

Delays and data pose dual ESG challenges for funds

Niamh O'Shea and Ian Conlon of the **Maples Group** discuss how to overcome the twin difficulties of delays to implementation and lack of transparency and reporting standards for ESG data in the EU

The demand for investments with strong ESG credentials is ever increasing, with global ESG assets under management (AUM) on track to exceed \$53 trillion by 2025. This would represent more than a third of all worldwide investable AUM, according to research from Bloomberg Intelligence.

This trend is driven by a genuine desire to move towards more ethical and responsible investment and investor demand. Asset managers are under increasing pressure to integrate ESG considerations into their investment approaches, but this is not without its challenges.

The two main ESG challenges for funds are, first, the series of delays to the implementation dates of regulations and, second, a lack of transparency and reporting standards for ESG data. This article examines these two challenges with a particular focus on Europe.

Leading the ESG charge

The EU is leading the ESG charge and is at the forefront of policy making and legislative developments. To achieve this goal, in 2019 it adopted the Action Plan on Financing Sustainable Growth (the Sustainable Action Plan), which consists of a series of legislative measures on sustainable finance to be introduced this decade.

A key objective of the Sustainable Action Plan is to channel private investment into projects to complement public money. This will help transition the EU into a climate-neutral economy.

The European Commission also published its renewed Strategy for Financing the Transition to a Sustainable Economy in July 2021, reaffirming its commitment to channelling financial flows towards the achievement of the Paris Agreement. The 'green regulatory tsunami' in Europe includes the Sustainable Finance Disclosure Regulation



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disclosed. Under the Taxonomy Regulation, an economic activity qualifies as environmentally sustainable where it:

- Contributes substantially to one or more of the six environmental objectives, being (i) climate change mitigation; (ii) climate change adaptation; (iii) the sustainable use and protection of water and marine resources; (iv) the transition to a circular economy; (v) pollution prevention and control; and (vi) the protection and restoration of biodiversity and ecosystems (the environmental objectives);
- Does not significantly harm any of the other environmental objectives;
- Is carried out in compliance with minimum safeguards; and
- Complies with the technical screening criteria established by the European Commission.

Certain requirements of the Taxonomy Regulation will apply on a staggered basis depending on the environmental objective of the relevant financial product. The requirements in relation to climate change mitigation and climate change adaptation apply from January 1 2022, while the requirements for the other four environmental objectives will apply from January 1 2023.

Under Article 8(1) of the Taxonomy Regulation, large undertakings that are required to publish non-financial information pursuant to the NFRD are required to disclose information to the public on how and to what extent their activities are associated with environmentally sustainable economic activities.

These NFRD disclosures now apply to large public interest entities with more than 500 employees. However the proposed Corporate Sustainability Reporting Directive (CSRD) intends to widen the scope of entities to which these disclosure obligations apply and aims to address perceived gaps in the operation of the NFRD.

The CSRD will amend the existing reporting requirements of the NFRD and seeks to increase transparency on corporate performance in terms of sustainability. The scope of reporting entities and the content of the reports has expanded. If implemented in the form proposed, the CSRD will increase the scope of NFRD (including Article 8 of the Taxonomy Regulation) to include all large companies and all

(SFDR), the Taxonomy Regulation and the Corporate Sustainability Reporting Directive.

Financial market participants (FMPs), including alternative investment fund managers and undertakings for the collective investment in transferable securities management companies, have been required to comply with the SFDR on a level 1 or high-level principles basis since March 10 2021.

While the SFDR contains requirements that apply to all FMPs and products (even those without an express ESG or sustainability focus), it also provides for further disclosures to be made in respect of products that promote environmental and/or social characteristics (Article 8

SFDR products) and those that have sustainable investment as their objective (Article 9 SFDR products).

The Taxonomy Regulation amends the disclosure requirements in place under the SFDR and the Non-Financial Reporting Directive (NFRD). The Taxonomy Regulation has applied on a level 1 or high-level principles basis since January 1 2022 and requires additional disclosures to those set out in the SFDR.

The disclosures cover how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. Where the product does not meet environmentally sustainable criteria, this must also be

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companies listed on EU regulated markets (except listed micro-enterprises) and all large companies meeting two of the following conditions:

- A balance sheet greater than €20 million;
- A net turnover greater than €40 million;
- An average number of employees greater than 250.

If the European Parliament and the European Council agree the text of CSRD during the first half of 2022, it is anticipated that companies in scope under the CSRD will be expected to comply with a broad range of reporting requirements by January 1 2024 (covering the financial year 2023).

Delays to ESG legislation

One of the main challenges relates to the delay and staggered implementation of ESG legislation. The legislative implementation process for both the SFDR and the Taxonomy Regulation has been significantly disrupted due to the Covid-19 pandemic.

The SFDR and the Taxonomy Regulation provide for the development of regulatory technical standards (RTS) to specify the disclosure requirements in detail.

The RTS set out the granular specifications for the content, methodology and presentation of certain disclosures outlined in the SFDR and the Taxonomy Regulation, including the entity level principal adverse impacts as well as the content and presentation of financial product level pre-contractual, website and periodic reports for Article 8 SFDR Products and Article 9 SFDR Products.

These RTS or level 2 requirements have been repeatedly delayed and will at the time of writing take effect on January 1 2023. This continuing delay has created uncertainty in terms of timing. FMPs are required to continue to comply with the high level and principle-based level 1 requirements and will then need to comply with the more detailed level 2 requirements once the final RTS are implemented.

Confusion regarding SFDR compliance is widespread in the industry and is compounded by the lack of regulatory guidance and differing views on interpretation across the EU. In July 2021, the European Commission published its long-awaited reply to the letter from the European Supervisory Authorities (the

ESAs) seeking clarity on certain priority issues of the SFDR.

While certain explanations and clarifications were welcome, a number of answers did not provide the clarity expected and do not answer all of the outstanding questions. For example, there is still some uncertainty regarding the application of firm-level obligations to non-EU AIFMs. In addition, one of the most surprising developments was the European Commission's response regarding the criteria for an Article 8 classification and the definition of 'promotion'. The answers did not provide any minimum sustainability criteria and merely noted that a firm must do more than simply integrate the consideration of sustainability risks into the decision-making process.

The European Commission included an extremely broad definition of 'promotion' in the context of an Article 8 categorisation. As such, the test as to whether a fund 'promotes' environmental and/or social characteristics is a subjective one, provided that such claims are disclosed in its pre-contractual disclosures. However, this definition should be approached cautiously, as the European

Commission has indicated in its Strategy for Financing the Transition to a Sustainable Economy that it will consider the introduction of ‘minimum sustainability criteria’ for Article 8 funds.

The European Securities and Markets Authority (ESMA) announced that it would issue a set of questions and answers providing guidance on the practical application of the SFDR after some EU member states issued their own doctrines on how fund firms should comply with the rules. The ESMA has indicated that it will be submitting further questions to the European Commission asking for clarification of some areas on the main regulatory text of SFDR, which will be the second time it has asked for clarification of SFDR. The lack of clarity is frustrating, but market practice will evolve and further regulatory guidance will inevitably be published.

Therefore, over a year after the SFDR came into force, ambiguities in the labelling thresholds and certainties over how the regulation applies to some firms and products remain. However, this has not deterred the asset management industry. According to the latest data from Morningstar for Q3 2021, Article 8 and Article 9 funds could reach 50% (from close to 37% today) of overall EU fund assets (equities, bonds, alternatives etc.) by mid-2022 or sooner as managers continue to upgrade strategies and launch new products that will meet the Articles’ requirements.

Data gap continues to exist

The second main ESG challenge faced by funds is the availability and quality of the data needed to meet their disclosure obligations under SFDR and the Taxonomy Regulation. There is a deep disconnect between ESG data required and that which is readily obtainable. Compounding this is also a lack of comparable, reliable and publicly available data. This data gap will likely exist until 2024 when the CSRD is implemented.

The RTS introduces a highly detailed and prescriptive set of requirements for FMPs to follow for the principal adverse sustainability impacts (PASI) disclosures via a standardised template or PASI statement. This includes a range of mandatory and optional PASI indicators for FMPs to report on alongside more qualitative aspects.

FMPs that publish a PASI statement will be required to include the additional principal adverse impact data specified in Annex I of the RTS for the first time by June 30 2023, meaning that the first reference period will be from when the FMP starts considering principal adverse impacts to December 31 2022.

The Irish Funds Industry Association has published a paper to assist asset managers to prepare for reporting on principal adverse impacts. The paper includes a survey of ESG data vendors and the findings reveal patchy coverage on several ESG data points and a wide range of variance in the reported data with low levels of comparability. The findings reveal that data is generally available for only eight of the 14 mandatory principal adverse impacts relating to investee companies.

For a number of the indicators there is wide variance among the data points provided by the data vendors being used to meet the specifications of the principal adverse impact indicators. This wide variance could have an impact on the credibility of the data reported. The results of the survey illustrate that the lack of common sustainability reporting standards for companies hinders the comparability and credibility of the reported data.

The RTS provides that where information relating to any of the indicators used is not readily available, details of the “best efforts used to obtain the information either directly from investee companies, or by carrying out additional research, cooperating with third party data providers or external experts or making reasonable assumptions” should also be disclosed. There is no specific guidance on what is considered ‘best efforts’; however the recitals to the RTS give an indication of the level of effort that the ESAs expect an FMP to make to obtain the information required.

They provide that FMPs should identify principal adverse impacts on sustainability factors through “all reasonable means available” and that FMPs “may employ market research providers, internal financial analysts and specialists in the area of sustainable investments, undertake specifically commissioned studies, use publicly available information or shared information from peer networks or collaborative initiatives and may also engage directly with the management of

investee companies to better understand the risk of adverse impacts on sustainability factors. Direct engagement may be particularly necessary in situations where there is an insufficient level of data available.”

The recitals to the RTS also note that where taxonomy-aligned activities are not yet disclosed by undertakings under Article 8 of the Taxonomy Regulation, third-party data providers may be relied on. The implication of the RTS is therefore that the information should primarily be gathered through direct engagement with investee companies and then from internally or externally available data.

The other main data challenge relates to the mandatory pre-contractual disclosure templates for Article 8 SFDR Products and Article 9 SFDR Products contained in the RTS, which will now have to be completed by January 1 2023. The templates are very detailed and will require a significant amount of data to complete them. To date one of the main challenges is that there is a disconnect between the ESG data required to complete these templates and what data is available and obtainable.

In addition, amendments to the Markets in Financial Instruments Directive (MiFID) II will take effect on August 2 2022. These amendments relate to matters including sustainability preferences. The timing of the new MiFID requirements to incorporate customer sustainability preferences in August 2022 remains problematic in terms of data availability. In order to establish these preferences, information to be reported under the SFDR, Taxonomy Regulation and NFRD/CSRD will be required but will not be in force by August 2 2022. These sequencing issues will pose significant challenges as data will only be available on a quantitative basis from 2023.

Global regulators have put forward proposals for the regulation of ESG data providers. Notably, a final report published by the International Organisation of Securities Commissions established a set of recommendations regarding the conduct of ESG data providers and methods of oversight by their respective national regulators. The hope is that the call for data providers to be more transparent about their methodologies and business models could presage the creation of regulatory frameworks in the EU and elsewhere.