ESG: transparency, reporting and the end of ‘greenwashing’

2021 has the potential to be a real turning point for ESG. A move from subjectivity to objectivity, with ongoing regulation poised to more rigorously assess a company’s ESG credentials.

The Commission’s stated aim of stimulating in the region of €1 trillion of sustainable investment during the period to 2030 has been underpinned by a 10 point action plan on sustainable finance which, through the introduction of the Sustainable Finance Disclosure Regulations (“SFDR”) and the EU Taxonomy Regulation, sets out a framework for identifying, quantifying and reporting on the sustainability of any given investment.

The introduction of the SFDR and Taxonomy Regulation, together with proposed changes to the Alternative Investment Fund Managers Directive (the “AIFMD”) and the Markets in Financial Instruments Regulation (“MiFiD II”), form part of a concerted effort by the EU and Member State governments to promote sustainable investment and accelerate the drive toward carbon neutrality.

In this first in a series of articles on ESG regulation, we will explore what’s in store for 2021 and beyond and what it means for managers.

The ten point plan

The EU has a bold plan – to become the first climate neutral continent by 2050. To achieve this, over €260 billion in annual investment is required over the coming decade.

So, where is this money going to come from? In part, publicly through the European Fund for Strategic Investments, but private capital will also play a pivotal role.

To this end, the Commission has developed a comprehensive policy agenda on sustainable finance and an associated action plan. There are 10 key actions set out in the plan, with the most relevant to alternatives managers (for now) being actions 1, 5 and 7 (outlined below), which create a framework for ensuring that an investment qualifies as 'sustainable' within the Commission's overall policy aims.

Action 1: Establishing a taxonomy to provide a clear and detailed classification system for sustainable activities.

Action 5: Developing sustainability benchmarks to provide investors with better information on the carbon footprint of their investments.

Action 7: Clarifying asset managers' and institutional investors' duties regarding sustainability, including sustainability related disclosures. These action points are underpinned by further legislation, namely:

- the SFDR, which will in turn be underpinned by associated Regulatory Technical Standards ("RTS");
- the EU Taxonomy Regulation, which will in turn be underpinned by a final report and technical annex with delegated regulations;
- the Low Carbon Benchmark Regulation; and
- AIFMD/MiFID II amendment regulations.

Coming 10 March 2021

Under SFDR, managers operating in the European market will become subject to a number of sustainability related disclosure and reporting requirements, specifically in respect of the integration of sustainability risks in their investment decision making and advisory processes.

In summary, SFDR requires in-scope firms to comply with up to three tiers of sustainability related disclosures or reporting as follows:

1.Sustainability risk disclosures: Environmental, social or governance events or conditions that, if they occur, could cause an actual or a potential material negative impact on the value of an investment.

2.Principal adverse impact disclosures: Environmental, social and employee matters, respect for human rights and anti-corruption, irrespective of their effect on investment value. Of the new disclosure and reporting requirements introduced by SFDR, it is principal adverse impact disclosures that appear at this stage to have the broadest potential application. Unlike Tier 1 sustainability risk disclosures, disclosures relating to Tier 2 matters are not subject to an event having or having the potential to have a material negative effect on investment value and unlike Tier 3 disclosures (see below), Tier 2 matters will need to be considered irrespective of whether the fund in question is ESG/sustainability focused or not. At this stage therefore, it appears that any manager or fund falling within scope of SFDR will need to consider principal adverse impact matters, irrespective of their potential impact on value and irrespective of the strategic objectives of the fund in question.

3.Additional disclosures for certain ESG/sustainability focused funds (i.e. impact funds): Benchmarking compliance and the rationale/justification for any sustainability labels used.

Much of the detailed content, methodologies and the prescribed format for presentation of the information required to be disclosed under SFDR will be contained in the associated RTS, originally anticipated to be effective from 10 March 2021. While draft reporting mock-ups have been published in connection with 'additional disclosures' and a consultation process has been completed on the draft RTS, the Commission has now confirmed that its application will be delayed (to a date yet to be clarified). In the interim, affected firms will be expected to comply with the high level, principles-based, provisions of SFDR, which will still apply from 10 March 2021.

Coming on stream 1 January 2022

This is when the first tranche of sustainability disclosure and reporting requirements under the EU Taxonomy Regulation will land.

The Taxonomy Regulation establishes a classification system by which managers, investors, businesses and policymakers can better assess whether the economic activities they undertake or invest in are 'sustainable'. The Taxonomy Regulation also imposes additional disclosure obligations, requiring those in scope to disclose whether (and if so, to what extent) they take account of the Taxonomy Regulation. Those who do not take account of it are required to clearly disclose that fact and to state the reasons for it.

While the Taxonomy Regulation came into force on 12 July 2020, it will only become applicable for each stated environmental objective 12 months after the relevant technical screening criteria have been adopted.

The technical screening criteria will be used to determine when an economic activity can be considered to be ‘contributing significantly’ to each objective. The criteria will also determine whether the activity does any ‘significant harm’ to the objectives. Draft technical screening criteria for the two climate change focused objectives were to be submitted to the European Parliament and Council on 31 December 2020, with draft technical screening criteria for the other objectives to be submitted on or before 31 December 2021.

At present it is anticipated that the technical screening criteria relating to the two climate change focused objectives will come on stream on 1 January 2022, one year earlier than the four non-climate change focused objectives which will follow on 1 January 2023.

What does all of this mean?

Over the coming 12 to 24 months, managers coming to market who wish to capitalise on an ever-increasing investor appetite for socially responsible and sustainable investment will need to justify their and their fund’s ESG credentials by reference to prescriptive qualifying criteria.

Furthermore, managers will be required to expend resource throughout the lifecycle of a fund in order to monitor, measure, benchmark and disclose progress made towards stated ESG or sustainability goals by reference to qualitative and quantitative criteria.

Who’s in scope?

All managers marketing a fund into the European Union will be required to comply with the relevant parts of the regulations to some extent, with disclosures and statements of compliance (or explanations for non-compliance) required, irrespective of whether the fund in question promotes ESG related goals or has sustainability as an objective.

A number of key questions remain to be answered, however, not least the exact requirements of the RTS and technical screening criteria and confirmation of the point at which a fund will be deemed to be ‘promoting environmental or social characteristics’ or have ‘sustainable investment as an objective’. The distinction between a fund ‘promoting environmental or social characteristics’ and those which have ‘sustainable investment as an objective’ also needs to be clarified.

Managers wishing to minimise the impact of the new regulations by establishing funds which actively avoid ESG and/or sustainability focused investments will need to consider the potential impact this may have on investor appetite for their funds.

Transparency for investors

The introduction of standardised disclosures and templated reporting means investors will soon have the means to draw direct comparisons between the ESG and sustainability-related performance of various funds and managers. Indeed, investors may well soon scrutinise a manager’s green credentials as closely as the historic returns they have generated when considering investment opportunities and it is not impossible to predict a push by LPs to link carry and fees to the achievement of sustainability related goals.

Final thoughts…

Although much of the detail of the RTS and technical screening criteria is yet to be finalised, it is clear at this stage that the practical ramifications of the introduction of the new regulations are potentially significant and wide ranging. Aztec will continue to monitor developments over the coming months and will provide updates as the situation develops. Aztec is also actively working to develop solutions to assist managers with their new disclosure and reporting obligations, which will be explored in more detail in forthcoming articles in this series.