Sustainable Finance, a new era for asset managers

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Executive summary

The last few years have seen a rally towards Environmental, Social and Governance (ESG) products and ESG integration, with sustainable funds capturing a significant portion of inflows in Europe and some asset managers announcing that they will integrate ESG within their entire range of products. And this trend is likely to further accelerate over the coming years among others due to expected regulatory developments in Europe.

On 8 March 2018, the European Commission (the “EC”) issued its “Action plan on Financing Sustainable Growth” (the “Action Plan”). This initiative stems from the Capital Markets Union Action Plan and is part of the broader efforts to connect finance with the specific needs of the European and global economy for the benefit of the planet and our society. The EU defines “Sustainable Finance” as the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities – whilst the plan recognises the key role of “Governance”, there is a clear focus on “Environmental” and “Social” considerations.

This very ambitious Action Plan will impact all managers doing business in the EU in one way or another (operations in the EU, products sold in the EU). It aims to:

- Finance the transition to a more sustainable and inclusive growth – the objective is to direct investment into sustainable activities, aimed at leveraging on the financial sector to close the investment gap and finance an economically and socially sustainable economic system;
- Better manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues – acknowledging that environmental and climate risks are currently not always adequately taken into account by the financial sector, including the potentially destabilising impact of climate change;
- Foster transparency and long-termism in financial decisions – sustainability and long-termism go hand-in-hand and transparency is key to ensure that investors can take better informed and more responsible investment decisions rather than focusing on high returns over a short timeframe.

In order to fulfil these objectives, the EC identified in its Action Plan ten measures including legislative measures that will have a pervasive impact on the financial sector in Europe. Among the ten measures, the most noteworthy are three proposed regulations (in the areas of taxonomy, disclosure and low carbon benchmarks) as well as amendments to the existing MiFID II, UCITS and AIFMD level 2 regulations, alongside other consultations and non-legislative measures.

The EC had also set up a Technical Expert Working Group (“TEG”) to provide technical expertise and support in the following areas: taxonomy of environmentally sustainable activities, low-carbon benchmarks, sustainability factors and risks’ disclosure and EU green bond standards.

These measures will not only affect Asset Managers (“Managers”) and their products, such as investment decisions and product distribution, but also how Managers incorporate “ESG” in their business operations and strategy. As such, Managers will be asked to consider and measure both the effect of their products and services on sustainability topics as well as the impact of sustainability topics on their products and services.

Once these measures are finalised, the following significant changes can be expected in the market:

- Investors will be systematically asked about their ESG preferences, and offered products matching such preferences within their target market definition – with the vast majority of EU citizens considering climate change as a significant issue, this measure is likely to have a pervasive impact on the product mix on offer and on the viability of non-ESG products;
- Two new categories of products will be defined: (i) products that promote environmental or social characteristics and (ii) sustainable investments products. Each category will be required to disclose how such characteristics or objectives are attained.
- Two new categories of benchmarks will be introduced: (i) the EU Climate Transition Benchmark and (ii) the EU Paris-aligned Benchmark.
- All Asset Managers (the “Managers”), Investment firms, Authorised Alternative Investment Funds Managers (AIFMs) and UCITS management companies will be required to review their operating models to ensure sustainability matters and sustainability risks are adequately addressed in governance, processes, remuneration policies, conflict of interest policies, product governance, risk management, etc.
- “Financial market participants” and “financial advisors” will be subject to new and extensive disclosure requirements not only on “sustainability risks” (impact of ESG matters on the performance of investment), but also on “adverse impact on sustainability factors” (impact of investment decisions on environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters). These new disclosure requirements will pose significant challenges, in terms of timing, methodology as well as data accessibility and reliability.

And new measures can be expected in 2020, as the new EU Commission already reiterated the importance of financing the transition to a greener economy (“Green Deal Action Plan”). Expansion of the Sustainable Finance plan and revision of the non-financial reporting directives are envisaged for 2020.

The Action Plan will affect all market players, even the most ESG agnostic will have to modify their processes. But, unlike much of the regulatory agenda, it shall not be seen as a compliance exercise – market demand is present and will be accelerating – but as a real business opportunity. There will be a significant advantage for early movers embracing the change and capitalising on this new paradigm in order to further engage with their investors.

This paper explores the impact of the expected measures on AM operations. It includes published regulation drafts and reports available as of 13 March 2020.

Overview of Action Plan main measures and timeline

Three regulations are currently under finalisation:

	TAXONOMY	BENCHMARKS	DISCLOSURES
Description	Proposal for a Regulation of the European Parliament and of the Council on the **establishment of a framework** to facilitate sustainable investment.	Regulation (EU) 2019/2089 of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards **EU Climate Transition Benchmarks and EU Paris-aligned.**	Regulation (EU) 2019/2088 of the European Parliament and of the Council on **sustainability-related disclosures** in the financial services sector.
Focus on	• Criteria for determining the **degree of sustainability** of economic activities (contributing to 6 environmental objectives) • **Taxonomy alignment disclosures** • **Market monitoring** by ESAs • **Platform** on sustainable finance • Minimum **safeguards**	• **Climate Transition Benchmark** = Index whose underlying assets would be selected, weighted or excluded such that the resulting benchmark portfolio is on a de-carbonisation path. • **EU Paris-aligned Benchmark** = Index whose underlying assets are selected in such a way that the resulting carbon emission reductions in the benchmark portfolio are aligned with the Paris Climate Agreement's long-term global warming target objective	• **Large scope:** Financial market participants and financial advisers which provide investment advice. • **Transparency obligations** for the publication of sustainability information for EU products. • From the **disclosure of sustainability risks** to the **adverse impact on sustainability factors.**
Latest Developments	• Awaiting publication in OJEU following the political agreement reached in December 2019. • On 9 March 2020, the TEG published its final **report on EU Taxonomy**, with a short **user guide.**	• **The Regulation entered into force on 10 December 2019.** • On 18 June 2019, the **TEG published an interim report on Climate benchmarks and benchmarks' ESG disclosures**. The Final version of the report was published on 20 December 2019.	• **The Regulation will apply from 10 March 2021.** • The TEG published its **report on climate-related disclosures** in January 2019. • Level 2 (delegated acts) to be drafted in the course of 2020.

1. Taxonomy or "Framework" Proposal

The difficulty to define what is a sustainable product or what is an ESG investment, is a recurring debate amongst the industry professionals. In fact, it is inherent to the nature of ESG and the related investment approaches. Different approaches are indeed being pursued by Managers in order to meet the demand of investors, depending whether the latter are more or less ESG aware. Such approaches range from negative screening (such as norm- based exclusion), ESG integration, positive screening (best-in-class approach), "Engagement" (also called shareholders' activism) and thematic investing (investing in environmental or social projects/sectors) to impact investing (where investors are ready to sacrifice part of their financial performance as the societal impact is more important for them). ESG products usually combine several of these approaches.

The "Taxonomy Proposal" does not aim at defining or classifying ESG approaches, but tries to define sustainable investments through a focus on the activities financed by a financial product, aiming at defining "environmentally sustainable activities".

An activity will be considered as environmentally sustainable when its contributes significantly to one of the 6 environmental objectives identified by the Commission (climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems), provided it does not significantly harm any of the other environmental objectives. A Platform on sustainable finance will be created to advise the Commission on the technical screening criteria to be applied in order to determine when an activity contributes to (or significantly harm) any of the environmental objectives. The platform will leverage on the work performed by the TEG, who published their final report on the Taxonomy on 9 March 2020.

The delegated acts on screening criteria in relation to climate changes objectives shall be adopted by December 2020 and will apply from 31 December 2021. The technical screening criteria in relation to the other four objectives will be finalised by the end of 2021 for application from 31 December 2022.

The taxonomy regulation also includes disclosure requirements for financial products, which will add to the sustainability disclosure requirements imposed by the "Disclosures Regulation" as developed below.

All financial products with environmental characteristics or which are promoted as environmentally sustainable will be required to disclose the proportion of their portfolio invested in taxonomy aligned activities. Other financial products will be required to include a disclaimer indicating that they do not take into account the EU criteria for environmentally sustainable investments.

Recognising that obtaining the underlying data on the alignment of the activities performed by investee companies will be a real challenge, the regulation also introduces the requirement for large listed EU companies to disclose the percentage of taxonomy alignment as part of their non-financial reporting.

A political agreement was found on the taxonomy proposal in December 2019 and publication of finalised text is expected soon.

2. EU Climate Transition Benchmark and EU Paris-Aligned Benchmark Proposal

The "Benchmarks Proposal" will amend the Regulation (EU) 2016/1011 (i.e. the Benchmark Regulation) in order to include a "Climate Transition Benchmark" and also an "EU Paris-Aligned Benchmark" definition to impose ESG factors disclosure requirements.

3. Disclosures Regulation

Transparency is a key feature of ESG investment and a key concern of EU regulators – hence it is not surprising that one of the first initiatives is to further regulate disclosures.

The "Disclosures Regulation" distinguishes between (i) disclosure on sustainability risks applicable to all financial market participants, advisors and all financial products, and (ii) further disclosures applicable to sustainable investments products and products promoting environmental or social characteristics.

"Sustainable investments" are being defined as investments in economic activities that contribute to an environmental objective or a social objective or investment in companies following good governance practices whilst the taxonomy proposal gives more precision on the definition of Environmentally Sustainable activities (see above).

Another category has been added (products promoting environmental or social characteristics) to accommodate for ESG products whose objective will not be confined to invest in sustainable activities as defined by the EU regulations. Both categories of products will be subject to specific disclosure requirements from pre-contractual disclosures to periodic reports.

The Disclosures Regulation also requires disclosure on how the remuneration policies are consistent with the integration of sustainability risks and does not promote excessive risk-taking in this matter.

Moreover, additional requirements will be imposed on large financial market actors exceeding 500 employees, extending the scope of the sustainability disclosure from being the risks "to" the portfolio (risk of negative impact on portfolio financial return) to include the impact "from" the portfolio (i.e. the impact of all the investment decisions made may have on the society (environmentally or socially adverse factors)).

Availability of complete and reliable data on the underlying companies is indeed a key concern in this context. Timing will also be challenging, as implementing measures (defining content of disclosures and methodologies to be followed) are unlikely to be finalised ahead of the planned implementation date of the regulation.

Estimated timeline

- **9 Dec. 2019** – Publication in the Official Journal of the European Union (OJEU) of the Benchmarks and Disclosures Final Texts
- **Q4 2019** – Finalisation of inter-institutions negotiations on the Taxonomy File
- **30 April 2020** – Methodology Compliance Deadline for Benchmark Administrators
- **30 Dec. 2020** – ESA's to submit draft RTS on Disclosures Regulation
- **10 March 2021** – Main Application Date for Regulation on Disclosures
- **31 Dec. 2021** – Taxonomy Regulation (Climate Change objectives)
- **1 January 2022** – Annual report disclosures
- **31 Dec. 2022** – Taxonomy Regulation (4 remaining objectives)

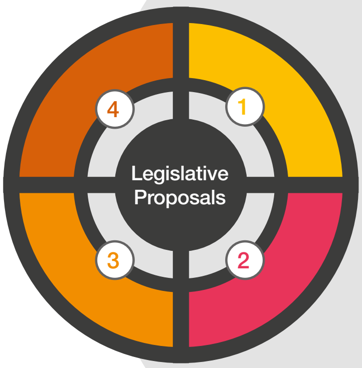
Amendments to existing level 2 measures

4. Amendments to MiFID II suitability tests – ESG preferences

The proposed amendments will modify MiFID II suitability test requirements, asking for a systematic inquiry about investors' ESG preferences. Whilst amendments to a level 2 text could go relatively rapidly, timing is expected to be aligned with the "Disclosures Regulation" mentioned above due to cross reference between the two texts (sustainable investment definition).

5. Amendments to MiFID II, UCITS and AIFMD to include sustainability risks

Following the mandate granted by the EC, the European Securities and Markets Authority (the "ESMA") has issued advice on possible amendments to MiFID II, UCITS and AIFMD level 2 texts in order to include references to sustainability risks and factors within organisational requirements, operating conditions and resources, risk management and product governance requirements. Such changes would require all management companies, AIFMs and MiFID firms to review processes and resources as well as to include sustainability risks within risk management processes.



1 Sustainability Risks

On 3 May 2019, the ESMA issued its Technical Advice to the EC on integrating sustainability risks and factors in the UCITS Directive and the AIFMD (ESMA34-45-688).

- Organisational requirements;
- Operating conditions; and
- Risk management.

2 Non-Financial Disclosures

- On 20 June 2019, the EC Communication entitled "Guidelines on non-financial reporting: Supplement on reporting climate-related information (2019/C 209/01)" was published in the OJEU. It consists of a new supplement to the existing guidelines on non-financial reporting, which remain applicable.
- On 20 February 2020, the EC published a consultation on the revision of the non-financial reporting directive.

3 Product Governance

- On 3 May 2019, the ESMA issued its Technical Advice to the EC on integrating sustainability risks and factors in MIFID II (ESMA35-43-1737)
- On 3 May 2019, the EIOPA issued its Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD (EIOPA-BoS-19/172).
- Both product manufacturers and distributors would be required to take account of whether the products or services they offer in the EU fulfil their EU customers ESG preferences.

4 ESG Preferences

- On 4 January 2019, the European Commission (EC) published draft rules to ensure investment firms and insurance distributors (hence with amendments to MiFID II/IDD) take sustainability considerations and preferences into account when providing advice to their clients.
- The EC is expected to adopt these rules in early 2020.

Other initiatives to follow up

6. EU Ecolabel criteria for retail financial products

The EU has recently consulted (December 2019) on the opportunity to create an EU Ecolabel for financial products addressed to retail investors – such a label would be awarded to the products with the best environmental performance, setting some requirements regarding alignment of the portfolio with the taxonomy.

7. Transparency on engagement policy

Amendments to the shareholders right directive (referred as “SRD II”) were transposed this summer. Asset managers, management companies and AIFMs are now required to develop and publish their engagement policy, including on ESG matters and shall report annually on how this has been implemented, including explanation of the most significant votes.

Upcoming Regulation	Areas impacted	Impact
Disclosures Regulation	Strategy, Products definition, Remuneration, Risk management, Reporting, Data, Distribution, Legal documentation	Very high
Taxonomy Proposal	Products definition, Reporting, Strategy disclosure	Very high
Benchmarks Regulation	Passive products	Low to Medium
Amendments to MiFID II Suitability Tests (ESG Preferences)	Strategy, Products range, Distribution	Very high
Amendments to UCITS & AIFM L2 Texts	Governance, Processes and Controls, Risk management, Conflict of interests	High
Amendments to MiFID L2 Texts	Product governance, Conflict of interests, Processes and Controls	High
EU Ecolabel for Retail Financial products	Label for taxonomy aligned products	Low to Medium

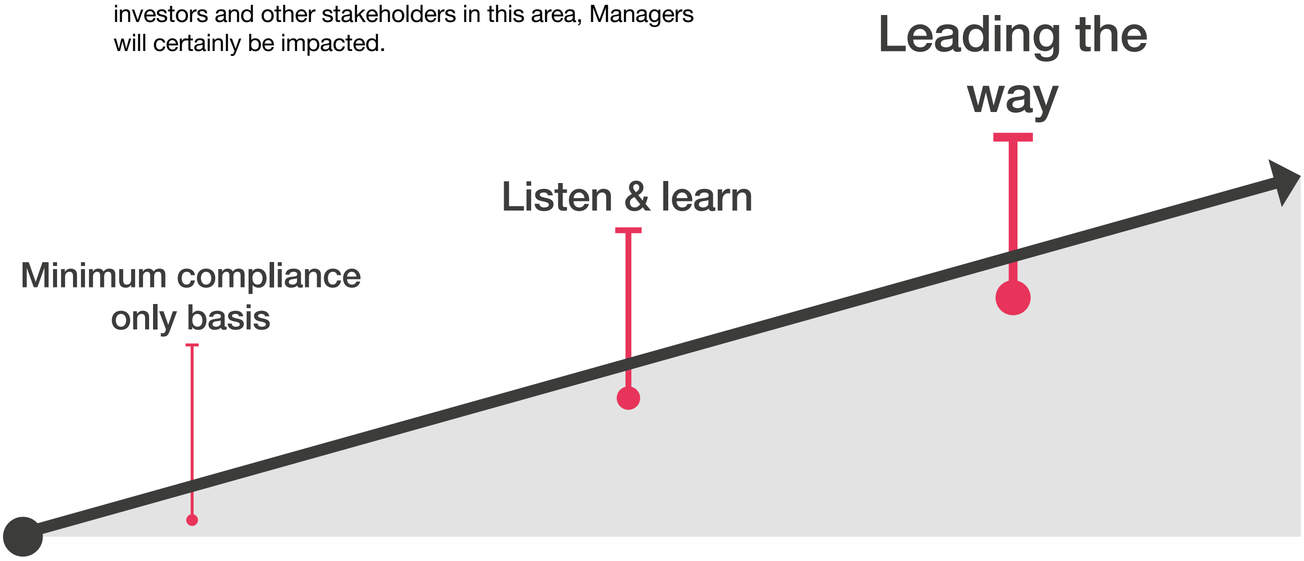
What is next?

The new EU Commission has, through the announcement of the Green Deal Action Plan, confirmed that financing the transition to a greener economy is more than ever a key priority. We shall therefore be expecting new consultations and additional measures, through for instance an announced consultation on the renewed Sustainable Finance action plan as well as revision to the non-financial reporting directive.

Impact for Asset Managers ("Managers") – How to surf the wave

1 Strategic Positioning – ESG, Do or Die?

When considering ESG strategic positioning, there is a variety of possible positions which could be taken. Ranging from compliance considerations through to a full assessment of the business opportunities, which arise both from the industry to the growing interest from investors and other stakeholders in this area, Managers will certainly be impacted.



The above spectrum can also vary from jurisdiction to jurisdiction - whilst some jurisdictions could themselves be seen as leading the way in terms of attitude and regulation, others may not be so advanced in their ESG journey.

But the trend is a global one. Regardless of the journey that is being taken within individual jurisdictions, the sustainability / ESG agenda is not one which can be ignored - this will be a global long-term journey which every country and company will have to take, and therefore it is at the stage of "ESG …. do or die" for every country and for every company. No Manager can continue to ignore industry-wide potential divestment costs from fossil fuels, tobacco, controversial weapons, animal testing products etc., and needs to assess the impact of future investments.

At a minimum, companies will have to comply with the upcoming EU regulations. Managers could decide to wait until current texts in draft / discussion / feedback stages are finalised by the EU, but this will not leave enough time for proper implementation as the calendar will be tight and the changes are pervasive.

Additional consideration will also be required by local regulators, leading to additional and different focus from jurisdiction to jurisdiction – e.g. “Value for Money” reporting within the UK.

If the sustainability journey is perceived as a compliance exercise only, the focus will be on the associated costs of compliance - whilst, this is always a concern, once the legislation is passed, it will be unavoidable. Additionally, whilst the monetary cost of non-compliance may be less than the cost of implementation, the non-financial cost could include adverse publicity, and could have a potential impact on longer-term financial returns.

Therefore, for Managers choosing the compliance only route - they need to consider whether this is actually the best avenue - investors and stakeholders may demand more. This choice of strategic positioning, whilst initially being the “cheaper” option, may cost more in the long run - and not just from a financial point of view.

Consideration of the “long term” within your strategic positioning is no longer just a consideration of short-term opportunities; they rather reflect a longer-term risk perspective. Companies that actively follow and engage with the ESG agenda can work to mitigate medium-term and longer-term risks both within their own businesses, and within their investee companies through strong governance engagement, leading to the possibility to generate longer-term and more sustainable returns over time for investors.

Adapting investment offerings to incorporate ESG products and strategies helps align both investors, other stakeholders and also regulators’ long-term and evolving requirements.

It is also an opportunity to add value for clients and to engage with them – many are already involved in ESG activities through engagement with investee companies regarding governance, diversity and exclusions but have not yet articulated this fully to investors, or reported on these policies.

“Winners” in this market will be those who can articulate their ESG policy and position their products early to take advantage of the growing interest in the market.

2 Investors – Where will the ESG agnostic be hiding?

Most sustainable investors expect better performance, bigger impact (“Return on Values” report), UBS

Asset and Wealth Management revolution: investors perspectives, PwC

For many years, investment decisions were not necessarily aligned with investors' value or long-term concerns. Even though more than 90% of EU citizens mention that climate change is a key concern to them*, climate change investment products have remained niche so far. Per UBS “Return on Values” report entitled, “Most sustainable investors expect better performance, bigger impact”, 65% of HNW investors believe it is highly important to help create a better planet, however only 39% say they have sustainable investments in their portfolio (*View QR Code*).

PwC conducted a survey of 750 institutional investors and 10,000 retail investors around the world in 2019 (PwC: Asset and Wealth Management revolution: investors perspectives – View QR Code). ESG is the third priority in importance among investors surveyed, as a whole group, and it outranks fees. According to the PwC survey, investors in Europe, as a general group, care more about ESG than their counterparts in North America. ESG is a key focus for many large pension and sovereign wealth funds demanding from the managers to whom they allocate mandates to meet their ESG expectations. And institutional investors expectations are rising rapidly. While the focus is currently stronger in Europe, no one managing money from an allocator in the EU can feel immune from these demands. And it's also increasingly important to younger generations, who will be receiving large wealth transfers from older generations over the coming years.

In addition, the anticipated changes in the EU regulatory environment are expected to further accelerate this shift in investors' appetite. Indeed, imagine that in less than two years' time, suitability tests under MiFID II will include questions about investors' ESG preferences… How many investors will articulate to their advisors that they do not care at all or that they are totally ESG agnostic? And for the majority who will express ESG interest, the intermediary will have to propose products whose ESG considerations match the investor's ESG preferences. Will any of the product range without any ESG integration survive this expected ESG wave?

Several Managers have already anticipated the trends and indicated that they are switching their entire product range towards ESG integration.

In this new market dynamic, the winners will be not only those who offer the right product at the right time, but also those who will be able to engage with the head and the heart of the investors, with comprehensive reporting that will tell the story of the investment decision impact on the investee company and the sustainability factors.

* source: EU 2019 Survey - Citizen support for climate change

3 Governance – Will the change come from the top?

Younger generations have led the way in marching for the climate. Will we note a similar trend within the financial sector with changes coming from the youngest employees? Youth can certainly be a force for change and innovation, but as in any significant strategic change, in particular those driven by regulation, the tone from the top will be critical.

These changes will not only affect Manager's products, investment decisions and product distribution but also how Managers incorporate ESG in their business operations and strategy. As such, companies will be asked to consider and measure both the effect of their products and services on sustainability topics as well as the impact of sustainability topics on their products and services.

In order to identify the impact of sustainability on the company's business model as well as strategy, it will be necessary to define oversight, accountability and responsibilities within the company. Processes and frequencies around board information need to be established.

This applies to both risks as well as opportunities linked to sustainability.

Identifying exposed business areas, on the one hand, requires a breakdown of assets under management ("AUM") by business sector across asset classes such as equity, bonds, infrastructure, real estate, structured products, Mortgage-Backed Securities or derivatives, which is needed to demonstrate awareness. On the other hand, this heat map will identify current economic exposure and concentrations in industries or geographies that might be positively or negatively affected by sustainability topics, such as climate change. Identifying, measuring and monitoring of ESG risks and opportunities will require investment in data tools and technology. High data quality as well as a high portfolio coverage are essential to measure and report on ESG performance and attributes.

The regulatory changes will require top management to ensure that:

- Sustainability risks are adequately taken into consideration at all levels: in decision-making procedures and organisational structure, in staff training, in internal control mechanisms, in internal reporting and in the communication at all levels and with any third party, in orderly business records;
- Employees (including those in charge of governance) possess the skills, knowledge and expertise, taking into account the effective integration of sustainability risks;
- Disclosure on remuneration policies is updated to show how they are consistent with the integration of sustainability risks;
- Conflicts of interest potentially arising from integrating sustainability risks are adequately identified and managed. Conflicts of interest could arise from remuneration or personal transactions and any sources of conflicts that could give rise to greenwashing, mis-selling, misrepresentation of investment strategies or churning. Consideration should also be given to conflicting interests between funds with different investment strategies managed by the same Manager as well as situations where there are other business-relationships with investee companies, conflicting group interests, investments in entities with close links or similar circumstances.

4 Product Strategy – Is there a future for non-ESG products?

As mentioned above, the requirement to match ESG consideration with investors' ESG preferences will require a profound review of the product range and their target market definition.

Moreover, the "Disclosures Regulation" introduces two categories of products, with specific reporting requirements. Managers will therefore be required to map products to these new categories:

- Products promoting, amongst other characteristics, environmental or social characteristics, or a combination of those characteristics (provided that the companies in which the investment is made follow good governance practice);
- "Sustainable investment", meaning investment in an economic activity that contributes to an environmental objective or a social objective, provided that such investment does not significantly harm any of the other objectives and the investee company follows good governance.

	Environmental objective	Social objective
Investment in economic activity that contributes to one of environmental or social objective	Measured, for example, by: • Key resource efficiency indicators on the use of energy, renewable energy • Key resource efficiency indicators on the use of raw materials • Key resource efficiency indicators on the use of water and land • Production of waste • Greenhouse gas emission • Impact on biodiversity and the circular economy	• Contributes to tackling inequality • Fosters social cohesion, social integration and labour relations • Investment in human capital of economically or socially disadvantaged communities
DNSH	"Do not significantly harm (DNSH)" - such investments do not harm significantly any of the above objectives	
Governance	Provided that the investee company follows good governance practices, in particular with respect to sound management structure, employee relations, remuneration of staff and tax compliance	

Implication on product range - Integration versus sustainability objective?

Many different approaches exist for incorporating ESG considerations into products. This creates some important strategic questions for Managers and their business models.

On one hand, the "Disclosures Regulation" may encourage Managers to integrate ESG considerations into their investment decisions by requiring them to be more transparent with investors about how this is being done. This is likely to be done at group-level and applied consistently across all portfolios.

Managers may also have funds with explicit sustainability objective, which will typically be marketed on this basis. The "Disclosures Regulation" will require firms with such funds to publicly report on their performance against relevant sustainability objectives. While the "Disclosures Regulation" stops short of mandating funds with this type of strategy, it may have the practical effect of encouraging firms to develop these types of products, as firms seek to respond to the ambitions of policymakers and evolving public attitudes.

A number of different approaches exist in relation to funds with explicit sustainability mandates:

- **Negative screening**: an investment strategy, which excludes specific sectors, companies or business activities on the basis that they are deemed not worth investing in.
- **Positively managed investment approaches**: an investment strategy that positively screens sectors, companies or business activities to focus on investments with good ESG ratings. This can include, for example, thematic investing (i.e. investing on the basis of specific themes) or 'best in class' (i.e. investing in the best companies within a given sector).
- **Impact investing**: an investment strategy that aims to generate a positive social and/or environmental impact, even if financial returns are compromised.

Practical considerations will arise as to how to map these against ESG consideration and product categories introduced in the new "Disclosure Framework".

There is a legitimate question over the future for funds that do not, in any way, have an ESG component. It seems difficult to imagine that firms will not integrate ESG factors into decisions over how their funds are invested. However, it remains to be seen as to whether firms will develop a wider range of sustainable investment products.

Will some firms move towards a position where all AUM are managed in accordance with ESG criteria, or will portions of AUM be carved out and managed according to a discrete ESG strategy? What is clear is that the current regulatory environment presents an opportunity for firms to adapt their business models and product strategy to give a bigger role to ESG and sustainability. Firms should, therefore, review their fund ranges and consider opportunities to develop funds with these sustainability mandates.

Implications for product governance

The MiFID II product governance regime requires firms to clearly define a target market, establish and monitor appropriate distribution channels (and potential conflicts of interests) and communicate this clearly to stakeholders.

In practice, Managers rely on intermediaries to distribute products in a heavily intermediated market, but it is still incumbent upon Managers to construct products with a clear demographic in mind, ensuring that the product meets their investment needs and objectives, and communicate to distributors for whom the product is intended.

In relation to defining what constitutes ESG products, target markets, and other areas that require more regulatory guidance, the ESMA has proposed a flexible approach, at least initially, which is intended to serve as a starting point allowing market participants to accommodate themselves to ESG-requirements in the context of product governance.

On this basis, firms could expect a degree of deviation to be tolerated as the regulatory position on sustainability continues to evolve.

Conduct risks associated with products

As the prominence of ESG investing increases, new conduct risks may arise. Firms need to be mindful of these risks when developing their products.

Possible conduct risks include:

- **Information asymmetries** between investee companies and Managers in relation to the ESG credentials of the former. Poor company data on ESG credentials means that Managers do not have a clear understanding of whether their investments are supportive of a fund's specific investment strategy. This could result in investments that do not adequately align with clients' investment objectives. In addition, it could mean that Managers reflect the uncertainty they have in relation to ESG credentials of investee companies into the price formation process (in both primary and secondary markets), distorting the efficiency/integrity of price formation and, ultimately, bringing into question whether they are securing the best pricing outcome for their clients. Emerging technology can assist fund managers in overcoming problems relating to information asymmetry. Some firms are employing innovative ways of obtaining data, including using AI systems to churn through unstructured data, linking sustainable initiatives to companies through searching through patent filings, news stories and other sources of information in cases where public reporting may be less transparent.
- **Greenwashing/mis-selling**: Firms also need to be mindful of how they are presenting their funds to investors from an ESG perspective. In practice, investors may have little visibility of the ESG credentials of the companies funds they are investing in - this information asymmetry creates a conflict of interest between the Managers and the client, which firms need to manage. Linked to this, firms may also be mis-selling without realising. There are numerous components to this, including a lack of agreed standards for green investments and patchy reporting. Firms should be clear on where the proceeds of capital marketed as a green investment is allocated, and reflect this in their reporting. The EC's green bonds standard and the UK's green finance strategy will help support the development and credibility of the market by boosting transparency and thereby raising the standards for green bond issuance.
- **Re-packaging existing products/strategies** and presenting them as fulfilling ESG preferences where they do not.
- **Value/costs agenda dimension**: how do firms consider any additional costs associated with screening and research into ESG-related instruments - if market participants and their representatives, in response to ESMA, believe that there is no inherent rationale for why ESG products should be more costly, the question will arise as to who will bear these costs.

5 Distribution – The last missing link?

On 4 January 2019, the EC published the updated MiFID II/IDD rules on how investment firms and insurance distributors should take sustainability issues into account when providing advice to their clients.

The EU publication allows for differentiation between investment objectives on one hand and ESG preferences on the other. The EC stated that this differentiation is important in order to avoid mis-selling, which may happen should an ESG consideration take precedence over a client's personal investment objective.

The amendments also state that investment firms should identify "at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, and ESG preferences (where relevant), the financial instrument is compatible."

In its advice to the EC, ESMA elaborated on proposed changes to MiFID II suitability guidelines - the amendments would require firms to (i) take into account ESG preferences in the context of assessing client's investment objectives and (ii) to consider ESG factors in the context of product classification. The ESMA has suggested adopting a high-level approach that will allow firms to decide how best to incorporate these preferences within their existing suitability processes.

Manufacturers and distributors should specify, with a meaningful level of granularity, which ESG preferences the investment product fulfils. For example, it would not be sufficient to specify that the investment product has, as a target market, clients who are interested in environmentally sustainable, social and good governance investments. Firms should instead specify more precisely which ESG preferences it fulfils.

Such requirements may increase the complexity of the suitability process, and general references to ESG could lead to divergent interpretations of how the amendments should be implemented.

Moreover, incorporating ESG preferences into the target market assessment for distributors could also create problems as that responsibility for reliably ensuring that a product has ESG characteristics primarily resides with the manufacturer and not the distributor of the product. A lack of available ESG data on issuer activities can aggravate this, particularly when a manufacturer is not subject to MiFID II and therefore is not obliged to assess a target market.

In this case, the distributor has to assess a target market "as a substitute" – a task which is regarded even more difficult by the respondents given the aforementioned information gaps.

ESMA has maintained that it expects distributors to conduct their own target market assessment according to Article 10(2) of the MiFID II Delegated Directive.

- In doing so, the distributor scrutinises the manufacturer's target market and eventually refines it according to its own data or the specific needs of the client base.
- Without sufficient information, distributors will not be expected to recommend or to market products for which they are unable to check the plausibility of certain features – especially if they are used for marketing purposes.

Practical steps for product manufacturers

Clear product labelling

Manufacturers may look to obtain a product label to make it clear how ESG has been incorporated into funds. Labels have been flourishing in Europe in the past years as labelling could, in some way, address the mis-selling conduct risks mentioned.

Ongoing engagement with product distributors

Including training sessions and materials that can be accessed by product distributors.

Publicly available ESG policies

Making firm-wide and product-specific ESG policies publicly available increases the chances that end-investors will be able to access the information they need.

Engagement apps and robo-advice

Develop tools to capture ESG investor preferences and direct them to appropriate products.

Could be integrated into existing tools used by distributors or simply provided alongside publicly available ESG policies.

Any tool would need to consider (and appropriately weigh) wider investment considerations such as risk appetite, historic performance, expected returns and fees.

Assurance and standards

Consider obtaining external verification of the ESG credentials for certain products to reduce risks of mis-selling.

Data collection

Obtain data from distributors to understand who is investing in these products and how these products are being marketed as regards ESG preferences.

Reward and remuneration

Consider linking a component of distributor incentives (where the regulatory regime allows) to the capturing of ESG preferences of end-investors.

6 Business processes and operations – The practical challenges

The data challenge

Dealing with non-financial information embeds practical key challenges as this data is mainly partial (non-financial reporting is not imposed on all companies nor is the content harmonised by binding regulation) and very often self-declaratory (not subject to mandatory external assurance). In this context, Managers shall ensure implementing strong data processes around:

- Choosing the appropriate data vendors;
- Filling in any data gap;
- Choosing the right set of Key Performance Indicators (KPIs);
- Establishing a robust process in data collection;
- Enhancing current data systems to integrate these new ranges of data and new sources for challenging available data (AI);
- Obtaining assurance vis-à-vis the data reliability.

The risk management challenge

Managers (including management companies and AIFMs) will have to ensure that ESG risks are assessed in relation to each investment and that a proper risk management system is implemented.

In this context, the following aspects should be considered:

- Documented and regular due diligence process when investing on behalf of the investors (respectively on behalf of the fund(s)). The criteria for such due diligence should be adapted to the investment strategy, objectives and risk profile of the fund and they need to fully integrate the ESG dimensions;
- Risk Inventory: risks towards each investment in the portfolio should be properly identified, measured, managed and monitored on an ongoing basis;
- Risk measurement: management and monitoring of each risk, including ESG, towards each product;
- Risk Management policy: an adequate and written policy with appropriate frequency of review;
- Quantitative and qualitative risk limits for each product, taking into account the ESG criteria, the risk appetite of the product and any commitments to investors;
- Alignment of the prospectus / offering document with the risk management process;
- Effective and proper implementation of ESG factors into the Risk Management Policy;
- Reporting on ESG risks.

The people and skills challenge

ESG and sustainability trained resources will be required at all levels of the organisation (from top management, investment managers, analysts, product design, sales, oversight of delegates and outsourced functions, risk management, reporting, controls function and internal audit).

Recruitment of new talents will be the obvious answer, but skilled resources are limited. In the absence of available talent pools, **upskilling** might be the right tactical answer to this challenge. Managers should also anticipate the skills challenge faced by delegates and service providers, who will also be required to upskill their teams.

The accountability challenge

The "Disclosures Regulation" will require Managers to disclose the ESG policy towards a wider group of stakeholders. Managers will have to ensure that they meet their commitments towards these stakeholders. In this context, Managers will have to answer the following questions:

- What to disclose without over-committing and remaining balanced?
- How to ensure the principles disclosed in the ESG policy are those consistently applied prior to the investment decision and also when monitoring AUM?
- How to monitor the activities in a timely manner?
- How to cater to shareholders' voting activity with relevant topics and effective influence?

7 Reporting and Investor Engagement – The winner takes it all

Transparency is a key component in the sustainability agenda. The “Disclosures Regulation” will impose very demanding reporting requirements. All financial market participants and advisors will be required to report on sustainability risks: how these risks are integrated in their investment decisions as well the assessment of the likely impacts of these risks. If these risks are deemed not relevant, Managers will be required to justify this decision.

All Managers will be required therefore to collect data (refer to the data challenge mentioned above) and implement adequate methodology, processes and systems to assess, monitor and disclose these risks.

Moreover, specific products will be required to add specific disclosure requirements (in the prospectus, on the website and in periodic reports). And the recently approved Taxonomy regulation already modifies the “Disclosures regulation”, by imposing disclosure of the proportion of the investments aligned with the Taxonomy for any product promoting environmental characteristics or considered as environmentally sustainable.

Disclosures Regulation	Products promoting environmental or social characteristics	Sustainable investment	Non-ESG products
	Sustainable risks	Sustainable risks	Sustainable risks
	How E or S characteristics achieved methodologies used to measure and extent met (or through benchmark disclosure if passive)	How objective will be attained, methodologies to measure impact and overall impact measurement (sustainability indicators) and/or benchmark disclosure (passive products)	
Additional environmental disclosures (Taxonomy proposal)	Products promoting environmental characteristics	Environmentally sustainable investment	Other products
	Information on environmental objective(s), how and to what extent invested in environmentally sustainable activities (including portfolio percentage and details on enabling and transition activities)	Information on environmental objective(s), how and to what extent invested in environmentally sustainable activities (including portfolio percentage and details on enabling and transition activities)	Statement that the financial product does not take into account the EU criteria for environmentally sustainable products

Besides the obligation of impact measurements applicable to sustainable investments, Managers are also encouraged to disclose their due diligence policy in measuring the adverse impacts of their investment decision on sustainability factors (i.e. measuring the cumulated environmental and social impacts of their investment decisions and portfolios). These requirements will become mandatory for large Managers of over 500 employees and their products (comply or explain approach).

Impact assessment and disclosure will be a real challenge, given the data challenge mentioned before and the lack of a universally recognised methodology. Timing will be particularly challenging as the implementing measures are not expected to be finalised ahead of the implementation deadline: the regulation will apply from 10 March 2021.

Frontrunners may nevertheless consider the reporting requirement not just as a burdensome challenge but as **a real business opportunity**.

Mandatory reporting will indeed make any greenwashing temptation more difficult. With the new “Disclosures Regulation”, as soon as Managers refer to “Environmental” or “Social” characteristics or “Sustainable” objectives in their prospectus, they will be required to disclose how they intend to achieve these objectives, how they will measure the results as well as the results achieved in their periodic reports.

Systematic reference to ESG risks in pre-contractual documentation will be an eye-opener even for the most ESG agnostic investors, who will realise that proper investment decisions need to integrate consideration of ESG factors and events.

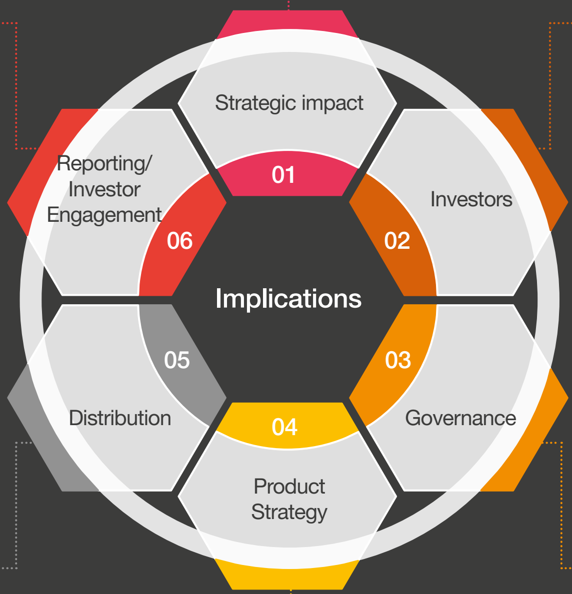
And last but not least, those who will go beyond the mandatory reporting requirements, shall seize the opportunity to tell the real impact story to their investors – how their investment has delivered positive impacts on the market, or has helped to stop inadequate ESG policies – and reconnect their investment decision with their personal interest. This is a real opportunity for Managers to talk not only to the minds of the investors (risks/performance), but also to their hearts and engage with them for the longer term.

Impact of Action Plan Implementation

- Decide on ESG/RI strategy (leader or follower)
- Assess interaction with local regulations as well as global developments (US/Asia)
- Decide on products strategy (e.g. which proportion to redefine, active or passive, etc.)
- Assess strategic impact with benchmark regulation and other EU regulation (SRD II)

- Capture engagement activities, ESG activities and sustainable activities within organisation
- Establish reporting lines and processes
- Decide on communication plan (corporate, products), decide on whether minimalistic approach (versus “telling a story” to investors) and assess on whether to perform impact reporting
- Perform gap analysis
- Implement product reporting (interact with administrators and other suppliers) process including quality control aspects

- Assess impact on current investor base (which percentage are likely to have ESG preference(s)? Sustainable activities products?)
- Decide on market positioning and communication strategy
- Assess and monitor engagement activities
- Update suitability tests as required



- Refine target market definition and communicate to intermediaries
- Assess current distributors, intermediaries
- Adapt distribution network and/or educate intermediaries as required
- Review process to assess target market efficiency

- Upskill management/board
- Embed ESG within corporate culture
- Assess ESG risks and decide upon corporate approach
- Review product governance
- Interaction with stewardship code

- Decide on whether more ESG products (or to remap existing ones) more thematic/sustainable activities
- Review existing product range, assess gap and decide on actions
- Categorise existing and amend documentation (prospectuses, marketing documents, KIDs)
- Launch additional products as required
- Decide on whether product label shall be required

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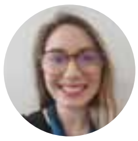

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