Regulating ESG: A step in the right direction

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# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTRODUCTION</td>
<td>5</td>
</tr>
<tr>
<td>ASSET MANAGERS DOUBLE DOWN ON ESG</td>
<td>6</td>
</tr>
<tr>
<td>THE ROLE OF REGULATION IN FORGING AN ESG MARKETPLACE: THE SFDR</td>
<td>7</td>
</tr>
<tr>
<td>TAKING STOCK OF SFDR AND ITS IMPLICATIONS</td>
<td>8</td>
</tr>
<tr>
<td>BUT FURTHER CLARITY IS NEEDED ON SFDR</td>
<td>11</td>
</tr>
<tr>
<td>THE NEED FOR A TAXONOMY</td>
<td>12</td>
</tr>
<tr>
<td>KEY POINTS</td>
<td>13</td>
</tr>
<tr>
<td>ABOUT IIMI</td>
<td>14</td>
</tr>
<tr>
<td>ABOUT THE AUTHOR</td>
<td>14</td>
</tr>
<tr>
<td>MEMBERS</td>
<td>15</td>
</tr>
</tbody>
</table>
ESG (environment, social, governance) investment practices are now being fully embraced by the global asset management industry. The COVID-19 crisis has accelerated a number of pre-existing trends and the growing investor appetite for ESG is one of them. COVID-19 has served as a stark reminder to investors about just how vulnerable our planet is to disruption. In turn, this has prompted more investors to pile into ESG-focused funds. Between April and June 2020, Morningstar found that ESG funds attracted inflows totalling $71.3 billion, turbo-charging their assets under management (AUM) to above $1 trillion.¹ Investor demand for ESG products is only expected to grow with PwC estimating that ESG funds will hold more assets than their non-ESG equivalents by as early as 2025. PwC added sustainable and responsible investment funds could control up to €7.6 trillion in Europe in the next five years, accounting for 57% of market share, versus the 15% they have today.²

Introduction

² Investment Week – October 19, 2020 – ESG funds to hold most AUM by 2025.
Regulating ESG: A Step in the Right Direction

INDEPENDENT INVESTMENT MANAGEMENT INITIATIVE

With ESG investing becoming more popular, it was clear that regulation was necessary. Since March 2021, the EU’s Sustainable Finance Disclosure Regulation (SFDR) has imposed heightened ESG reporting requirements on asset managers. SFDR applies at both an entity and fund level, although larger asset managers (i.e. those with more than 500 employees) are subject to tougher disclosure requirements. At a firm-level, managers must provide information on their websites articulating clearly their policies on how they integrate sustainability risks into their investment decision-making and remuneration practices. At a product-level, there needs to be a pre-contractual disclosure outlining how sustainability risks are factored into investment decisions, along with the potential impact sustainability risks could have on returns. Even if sustainability risks are deemed irrelevant to a product, managers must give an explanation outlining why this is the case.

The rules will impact any asset manager currently regulated under the MiFID (Markets in Financial Instruments Directive), AIFMD (Alternative Investment Fund Managers Directive) and UCITS regimes. According to a legal note prepared by Sidley Austin, it also appears that the SFDR (and the Taxonomy Regulation) simultaneously applies to non-EU AIFMs which are marketing AIFs into the EU through national private placement regimes (NPPRs). “The product-level requirements may also indirectly affect non-EU asset managers that act as delegates of non-EU financial market participants (such as EU AIFMs or UCITS management companies). As such, EU firms are likely to require the information from the non-EU delegate to comply with their own regulatory obligations. That is, a non-EU manager might not have a direct regulatory obligation to prepare the disclosures but might be contractually required by the delegating EU manager to do so,” continued the Sidley Austin briefing.

Asset managers double down on ESG

The impressive growth in ESG investing is being driven by a number of different dynamics. Firstly, early concerns that focusing on ESG issues might detract from performance have largely been disproved. The benefits of ESG integration are increasingly evident. Furthermore, the performance of funds with specific ESG characteristics has been promising with data suggesting ESG funds have delivered superior performance relative to their non-ESG counterparts. For example, Morningstar analysis found a sample of 745 European ESG-oriented funds outperformed their non-ESG fund equivalents over one, three, five and 10 year time horizons. Investors – many of whom are anxious to obtain returns amid the current volatility – have responded by increasing their allocations into ESG funds. Changing client demographics are also playing a vital role in driving inflows into ESG funds. Millennials – a number of whom take sustainability very seriously – are becoming more involved in the investment decision-making processes at institutions. With more investors imposing stringent ethical criteria on fund selection, asset managers will need to evolve their business models.

There is also a compelling risk management case for firms to focus more on ESG. Stranded asset risk is one of them. This is when an asset or security is subject to a significant write-down or devaluation or simply becomes obsolete as a result of regulatory change or shifting consumer behaviour. Coal plants are a prime candidate for this as they could become redundant either through a transition in government energy policy or a tectonic transformation in demand as customers pivot towards renewable energy sources because of ethical concerns or cost benefits. It is not just companies involved in fuel production which are at risk, but organisations heavily dependent on pollutant energy sources as inputs of production. Asset owners and asset managers with exposures to these companies could see the value of their investments sharply decline or wiped out if organisations do not change their business strategies. These fears are leading to greater investor engagement with companies, whose operating models appear to be vulnerable to such disruption.

The role of regulation in forging an ESG marketplace: The SFDR

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3 Financial Times – June 13, 2020 – Majority of ESG funds outperform wider market over 10 years
4 London School of Economics – January 13, 2018 – what are stranded assets?
5 Ibid
Taking stock of SFDR and its implications

IIMI recently polled its membership, which is comprised of leading independent asset management firms from the UK and Continental Europe, to gather their views on the SFDR and how it would impact their firms and the wider industry.

IIMI’s diverse membership appears to support the SFDR regime. A survey conducted by IIMI found more than three quarters of its membership believed that their organisations will benefit from the new sustainable finance disclosure requirements. One member said the SFDR requirements would help promote discipline around ESG reporting in the industry. Others concur. “In general, the industry seems to be quite supportive of the SFDR as it will help facilitate consistency,” commented Owen Lysak, partner at Clifford Chance. Elsewhere, 61% said the SFDR would improve competition in the asset management industry, although 22% stated the exact opposite. One member said managers would strive to become more ESG compliant in order to win mandates from sustainability focused institutional and retail investors.

However, some members feel the rules could disadvantage boutiques. For instance, a member complained that the rules benefited larger fund houses at the expense of boutiques firms. The manager added that the supplementary costs as a result of SFDR – such as the procurement of ESG analytics from data providers for reporting purposes – would be felt disproportionately by smaller boutiques. Some member firms have called on EU regulators to cap the amount which data providers can charge for ESG analytics in order to create a more level playing field between boutiques and larger managers.

Interestingly, only a minority of IIMI members (27%) have hired ESG specialists to deal with the regulations. Meanwhile, 66% said ESG work is already integrated into their investment team’s processes. One member said that while his organisation was increasingly embracing ESG, COVID-19 and the recent volatility had forced them to think carefully about costs, precluding them from appointing additional ESG specialists to deal with the regulations. “Rather than hiring a full-time ESG expert, we have formed an ESG committee comprising of people from different parts of the business such as marketing and middle office. We are leveraging external ESG consultants too,” he said. In contrast, another member said they had steadily built up an ESG team, having learned early on that ESG investing involved a significant amount of research, company engagement and client reporting. With the SFDR coming into effect in
less than two months (at the time of the survey), the member added they would like to appoint an additional ESG expert to their team although conceded that costs could be a restricting factor in this.

Despite the regulation having a number of positives, uncertainties do persist, a point made by Leonard Ng, partner at Sidley Austin. Under the rules, those funds that have sustainable investment as their ultimate objective will be designated as “Article 9 products”, which carry specific disclosure requirements under the SFDR. Even funds that are not primarily sustainability funds – but which do promote ESG characteristics to some extent – could be designated as being “Article 8 products”. These also have disclosure requirements under SFDR. There is debate as to how sensitive the trigger for Article 8 classification will be, and whether simply taking into account specific ESG criteria, as part of the investment decision-making process, is sufficient to bring a fund into that classification. “These disclosure requirements under SFDR will require managers to complete a disclosure template, in which they must outline their sustainability features. The template, which will be mandatory from 2022, is expected to be quite granular in nature – requiring impacted managers to make both quantitative and qualitative disclosures about sustainability impacts. This issue has generated enormous discussion at a number of industry associations,” said Clifford Chance’s Lysak.

Ng also warned that this loose definition of what constitutes “promoting” ESG could inadvertently ensnare a wider number of investment managers, including those who engage in negative securities screening, thereby subjecting them to greater template reporting under SFDR. “There also needs to be clarification as to what extent firms are caught out by the rules. For instance, a UK manager using the NPPR (national private placement regimes) to market its fund into Germany, would most likely need to comply with the SFDR. The issue is whether that manager would need to comply only at the product level, or also at the entity/manager level,” said Ng.

So what does this mean for UK asset managers post-Brexit? With the UK transition period having ended on 31 December 2020, EU rules introduced after that date will now no longer apply. This includes the SFDR. However, the SFDR is extraterritorial, meaning it affects UK AIFMs distributing AIFs via NPPRs. It is also clear that the UK is unlikely to deviate substantially from EU rules, especially if it wants to ensure that domestic fund managers can continue to access EU investors post-Brexit. As a result, most legal experts advise that UK managers comply with the SFDR or something very similar. However, Neil Robson, financial markets regulatory partner at Katten, said the UK had yet to onshore the SFDR – although added that UK managers marketing into the EU have been required to comply with the rules since 10 March 2021. This, he continued, was because the high-level disclosure obligations contained within the SFDR have essentially been integrated into the AIFMD disclosures.

But further clarity is needed on SFDR

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The need for a taxonomy

One of the challenges around ESG investing has been a lack of common standards. It makes some sense for investors to take their own approach to ESG integration, reflecting differences in investment process and client requirements. However, the lack of common definitions and disclosures can cause confusion, and increases the potential for so-called ‘greenwashing’ (misrepresenting the extent of their green credentials). SFDR provides a standard for assessing and disclosing negative sustainability impacts for funds with specific ESG characteristics or objectives. “The multitude of different ESG standards has been particularly problematic for the industry and confusing for investors,” said Robson. Similarly, the proliferation of ratings agencies – all of which are offering their own unique ESG analytics – has further added to the complexities facing investors.

One particularly acute problem is around claims of funds being environmentally friendly, or ‘green’. Funds which consider ESG issues, or adopt some related criteria, are not necessarily invested in environmentally sustainable companies. Furthermore there has been no standard definition of environmentally sustainable corporate activity. This has lead to concerns that some funds and companies may be greenwashing.

As a result of this, the EU has decided to act decisively through the development of a taxonomy, which will formally define sustainable economic activities. Again, the taxonomy has largely been welcomed by the industry. Ng highlighted the taxonomy would play an effective role in eliminating greenwashing, while Robson acknowledged that a common standard will provide investors with a greater degree of comfort when allocating into ESG products. While the taxonomy is likely to usher in more clarity, one IIMI member voiced concerns that any standards will need to be harmonised with those in other major markets, otherwise it risks leading to a widening of regulatory arbitrage.

Key Points

- IIMI membership largely supports the SFDR, but there are concerns in some quarters that the rules could create an imbalance between boutiques and larger asset managers.

- Some member firms have called on EU regulators to cap the amount which data providers can charge for ESG research and analytics in order to create a more even playing field between boutiques and the larger investment managers.

- The ongoing uncertainties around SFDR – namely around article 8 designation – need to be clarified.

- IIMI fully supports the principles behind an ESG taxonomy insofar as that it will be vital in eliminating the risk of greenwashing.

- It is vital that ESG standards across major markets do not diverge excessively otherwise it could lead to confusion.
About IIMI

The Independent Investment Management Initiative is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010 as New City Initiative and relaunched as IIMI in 2021, the IIMI counts amongst its members some of the leading independent asset management firms in the City and the continent. The IIMI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned “client-centric” approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

Charles Gubert is a consultant to IIMI and Head of Regulation. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at C00Connect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

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