Future First℠

ESG: EU Regulatory Change and Its Implications

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Despite the sharp change in the financial landscape over the past year and an increasingly challenging macroeconomic climate, investment focused on environmental, social and governance (ESG) factors is set to grow. Global ESG assets may reach $50 trillion by 2025, one-third of the projected total assets under management globally, from $35 trillion in 2020.[i] Climate-related challenges, in particular, have come to the fore given the experience of unprecedented heat waves in parts of Europe, forest fires in the U.S. and devastating floods in Pakistan during 2022.

The first paper in this series explained how many institutional investors, including asset managers, asset owners and pension fund providers, have begun mapping their impact processes and integrated screening tools into their investment protocols, incorporating ESG priorities, obligations, and expectations. It also outlined global regulatory compliance responsibilities at a high level and assessed the challenges institutional investors face given inconsistent data quality and differing national and regional approaches to ESG regulation, which can be problematic for global investors.

This paper is focused primarily on the European Union's (EU) regulatory approach to sustainability disclosure and on recent developments and likely forthcoming initiatives. It considers the implications of these measures for institutional investors and assesses the remaining uncertainties and the key practical challenges that need to be addressed for preparedness. The paper also briefly outlines U.S. and UK ESG regulation, which is at an earlier stage than the EU; the U.S. and UK regulatory positions will be more fully assessed in a future paper.

A Recap of EU ESG Developments to Date

The EU's Sustainable Finance Disclosure Regulation (SFDR) seeks to improve transparency relating to sustainable investment products, to prevent greenwashing and to increase investor comfort regarding sustainability claims made by asset managers, pension funds and insurance firms (which are in scope of the broader SFDR definition of financial market participants (FMPs)).[ii] It imposes comprehensive ESG disclosure requirements covering a broad range of metrics at both entity- and product-level. The main provisions (known as Level 1) of the SFDR have been applicable since March 2021.

A Delegated Regulation, containing Regulatory Technical Standards (RTS) setting out the content, methodology and presentation of the sustainability information to be disclosed by FMPs under the SFDR, was published in July 2022 in the Official Journal of the EU following scrutiny by the European Parliament and the European Council.[iii] These so-called RTS will apply from January 1, 2023. Among other requirements, FMPs that consider the principal adverse impacts (PAI – see box for Key Concepts) of their investment decisions on sustainability factors must publish the information on those impacts using a prescribed reporting template by June 30 of each year (with the first report due in 2023).

The EU Taxonomy Regulation, which became applicable in January 2022, establishes an EU-wide classification system or framework intended to provide businesses and investors with a common language to identify the extent to which economic activities can be considered environmentally sustainable.[iv] Where an investment product falls within Article 8 (so-called 'light green' funds) or Article 9 ('dark-green' funds – see Key Concepts for details) of SFDR, the FMP must disclose the extent to which the investments in this product are aligned with the EU Taxonomy Regulation via a graphical presentation in the SFDR RTS disclosure templates. This will, from January 1, 2023, include consideration of the first two (of six) EU Taxonomy environmental objectives, with the remaining four objectives to be implemented at a later date.

Beyond rules aimed at FMPs directly, the EU Commission is expanding its ESG initiatives to target corporates. One such initiative is the Corporate Sustainability Reporting Directive (CSRD), which will amend the existing Non-Financial Reporting Directive (NFRD) and ensure in-scope entities provide consistent and comparable sustainability information. The European Council and European Parliament have both approved the final text of CSRD which should be published in the Official Journal of the EU shortly. It will be implemented in several stages – January 1, 2024, 2025, 2026 and 2028 – depending on whether companies are already subject to the NFRD; are large EU undertakings which are not presently subject to NFRD; are listed SMEs or small and non-complex credit institutions and captive insurance undertakings; or are non-EU companies operating in the EU. The first reports – covering the financial year 2024 – are due in 2025.

It continues to be a challenge for FMPs to disclose appropriate information under SFDR and the EU Taxonomy Regulation without access to robust and reliable corporate sustainability data. It follows that ESG updates to MiFID II (Markets in Financial Instruments Directive), which require certain firms, including asset managers, to collect information from their clients as to their sustainability preferences, have presented challenges where appropriate sustainable products may not yet be identifiable to meet certain client sustainability preferences.[v] It is hoped that data reported by corporates under CSRD, once applicable, will go a long way toward resolving this reporting challenge, enabling FMPs to meet their obligations under the SFDR, the EU Taxonomy Regulation and other relevant legislation. In turn, this will enhance the flow of capital towards sustainable activities.

Key Concepts under SFDR

ARTICLE 6 is the default classification for products which do not have a sustainable investment objective or do not promote environmental and/or social characteristics.

ARTICLE 8 funds promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics.

ARTICLE 9 products target sustainable investments as an objective.

DO NO SIGNIFICANT HARM (DNSH) is the principle that an economic activity does not significantly harm any of the six environmental objectives set out in the EU Taxonomy Regulation. It is one of four criteria used to consider whether an economic activity can be considered environmentally sustainable. A sustainable investment must DNSH to environmental or social objectives.

PRINCIPAL ADVERSE IMPACTS (PAI) are the principal impacts of investment decisions and advice that negatively impact sustainability factors.

SUSTAINABILITY FACTORS are environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

SUSTAINABILITY INDICATORS are metrics used to measure the environmental or social characteristics or the overall sustainable impact of the financial product.

Another ESG initiative aimed at corporates, but also with consequences for FMPs, is the European Commission proposal for a Corporate Sustainability Due Diligence Directive (CS3D, also known as CSDD or CSDDD) which was published in February 2022. CS3D aims to foster sustainable and responsible corporate behavior across value chains by introducing requirements for companies to conduct detailed due diligence to identify and prevent adverse human rights and environmental impacts in relation to their own operations and along their value chains. Civil liability provisions are included where adverse impacts occur as a result of a company's failure to implement appropriate diligence procedures. CS3D will apply to EU and non-EU companies operating in the EU that meet various requirements relating to employee numbers and turnover. This requirement for companies to examine and address adverse impacts ought to facilitate mandated disclosures under CSRD which require companies to report on sustainability impacts connected with their own operations and with their value chains. It is expected to apply from 2025, although negotiations between EU policy makers are at a relatively early stage.

Practical Challenges to Be Addressed

While the details and timetable associated with the SFDR RTS are known, it remains unclear how some aspects of the new rules will work at a practical level; multiple challenges need to be resolved in the coming months.

To help FMPs consider these challenges and address them effectively in advance of implementation, it is useful to group them into three categories:

1. **DEFINITIONS AND TIMING:** What definitional ambiguities are to be addressed in the RTS and what are their implications? What challenges does timing present?

2. **DATA:** What challenges relating to data, such as reliability, remain to be solved, and how are FMPs tackling them? What role can technology such as AI play?

3. **DISTRIBUTION:** How will fund platforms and other distributors respond to SFDR RTS and what will be the impact on end investors' behavior?

Definitions and Timing: Ambiguities Remain

Over the past year, there have been a number of developments that have aided in the understanding of the RTS and other components of SFDR. However, even though the RTS measures are due to apply from January 1, 2023, further regulatory revisions are already being proposed, guidance is still being considered and released and some foundational matters remain unclear.[vi] Three key challenges are outlined below.

1. Defining 'Sustainable Investment' and its Integration into Asset Allocation

In September 2022 the European Supervisory Authorities (European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA)) collectively (ESAs) published a set of questions to the European Commission (EC) relating to the interpretation of SFDR.[vii] Chief among these is the definition of sustainable investment. Specific queries include:

- If 20% of an investee company's activities are reported as contributing to environmental or social (E/S) objectives, and the remaining 80% does not significantly harm any E/S objectives and the company follows good governance practices, should the entire holding be considered as a sustainable investment or just the 20% of activities?
- Does the economic activity itself have to contribute to E/S objectives, or can any activity, provided it is carried out in a sustainable manner, or where the company has a transition plan (in the case of climate change), count as contributing to an E/S objective?
- What distinguishes a product 'promoting' carbon emissions reduction (CER) as an environmental characteristic from one with a CER objective? Should a product

disclosing CER always be treated as having a sustainable investment objective (and therefore be considered as an Article 9 fund) or might it be classed as an Article 8 fund if CER is an environmental characteristic?

The clarification of sustainable investment is critical. If the EC's response to the ESAs' questions is not in line with market practice, and we do not expect a response until next year, then FMPs may need to review and adapt their investment approach or potentially reclassify certain products. It should be noted that, while the aim of SFDR was to introduce clear disclosure requirements where products were being marketed with sustainable characteristics or objectives, the market has interpreted the disclosures in Article 8 and Article 9 SFDR as a label; market participants have recognized value in being able to promote products as Article 8 or Article 9 funds.

The lack of clarity compounds existing challenges raised by the ESA's June 2022 clarification on key SFDR topics.[viii] Here, the ESAs specified that products with a sustainable investment objective should only make sustainable investments. Yet this has not been the case to date for much of the market. Research by Morningstar estimates that of the approximately 950 Article 9 funds currently available in the EU market, around 40% have a sustainable investment goal where less than 50% of the investments made are in sustainable investments. Only around 2.5% have target allocations higher than 90%, and only a dozen report having 100% sustainable investments.[ix]

Ambiguity about the definition of a sustainable investment risks undermining confidence in sustainable financial products. Analysis by Clarity AI of roughly 750 Article 9 funds shows that many also appear to fall short in relation to the concept of DNSH. Nearly 20% of the Article 9 funds have a more than 10% exposure to companies that violate the UN Global Compact principles or the OECD Guidelines for Multinational Enterprises, and 40% have more than 5% exposure. Moreover, 10% of Article 9 funds have more than 10% exposure to fossil fuels.[x]

What do Article 8 and 9 funds look like?

- Equity and bond funds made up around 95% of the Article 9 universe and 65% of Article 8 funds at the end of 2021.
- For Article 8 funds, the remaining 35% are money market funds (16%) and multi-asset funds (19%).
- Corporate bonds represented the largest part of the bond fund portfolio at 50% for Article 8 funds and 62% for Article 9 funds.
- Sustainable equity funds are strongly invested in technology, which accounted for 22% of Article 8 funds and 20% of Article 9 funds at the end of 2021.

Source: https://efama.vcpgraphics.online/efama-fact-book-2022

There have already been reclassification of some products from Article 9 to Article 8 (and Article 8 to Article 6). This trend is accelerating as there are additional clarifications regarding definitions and other criteria, prompting firms to review their initial assessments. A total of 41 funds were reclassified from Article 9 to 8 in Q3 2022.[xi]

2. Fund Names Using ESG or Sustainability-related Terms

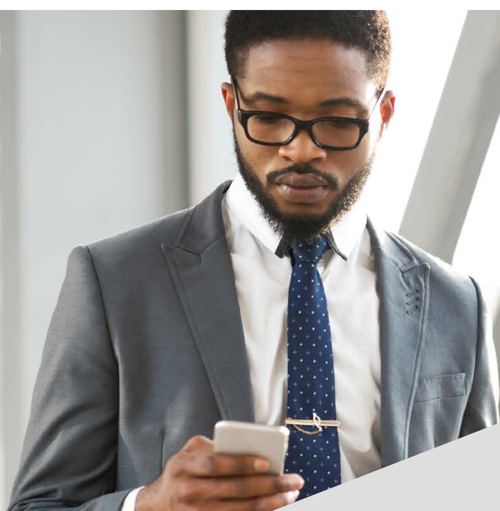
Moreover, in November 2022, ESMA published a consultation on guidelines on fund names using ESG or sustainability-related terms.[xii] The principal aim of these guidelines is to address any misuse of such terminology in fund names and prevent greenwashing.

The core proposal introduces quantitative thresholds on the following basis:

i. For any fund names that include any ESG-related words, a minimum proportion of 80% of the investments should be used to promote the E/S characteristics or sustainable investment objectives.

ii. For any fund names that include the word 'sustainable' (or derivatives thereof), within the 80% mentioned in point one above, FMPs should allocate a minimum of 50% of these investments to sustainable investments.

In the broader market context of an acceleration in the reclassification of funds, this proposal will require further reviews by FMPs to ensure their fund ranges comply with the guidelines. From a timing perspective, this is late in the day, with final guidelines not expected until Q2/Q3 2023 but with an application date shortly afterwards (though the guidelines contemplate a transition period of 6 months for existing funds). In light of this, FMPs will need to carefully manage communications with investors to clarify how they are implementing the guidelines across their in-scope products and how any changes have been made.



3. SFDR RTS Changes Planned and Expected

Despite the SFDR RTS application from January 1, 2023, there are already proposed and planned changes that FMPs need to be aware of, and plan for. This can, in large part, be attributed to the intended dynamic nature of the EU Taxonomy framework in classifying economic activities. As new activities are brought into scope, corresponding disclosures via the SFDR would likely need to be adapted to fit. FMPs will need to constantly monitor the situation and address issues as they emerge. In addition, the current uncertainty regarding the timing for the application of some changes poses challenges for firms when it comes to prioritizing tasks and implementing solutions.

As an example, in September 2022 the ESAs published draft changes to the SFDR RTS to introduce additional disclosures relating to investments in taxonomy-aligned fossil gas and nuclear economic activities, following the late decision by EU policy makers to include these activities within the climate change mitigation and adaptation objectives in the EU Taxonomy Regulation. These draft changes are aimed at mandating corresponding EU Taxonomy alignment disclosures in the SFDR RTS, which will in turn require additional data sourcing. Given the impending application date for the existing RTS, the expectation is that these amendments will be phased in after January 1, 2023. However, at this stage, uncertainty in the timing poses a challenge for FMPs.

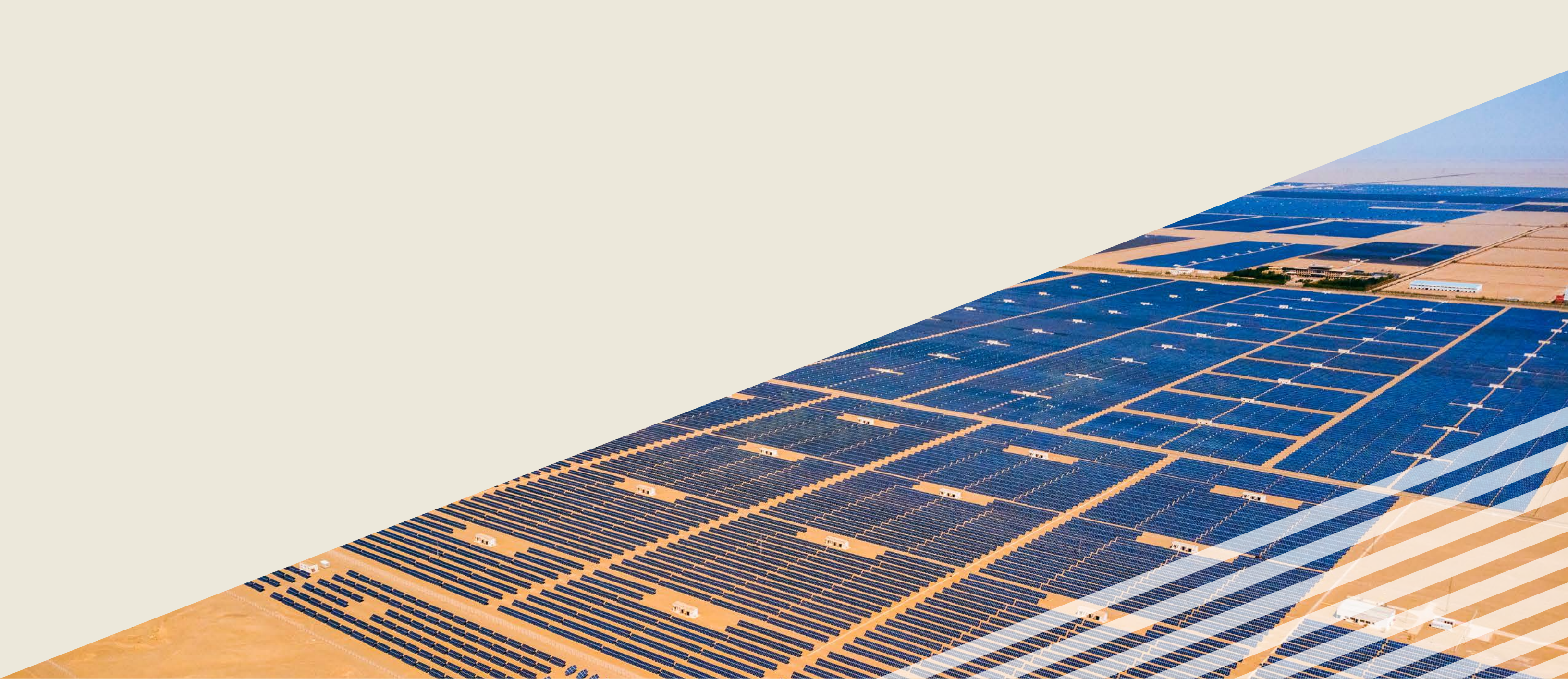
Another anticipated change is linked to the planned review by the ESAs of PAI indicators and product-level disclosures. The ESAs were mandated by the European Commission to deliver these updates by April, 2023. However, as a result of their focus on delivery of the revised RTS to take into account fossil gas and nuclear activity (outlined above), the ESAs recently announced an up-to six-month delay for delivery of the revisions. While the delay announced sounds positive at first glance, the nature of the changes remains unclear, as does the timeline for application. The European Commission will need to consider the fact that these disclosures are (principally) annual, to afford FMPs sufficient time to plan and implement the resulting changes. FMPs will need to plan their resourcing for the review and implementation of any changes, which will likely require existing operating models to be reconfigured.

Data: Quality and Consistency Are Problematic

The quality and consistency of data is a key challenge for asset managers when managing a fund that seeks to achieve a specific ESG objective. As outlined in the first paper in this series, the absence of consistent, robust, verified and widely accepted data standards makes it difficult to compare the ESG characteristics of a company that is a potential investment target against another. It also makes it difficult for asset managers to comply with regulatory obligations around disclosure and assessing sustainability risks and opportunities.

Analysis by Clarity AI demonstrates the scale of the problem. Firstly, just 17% of the world's listed companies – or 6,500 firms – report their carbon emissions. Secondly, comparing data points from three leading providers across five years, Clarity AI found that there were significant discrepancies (i.e. a divergence by 20% or more) in 13% of the data, or more than one in eight data points. [xiii]

While it is hoped that inconsistent reporting of underlying investee company information will be addressed by initiatives such as the CSRD, FMPs are required to report in line with the SFDR and EU Taxonomy Regulations before corporates are obliged to produce and disclose the required metrics. It remains unclear how this misalignment will impact data quality, what approach regulators could take during this period, and what potential implications there could be for FMPs.

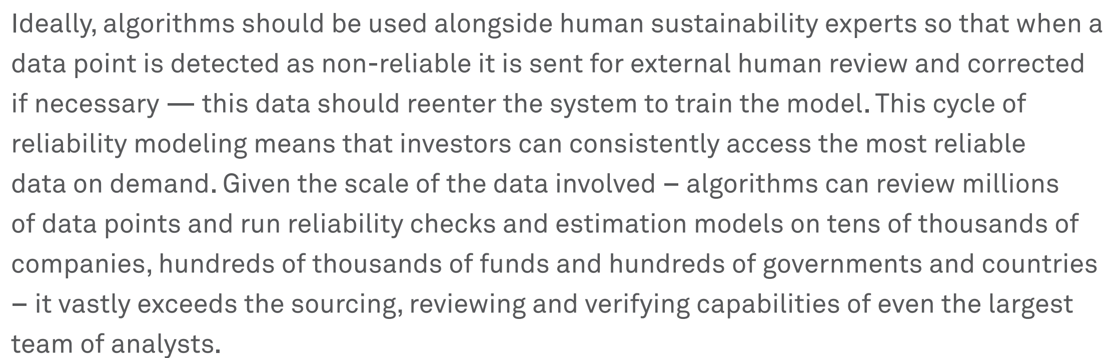


What role can technology play?

FMPs are evaluating their data challenges in relation to SFDR and are seeking technological solutions, such as machine learning (ML), to identify and address problems relating to data reliability. Data issues can be addressed using simple methods such as outlier filtering. However, this approach creates the possibility of both false positives and negatives: an outlier is not necessarily wrong, nor is data that is not an outlier necessarily correct.

An alternative approach, as developed by Clarity AI for example, is to:

1. Curate a robust dataset of sustainability data points, which has gone through rigorous quality checks.
2. Train, calibrate, and validate a supervised ML model to select the most reliable data points and filter out non-reliable data. It is important to use multiple features for each data point to ensure sufficient context to understand its plausibility given the broader context of the company's history, its peer companies and sector, and other factors, such as size and pace of growth.



Ideally, algorithms should be used alongside human sustainability experts so that when a data point is detected as non-reliable it is sent for external human review and corrected if necessary — this data should reenter the system to train the model. This cycle of reliability modeling means that investors can consistently access the most reliable data on demand. Given the scale of the data involved – algorithms can review millions of data points and run reliability checks and estimation models on tens of thousands of companies, hundreds of thousands of funds and hundreds of governments and countries – it vastly exceeds the sourcing, reviewing and verifying capabilities of even the largest team of analysts.

Technology can also help to overcome other problems relating to sustainable investment. Inevitably, investment assessments reflect human bias. Algorithms can help fight that bias by making assessments more systematic, structured and transparent. For example, Clarity AI's algorithms use a narrow definition of sustainability that closely matches the EU Taxonomy, which means that investors can have confidence that their reporting is as accurate as possible. Using artificial intelligence to analyze the true impact of investments could be an important step in helping investors and regulators ensure accuracy.

Distribution: How Will the Landscape Evolve?

While there remains significant work to do to clarify various aspects of SFDR and resolve issues relating to data quality, it is not too early to consider the consequences of EU ESG regulation with regards to the distribution of financial products. One of the ultimate aims of the SFDR, the EU Taxonomy Regulation, and myriad other regulatory initiatives in the EU is to increase the flow of funds towards more sustainable investments. Is ESG regulation in the EU prompting changes in end investor behaviour that help to achieve this objective? It would appear so, given there has been a slew of new Article 8 or Article 9 funds (640 in 2021 and a further 577 in the first three-quarters of 2022). [xiv] [xv]

However, there have also been teething problems caused by the lack of precision about the definition of sustainable investment, which could give rise to concerns about greenwashing. As we highlight above, in the third quarter of 2022 alone, 41 funds were reclassified to Article 8 from Article 9. This compares with 27 funds reclassified to Article 9 in the same period, from Article 6 and Article 8.[xvi]

It is unclear the extent to which fund platforms and other distributors are changing their marketing to align with new fund classifications. ESMA's consultation on guidelines on fund names using ESG or sustainability-related terms is welcome. But FMPs and national regulators are already moving further and faster. For instance, reports suggest that intermediaries in some regions are beginning to demand that Article 8 include minimum percentages of sustainable investments and disclose this information using the European ESG template.[xvii] Similarly, national regulators in some countries have been considering setting minimum thresholds for sustainable investments. For instance, in Germany, last year the Federal Financial Supervisory Authority (BaFin) consulted on guidelines which stated that if a fund is named as sustainable, or is distributed as a sustainable fund, certain conditions must be met.[xviii] Final guidelines have since been revoked, nevertheless BaFin has explained that it will use its principles in its administrative practice.

To date, retail investors are largely unaware of the distinction between funds that qualify for Article 8 or Article 9 let alone the percentage of sustainable investments in funds. The use of Article 8 and Article 9 as labels denoting ESG credentials, while unintended by European policy makers when proposing the rules, should ultimately help to establish clarity in the ESG product space. However, considerable investor education may be required before this point is reached. More effort now needs to be made, both to clarify the criteria for Article 8 and Article 9 inclusion and to communicate this information more effectively to the market. More generally, it remains to be seen if retail investor appetite for ESG funds may be undermined by a prolonged bear market or economic downturn.

The International Dimension

The EU's ESG disclosure rules are not being developed in isolation, though the region is at the forefront of global efforts.

- The UK's Financial Conduct Authority (FCA) plans a sustainable investment labelling system – with three categories: 'Sustainable Focus', 'Sustainable Improvers' and 'Sustainable Impact' – as well as rules to protect consumers from greenwashing (including naming and marketing rules for financial products), and additional product and entity level disclosures aimed at consumers and professional investors.
- Mandatory climate-related disclosures for FCA regulated asset managers, life insurers and FCA-regulated pension providers, listed issuers and large UK private companies are closely aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). These will be extended in due course to align with climate and general sustainability standards being developed by the International Sustainability Standards Board.
- In May 2022, the US Securities and Exchange Commission (SEC) announced a proposal intended to promote consistent, comparable, and reliable information for investors relating to funds' and advisers' incorporation of ESG factors.
- A second proposal aims to expand the regulation of the naming of funds with an ESG focus.
- The proposed rules follow the SEC proposal announced in March 2022 requiring public companies to disclose extensive climate-related information in their SEC filings. These include climate-related risks that are likely to have or have had a material impact on a public company's business or financial statements and affected or are likely to affect its strategy, model or outlook, along with disclosures on greenhouse gas emissions and climate-related financial metrics.

Conclusion

Much has changed in the ESG space – as well as the broader financial markets and the macroeconomic environment – in the past year. There is now greater certainty about many key aspects of the EU ESG regulatory regime. The scale of the challenge relating to data, for example, has come into sharper focus, while potential technological solutions are emerging. As the bar is raised for investment products claiming sustainability credentials, the potential for greenwashing should recede and confidence in the ESG regulatory landscape should grow. Yet key questions about the nature of some regulations and definitions remain unresolved – with potentially significant consequences for FMPs.

For firms impacted by the EU SFDR regime, the focus should be on preparing initial pre-contractual and periodic disclosures for in-scope Article 8 and Article 9 products in preparation for the January 1, 2023 deadline. Asset managers and owners would do well to ensure alignment between these documents despite the challenges in definitions, data coverage and data quality as outlined in this paper. Impacted firms will then quickly need to pivot to address the required entity-level PAI calculations, which are due by June 30, 2023.

Many institutional investors, including asset managers, asset owners and pension fund providers have an international perspective and business model, which adds complexity given different regulatory regimes.

FMPs would do well to pay close attention to the evolution of regulations in the EU, the UK and the U.S. where relevant. There are some significant differences in the detailed implementation requirements which may pose significant challenges for firms operating across these markets: the concept of DNSH, which exists in EU regulation, is not expected to be an initial part of UK rules, for instance. The time, effort and costs associated will be significant to ensure products are effectively scoped and categorized. But the rewards are potentially enormous – for the industry, humanity and the planet alike.

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[i] https://www.bloomberg.com/company/press/esg-may-surpass-41-trillion-assets-in-2022-but-not-without-challenges-finds-bloomberg-intelligence/

[ii] REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability-related disclosures in the financial services sector. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R2088-20200712&from=EN

[iii] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022R1288&from=EN

[iv] REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN

[v] Directive 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast). https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02014L0065-20220228&from=EN

[vi] A recent example of this is the ESAs Q&A document, published November 17, 2022 https://www.esma.europa.eu/sites/default/files/library/jc_2022_62_jc_sfdr_qas.pdf

[vii] https://www.esma.europa.eu/sites/default/files/library/jc_2022_47_-_union_law_interpretation_questions_under_sfdr.pdf

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[ix] https://www.bloomberg.com/news/articles/2022-09-14/asset-managers-face-significant-wave-of-esg-fund-downgrades

[x] https://clarity.ai/research-and-insights/sfdr-just-how-sustainable-are-article-9-funds/

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[xii] https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related

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