



Newgate News

ESG: A changing regulatory landscape

In this Newgate Newsletter, Senior Consultant Jay Pyne (“**JP**”), sits with one of our Junior Consultants, Amber Williams (“**AW**”), to talk ESG and Sustainability (“ESG”), what regulatory changes are taking place and how our clients can start integrating ESG and Sustainability in to their governance, control and disclosure framework in 2021 and beyond.

JP: Amber, you are making your debut in the Newgate Newsletter this month. Would you like to introduce yourself to the audience and explain what your main role is in the firm?



Jay Pyne, Senior Consultant



Amber Williams, Junior Consultant

November 2020

- What is ESG?
- The EU's aim for a fairer society
- Taxonomy Regulation
- Non-Financial Disclosure Regulation (NFRD)
- Sustainable Finance Disclosure Regulation (SFDR)
- 2020 Stewardship Code
- Brexit
- Changes to your regulatory obligations
- How Newgate can help

AW: Yes, thank you for the introduction Jay. I joined Newgate in January this year and in between fielding the team's excessive requests for refreshments I have now settled down into a role in supporting the consultancy team on various ongoing tasks. I have also taken a keen interest in keeping up to date on regulatory updates from the FCA, helping draft our periodic newsletters and enforcement primers and participating in our internal weekly regulatory digest meetings.

JP: Thank you Amber. Your last sentence is relevant to our topic of discussion today. How have you found keeping up to date with the various items of regulatory change since joining the firm?

AW: It has certainly been a challenge keeping up. Aside from dealing with unprecedented events such as BREXIT and the COVID-19 pandemic, regulatory change seems to be coming at some pace. It seems that even though the UK is leaving the EU with effect from 31 December 2020, it will still need to be mindful of regulatory change occurring in the rest of Europe to remain a competitive market to do business in. And that leads me into the topic of this article. I have seen a lot of debate at an EU level on ESG and indeed proposed focus on these areas in underlying legislation that impacts MiFID firms and AIFMs. I have not seen too much direct correspondence from the FCA on these topics. I therefore ask you Jay to tell me more about what ESG and Sustainability means? Where did the term come from and how relevant is it from a compliance point of view for our clients?

JP: I say Amber that is an excellent question. If only there was someone else here, I could refer you to for an answer! In short, Environmental, Social and Governance requirements are a helpful framework for understanding Sustainable Investing. European sustainable funds now hold a hefty [€668 billion of assets, up 58% from 2018](#). ESG is an increasingly attractive part of investment for investors wanting to create returns and positively impact the environment. As a result of this, we have seen growing attention across the financial services sector for products that are to some degree ESG-conscious.

AW: What do you mean by 'ESG-conscious'?

JP: I mean that 'ESG' is an unregulated term. We can see an increase in products and offerings that focus on ESG impact, however it is not easy to estimate how far these positive ESG impacts really go. 'Green washing', or overstating the positive impact of a fund, has been a crucial part of the recent [regulatory changes](#) to ESG requirements by the [Financial Conduct Authority \(FCA\)](#) and the [European Union \(EU\)](#).

SUSTAINABLE DEVELOPMENT GOALS



AW: Can you tell me more about the regulatory changes you refer to? Who does this affect?

JP: ESG and Sustainability has been a crucial focus for the EU over the past decade (arguably beyond this). In 2015, the UN published its 'Sustainability Development Goals' (SDG), and then in 2016 the Paris Agreement, we can see a proliferation of regulatory changes to coincide with the EU's overall ambition to create a more sustainable and fair society. In December 2019, the Council and the European Parliament reached a political agreement on the Taxonomy Regulation, which provides performance thresholds for identifying environmentally sustainable economic activities. To qualify, a project or business activity must: (1) make a substantial contribution towards one of six climate change and environmental goals, (2) avoid significant harm to other environmental objectives; (3) meet certain social and governance safeguards related to responsible business practices.

AW: What kinds of disclosures will firms be asked to make because of the Taxonomy regulation?

JP: The Taxonomy advances different disclosure requirements for "large companies" (listed companies, banks, and insurers with over 500 employees) and "financial market participants" (entities which offer financial products in the EU). Financial market participants must disclose, for each financial product, (1) how and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments, (2) to what environmental objectives the investments contribute, and (3) the proportion of the underlying investments that are Taxonomy-aligned. Certain financial products, such as pension offerings, are required to include the disclosures, while disclosures for other financial products are required on a comply-or-explain basis.

AW: What are the timescales for this?

JP: Financial market participants will be required to complete their first set of disclosures by December 31, 2021, while large companies will be required to disclose in 2022.

AW: What else can we expect to see coming into force in the new year?

JP: If we view the Taxonomy regulation as the overarching legislation, it helps to explain two other important regulatory updates: the Non-Financial Disclosure Regulation (NFDR) and the Sustainable Finance Disclosure Regulation (SFDR). The former a valuable example of the ESG landscape moving forward, the latter an important regulatory update requiring action by asset managers and financial market participants.

AW: So firstly, what is the NFDR?

JP: NFDR requires large 'EU' "public interest" corporates to publish data on the impact their activities have on ESG factors. For example, disclosures could include the environmental sustainability of an investment and the provenance of ESG claims made or the risks that ESG considerations could present to investments.

AW: What can you tell me about SFDR?

JP: SFDR is where it becomes more practically important for our asset managers and firms with ESG product offerings to get to grips with. The SFDR applies product and manager level disclosure requirements to so-called 'Financial Market Participants' (FMP) for all products marketed into Europe (including those managed by non-EU firms).

AW: Can I clarify here exactly how the EU define a ‘financial market participant’ (FMP)?

JP: An FMP is an umbrella term including portfolio managers, pension providers, alternative investment managers (AIFMs) and UCITS Management Companies (ManCos).

AW: Okay great. What requirements fall under SFDR?

JP: There are three categories of product under SFDR: products that have sustainable investment as their objective (article 9 products), products that promote an environmental or social characteristic (article 8 products) and out of scope products – products that do not purport to promote any kind of ESG objective. All product providers will be subject to additional disclosure requirements because of SFDR to some degree, even if they only manufacture out of scope products, though the burden will be less for these firms. The form and content of the disclosures will be highly prescriptive, including the use of standardised templates. ESMA are trialling templates now and I am patiently waiting on the feedback!

AW: Where can we find these templates?

JP: Although the survey is now closed, you can find the templates via [EIPOA](#).

AW: Thanks. What else is there to the SFDR that our clients should know about?

JP: From the 10th March 2021, under SFDR all products must be accompanied with a pre-contractual disclosure that sets out the manner in which sustainability risks are integrated into investment decisions and the likely impacts of sustainability risks on the returns of the product. Even where sustainability risks have been deemed to be irrelevant, a brief explanation of the reasoning must be provided. Firms with over 500 employees must additionally disclose how the financial product considers principal adverse impacts on the sustainability of the product, or for smaller firms that have opted out, an explanation of the reasons why they do not consider the adverse impacts of investment decisions on sustainability factors. This requirement applies from December 2022.

AW: I see, a comply-or-explain basis makes sense for the varying levels of products in the market with an ESG offering. What can we advise those firms that do promote ESG characteristics or have a clear ESG objective, those ‘article 8 and 9’ products you refer to?



JP: These firms must make a pre-contractual disclosure in the form of a yet to be finalised mandatory template, to include: the product’s ESG objective and a breakdown of the different categories of investment; the investment strategy; an explanation of how indicators for adverse impacts are considered and how investments that cause significant harm to sustainable objectives are screened out; a list of sustainability indicators and information on how the use of derivatives is consistent with the ESG aims of the product.

The template must include a link to a more detailed product specific website disclosure, including information on monitoring, due diligence, and engagement around ESG factors. Periodic reports for article 8 and 9 products must also include a description of the extent to which the sustainability objectives of the products have been met. A mandatory template for inclusion for these disclosures is expected, yet to be finalised.

AW: How will periodic reporting requirements change for article 8 and 9 products?

JP: Article 8 and 9 products that promote environmental objectives are subjected to additional pre-contractual disclosure and periodic reporting requirements. These disclosures must break down the underlying sustainable investments into more granular categories set out in the Taxonomy Regulation and set out whether the investment makes a “substantial contribution” to these environmental objectives. The form and content of the additional reporting is to be set out in yet to be published regulatory technical standards.

AW: Thanks Jay. I guess we will have to wait to see how the final guidance and published rules will alter this for our clients. Am I right in thinking that currently we do not know how Brexit will affect the timelines for the SFDR disclosures?

JP: That is correct, Amber. The EU and potentially the UK is expected to implement SFDR in March 2021 after the Brexit transitional period has expired. However, the UK government has not confirmed if the next level of requirements (the Regulatory Technical Standards) will be implemented.

AW: Has the UK government made any other ESG-related promises as a result of BREXIT?

JP: The Chancellor of the Exchequer on Monday the 9th November 2020 asserted his commitment to ensuring the UK is net zero by 2050; he believes the financial services sector will be key in driving this. In his speech, the Chancellor promised that the UK will become the first country in the world to make the Task Force on Climate-related Financial Disclosures (TCFD)’s fully mandatory across the economy by 2025, going beyond the EU’s ‘comply or explain’ approach. The UK will also implement a green taxonomy which will improve understanding of the impact of firms’ activities and investments on the environment. We can see close overlap with the EU on this as the UK’s proposed taxonomy will take the scientific metrics in the EU taxonomy as its basis.

AW: Thanks Jay. How are we to navigate between EU regulations (some not yet in force) and promises made by the UK Government?

JP: I do appreciate the confusion, Amber! We have all agreed at Newgate that it is wise to proceed as if the SFDR, NFRD and the Taxonomy regulation will take force in the UK. This might be in nuanced form and not strictly in line with the EU. We can see convergence with the EU in areas such as the Taxonomy Regulation; the UK also intends to join the EU’s International Platform on Sustainable Finance (IPSF) and collaborate more closely on these matters in the future. At the same time, there are promises of divergence from the EU, the Chancellor would like disclosures to be mandatory from 2025.

AW: Thanks Jay. Only time will tell with regards to how the UK intend to implement or indeed take the EU’s efforts further. But we can certainly see that the Government would like the UK to be, as the Chancellor says: “world leader in green finance”.

JP: I agree. Our next steps shall be to ensure our clients incorporate ESG into their policies, monitoring and training programmes in addition to new disclosure obligations. We shall be getting in touch with our clients impacted by the issues described above to ensure they are meeting the new governance, risk, and compliance requirements. You were not planning on taking any leave in the next six months, were you?

Please contact your Newgate Consultant on 0203 696 8750 if you need assistance on any matters raised.