:

- the impact on management companies themselves
- the impact on products
- the impact on distribution
- the impact on investee companies



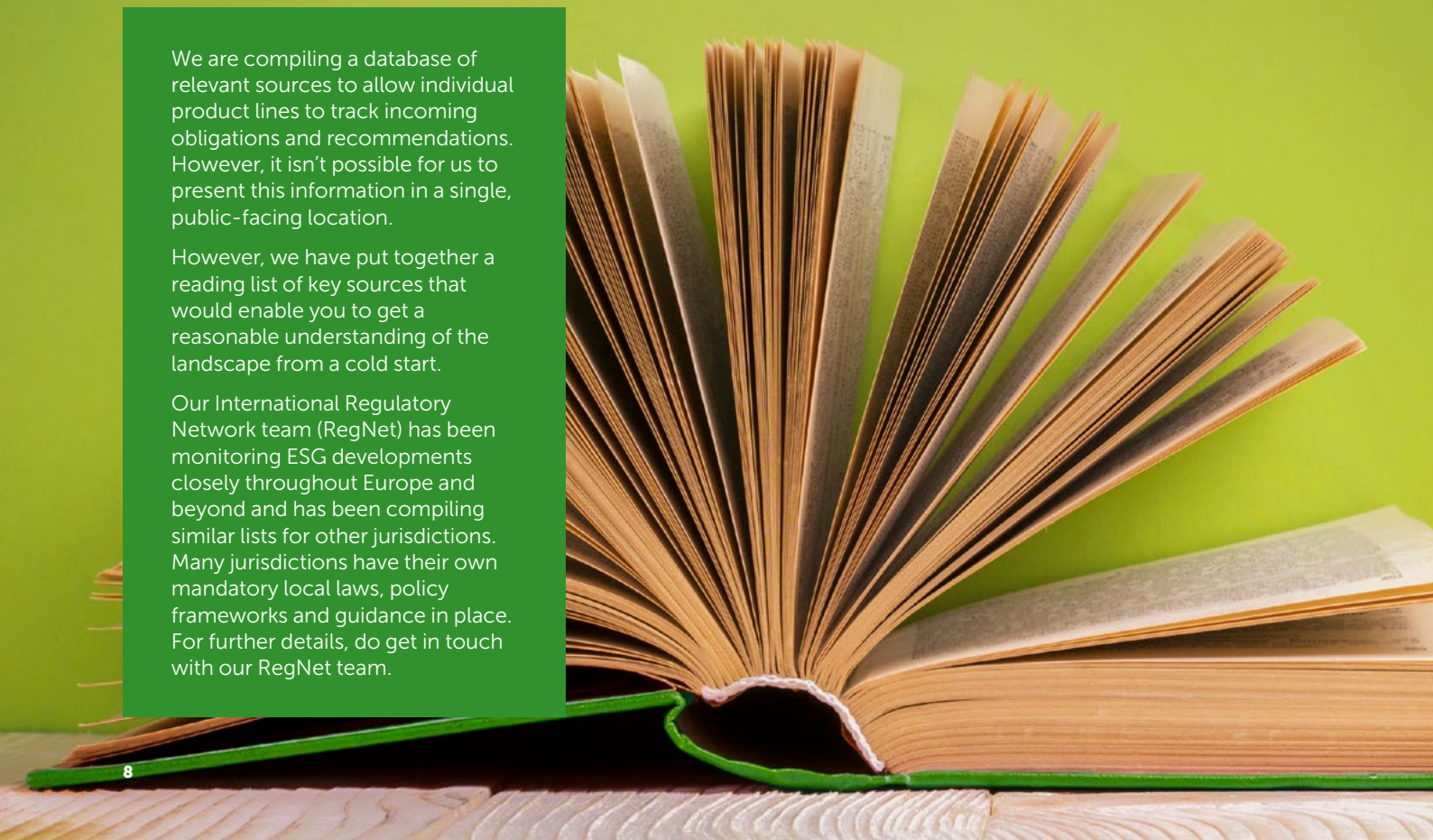
"Essential" reading

There are hundreds of documents in circulation on this topic.

We are compiling a database of relevant sources to allow individual product lines to track incoming obligations and recommendations. However, it isn't possible for us to present this information in a single, public-facing location.

However, we have put together a reading list of key sources that would enable you to get a reasonable understanding of the landscape from a cold start.

Our International Regulatory Network team (RegNet) has been monitoring ESG developments closely throughout Europe and beyond and has been compiling similar lists for other jurisdictions. Many jurisdictions have their own mandatory local laws, policy frameworks and guidance in place. For further details, do get in touch with our RegNet team.



		Asset Managers	Products	Investee companies	Implementation dates				
					2019	2020	2021	2022	2023
Mandatory	EU Disclosure Regulation (SFDR)	✓	✓				✓	✓	
	EU Climate Benchmarks Regulation	✓	✓			✓	✓	✓	
	EU MiFID II changes	✓	✓			TBD	TBD	TBD	
	EU UCITS and AIFMD changes	✓	✓			TBD	TBD	TBD	
	EU Taxonomy for sustainable activities	✓	✓					✓	✓
	EU Green Bond Standard		✓			TBD	TBD	TBD	
	EU Shareholder Rights Directive			✓	✓	✓			
Evidence gathering / policy frameworks	FS19/6: Climate change and green finance	✓	✓	✓					
	FS19/7: Building a Regulatory Framework for Effective Stewardship	✓		✓					
	Task Force on Climate Related Financial Disclosures (TCFD)	✓							
	PS19/13: Proposals to promote shareholder engagement	✓	✓	✓					
	Investment Association – Responsible Investing Framework	✓	✓						
	FCA / PRA / TPR / FRC Joint Declaration	✓							
	Changes to permitted links rules	✓							
	FCA DP 18/10 Patient Capital and Authorised Funds	✓							
	Changes to SIPs	✓	✓						
	Changes for Investment Governance Committees	✓							
	CP20/3: Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations	✓	✓	✓					
Guidance / voluntary measures	ESMA Guidance on sustainability in risk management	✓							
	Credit rating agencies practice and guidance	✓							
	FRC UK Stewardship Code	✓		✓					
	IA Responsible Investment Framework	✓	✓						

EU disclosure regulation (SFDR)

What is it?

The Disclosure Regulation (often referred to as "SFDR") aims to harmonise disclosures around the EU relating to sustainability risks and the consideration of principal adverse impacts on sustainability factors. It requires a number of disclosures to be made (pre-contract, periodically and online) at asset manager and product level for a wide variety of financial products.

Who does it apply to?

It applies to 'financial market participants' ("**FMPs**"). These include AIFMs and UCITS management companies, as well as entities such as pension product manufacturers and investment firms. It also applies to investment advisors.

When does it apply?

Obligations for firms under the Disclosure Regulation are phased in from March 2021 with the final obligations coming online in December 2022.

During this time ESMA will publish further technical guidance to be adopted as secondary legislation, on the form and content of certain disclosures. At the time of writing, draft Regulatory Technical Standards have been published for consultation, however the application of these RTS is currently unknown due to the implications of Brexit. We recommend that firms do consider the RTS as part of their consideration of the requirements of the Disclosure Regulation.

What will firms need to do?

Firms need to assess whether or not:

- **sustainability risks** are integrated into their investment decision-making processes and explain the position on their websites and in pre-contractual documentation. Where these risks are integrated, as part of the required disclosures firms will need to include information such as the manner in which sustainability risks are integrated into their investment decisions. Remuneration policies will also need to be updated to ensure that they are consistent

- **principal adverse impacts on sustainability factors** are considered and explain the position on their websites and in pre-contractual documentation. As for sustainability risks, prescribed information will need to be set out in these disclosures. For example, websites will need to detail information about, among other points, the policies on the identification and prioritisation of principal adverse impacts and indicators, and a description of principal adverse sustainability impacts. Pre-contractual information will need to include a clear and reasoned explanation of whether, and if so, how a financial product considers principal adverse impacts on sustainability factors

The Disclosure Regulation also sets out additional disclosure requirements for products which promote environmental or social characteristics (NB there are caveats on the definition of this type of product) and for products which have a sustainable investment, or a reduction in carbon emissions, as their objective.

Official name: Regulation... on sustainability-related disclosures in the financial services sector

Applies from: March 2021

View the primary legislation: https://eur-lex.europa.eu/legal-content/EN/TXT

Read our briefing: https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Financial_services/introduction-ESG-obligations-181219

EU taxonomy regulation

What is it?

The Taxonomy is a grouping system which sets out, in significant detail, categories of economic activity that companies and other investee businesses may undertake that are considered to be sustainable activities.

Who does it apply to?

The regulation applies to financial market participants (FMPs). These include AIFMs and UCITS management companies, as well as entities such as pension product manufacturers, investment firms and investment advisors.

The substantive obligations of the regulation apply directly to the FMPs of financial products that are subject to specific disclosure under the EU Disclosure Regulation (SFDR). However there may be various indirect/commercial impacts for data providers, distributors and investee entities who will need to understand taxonomy alignment.

There are a number of minor obligations that apply to every other FMP.

When does it apply?

The text of the Taxonomy was agreed politically by the Commission and the Council in December 2019. The technical expert group advising on the Taxonomy then published its final report on 9 March 2020 ("Sustainable finance: TEG final report on the EU taxonomy"). This report sets out recommendations on the overall framework of the Taxonomy and includes extensive guidance on how FMPs may use and disclose against the Taxonomy in practice. Further developments will be rolled out via a new Platform on Sustainable Finance. This platform is expected to go live in Autumn 2020.

The provisions of the Taxonomy concerning its eight environmental objectives is expected to enter into force in December 2021 with the first related company reports and investor disclosures falling due at the beginning of 2022. All other provisions are expected to follow and be applicable by the end of 2022.

What will firms need to do?

For products subject to specific disclosure under the EU Disclosure Regulation (SFDR), FMPs will need to make a series of disclosures (e.g. in a prospectus) including:

- the information on the environmental objective or environmental objectives to which the investment underlying the financial product contributes
- a description of how and to what extent the investments underlying the financial product are invested in environmentally sustainable economic activities

It is expected that third party data providers will supply information about investee companies' taxonomy alignment, but firms will need to incorporate new data plumbing to absorb this information.

For products outside the scope of the above disclosures, a mandatory disclosure will need to be included stating that the product does not take account of the taxonomy.

Official name: Regulation... on the establishment of a framework to facilitate sustainable investment, and amending Regulation 2019/2088 on sustainability-related disclosures in the financial services sector

Applies from: 1 January 2023

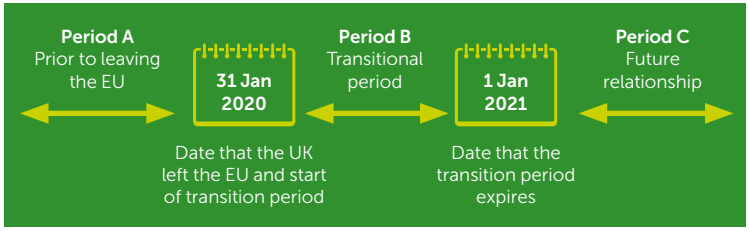
View the primary legislation: https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf

Read our briefing: https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Financial_services/EU-Taxonomy-Regulation_030720

Status of EU law in the UK

Many of the forthcoming requirements take the form of a series of EU regulations. Following the UK's departure from the EU, the status of these regulations is less certain.

The following summary sets out our understanding of the treatment of these laws under the assorted withdrawal legislation but this is, of course, subject to any subsequent trade agreement reached or other developments. The existing book of EU regulations prior to 31 January 2020 is preserved in the UK statute book. Laws that come into force during the transitional period are saved (or saved by default) but regulations that come into force from 1 January 2021, assuming no extension to the transition period, would not form part of UK law unless parliament legislates to incorporate them. And even then, there is the possibility that they would only be incorporated with modifications. This is relevant for frameworks where the regulatory technical standards (so-called 'Level 2' rules) have not yet been written.



	Status during Period B	Status during Period C
Regulations that were in force during Period A	**Preserved in UK law** s.2(1) European Communities Act 1972 as saved under EU (Withdrawal) Act 2018 (EUWA)	**Onshored** EU (Withdrawal) Act 2018 as amended by the EU (Withdrawal Agreement) Act 2020
Regulations that are to be implemented duringPeriod B	**Effective in UK on date specified** s.2(1) European Communities Act 1972 as saved under EU (Withdrawal) Act 2018 (EUWA)	**Onshored** EU (Withdrawal) Act 2018 as amended by the EU (Withdrawal Agreement) Act 2020
Regulations that come into force during period B but have an implementation deadline in Period C	**Effective in UK on date specified** s.2(1) European Communities Act 1972 as saved under EU (Withdrawal) Act 2018 (EUWA)	**Onshored unless Parliament legislates to the contrary** EU (Withdrawal) Act 2018 as amended by the EU (Withdrawal Agreement) Act 2020
Regulations that come into force during Period C	**Not applicable**	Only become part of UK law if Parliament positively legislates to incorporate them

Establishing a project

ESG might seem like a niche area, but the effect of the forthcoming developments must not be underestimated.

This is not a project that a single department can address on its own and we would urge firms to seriously consider establishing a full regulatory change programme with proper project governance - with reporting lines to senior management - and appropriate resourcing to implement these changes.

We have set out a high level step plan for your consideration:

1. establish a steering group in line within your usual project governance framework
2. consider representatives from compliance, investment ops, legal, marketing, product and risk with reporting lines to senior management

   For specific topics you may need to involve other business lines e.g. HR (remuneration policies updates required by Disclosure Regulation)
3. tracking and scoping. One problem in this area is understanding what is out there
4. impact analysis
5. implementation
6. documentation/traceability around implementation for audit purposes

New product launches

The FCA's Feedback Statement Climate Change and Green Finance (FG19/6) is clear that the FCA will be monitoring the market to discourage attempts by firms to 'greenwash' products – i.e. to talk up their ESG credentials where they lack the substance behind the scenes. This has been borne out in our experiences with the FCA's fund authorisations team over a number of years.

In our experience, you should consider the following for new authorised fund launches:

The FCA will expect:

- to see the management company's ESG policy as part of the submission
- to see a clear investment strategy and how ESG objectives/characteristics feed into this
- to understand what the universe of investments is and what criteria an investment must meet to be included
- firms to disclose where ESG elements sit in the pecking order of investment objectives

Be prepared to explain:

- the investment journey from wide universe to final model portfolio
- how any stated ESG objectives can be measured?
- how will the firm report on ESG to investors?
- how any terminology in the name of the fund can be justified (e.g. "social impact")
- at what point an investment be sold if an investment fails to meet / the investee company fails to respond to investor activism

How we can help

Training

We offer a series of training sessions covering broad 'what is out there' discussions to 'deep dives' into specific regimes.

These can be structured as discrete, discursive workshops or used as part of your internal education and awareness campaign. In light of COVID-19 we would add that training can be delivered virtually.

Helping you to scope

We can assist with initial scoping exercises to determine which products will be affected by the forthcoming regimes. We can assist you with an obligation tracker, which may be used to identify and document implementation steps and may subsequently be used as an audit trail (a so-called traceability matrix).

Helping you to interpret and implement

Interpreting new laws is a key skillset. Combined with our broad view of the market, we can help you to understand your obligations and prepare commercially-acceptable outputs.

International regulatory monitoring

Through our RegNet team we regularly coordinate regulatory projects across multiple jurisdictions. RegNet has been monitoring ESG developments closely throughout Europe and beyond and is working with various stakeholders to develop helpful tools and trackers for clients. We also maintain a database of essential reading, including mandatory local laws, policy frameworks and guidance, for these jurisdictions.

Get in touch

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