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# EU Disclosure Regulation, Taxonomy Regulation, and UCITS Directive Amendments: Summary of New EU ESG-Related Requirements

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Investment Company Directors
ICI Global Members
ESG Task Force
ICI Global Regulated Funds Committee SUBJECTS: Compliance
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Distribution
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MiFID, EMIR, AIFMD, UCITS V RE: EU Disclosure Regulation, Taxonomy Regulation, and UCITS Directive Amendments: Summary of New EU ESG-Related Requirements

The European Union (EU) recently finalized two pieces of legislation—the Disclosure Regulation[1] and Taxonomy Regulation[2]—that will impose a host of new ESG-related disclosure and other requirements on asset managers and financial products, including funds and separately managed accounts. It is crucial to note that the scope of these Regulations sweeps beyond ESG products and will impact asset managers and financial products more broadly. These new requirements may have implications for asset managers and funds well beyond the European Union.

The EU intends these disclosure requirements to interact with other pieces of legislation, including forthcoming amendments to the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD). Although these amendments have not yet been adopted, they are expected to introduce substantive new legal obligations that will require asset managers to consider ESG risks in the investment process and also take into account the impacts of portfolio companies on environmental and social sustainability.

This memo provides a high-level summary of the Disclosure and Taxonomy Regulations' new disclosure requirements, as well as the changes we expect to see in the amendments to the UCITS and AIFM frameworks.

The Disclosure Regulation requires UCITS management companies and alternative investment fund managers (AIFMs) (and other financial market participants[3]) to make various ESG-related disclosures at the manager level and at the financial product level, on managers' websites and in fund prospectuses and annual reports. The disclosure requirements apply as of 10 March 2021, with a couple exceptions.[4]

The Taxonomy Regulation also includes mandatory financial product disclosure requirements that will have a significant impact on funds. The disclosure requirements related to the Taxonomy's first two environmental objectives (climate change mitigation and adaptation) will apply from 31 December 2021, with requirements related to the other four objectives applying from 31 December 2022.

The attached Appendix contains a chart with the details for each new disclosure requirement, including the source of the requirement in the Disclosure or Taxonomy Regulation, location of the disclosure (e.g., prospectus), specific disclosure required, compliance date, and the status of any ongoing technical work.

## I. Manager-Level Requirements

### A. Disclosure Regulation

At the manager level, the Disclosure Regulation will require fund managers to disclose how they consider ESG risks in the investment process—viewing ESG through a financial lens. Managers also will be required to disclose how their remuneration policies are consistent with the integration of ESG risk.

Most significantly, the legislation requires managers to disclose how they consider the negative environmental or social impact of portfolio companies—viewing ESG through a sustainability impact lens. More specifically, asset managers must disclose a statement of due diligence policies for considering "principal adverse impacts of investment decisions on sustainability factors." This disclosure will be mandatory for large managers with over 500 employees and comply-or-explain for smaller managers with 500 or fewer employees.[5] Although larger managers are required only to "disclose" their due diligence policies, it will likely mean that these managers must have some process in place to assess the principal adverse impact of their portfolio companies on sustainability factors.

The Disclosure Regulation does not define the term "adverse impact," but one of the legislative recitals indicates that it "should be understood as those impacts of investment decisions and advice that result in negative effects on sustainability factors."[6]

This "adverse impact" disclosure requirement is one of the provisions for which ESMA is drafting RTS. The RTS will be critical for determining what this "adverse impact" due diligence requirement means in practice. ESMA is expected to propose requiring disclosure of certain environmental impact metrics or indicators.

### B. Commission Work to Embed Consideration of ESG Risks and Sustainability Impact in UCITS Directive and AIFMD

Separately, the Commission is drafting amendments to delegated acts under the UCITS Directive and the AIFMD that aim to reflect the above disclosure requirements in managers' substantive legal obligations under the UCITS and AIFM frameworks. We expect these amendments to explicitly require asset managers to take "sustainability risks and factors" into account in internal processes and procedures. These amendments likely will require asset managers to review their due diligence policies, resources, governance structures, conflicts of interest, and risk management practices.

Most importantly, we understand that the Commission intends to amend the UCITS Directive and AIFMD due diligence provisions to add a substantive “adverse impact” due diligence requirement for large asset managers that are subject to the Disclosure Regulation’s mandatory “adverse impact” disclosure provision.[7] We understand this would require those asset managers to:

- Take “adverse impact” into account when complying with the UCITS Directive/AIFMD due diligence provisions; and
- Ensure that engagement policies under the Shareholder Rights Directive II (SRD II) describe how they intend to establish, implement, and maintain the reduction of principal adverse impacts of portfolio companies on sustainability factors.

The Commission is expected to publish these draft amendments in spring 2020.

## II. Product-Level Disclosure Requirements

### A. Disclosure Regulation

The Disclosure Regulation’s product-level disclosure requirements apply to UCITS, alternative investment funds (AIFs), and separate accounts.[8] Pension products and insurance-based investment products are also included in the scope of the legislation.

The Disclosure Regulation includes disclosure requirements that apply to all funds, as well as extensive disclosure requirements for two categories of ESG-related funds (referred to as “ESG funds” for ease of reference), with the stated policy aim of preventing “greenwashing.” These two categories of funds, defined in Articles 8 and 9, are colloquially referred to as “light green” and “dark green” funds.

1. *Disclosure Requirements for All Funds*

All funds will be required to have prospectus disclosure (on a comply-or-explain basis) around how ESG risks are integrated into investment decisions and the likely impact of ESG risks on financial product returns. Similarly, prospectus disclosure must include (on a comply-or-explain basis) whether and how a product considers “principal adverse impacts on sustainability factors.” These provisions are analogous to the manager-level disclosure requirements discussed above.

Appendix A contains a detailed summary of these disclosure requirements. The legislation directs the ESAs (with ESMA leading) to draft RTS with further details on the disclosure requirements for “light green” and “dark green” financial products.

As a separate note, these categories will have importance in another context. The Commission is drafting amendments to MiFID II that are expected to amend the existing suitability provisions, requiring investment firms to ask clients about their ESG preferences. We expect those amendments to specify that the Disclosure Regulation’s two categories of ESG funds would be deemed to satisfy a client’s ESG preferences.

2. *Disclosure Requirements for “Light Green” Funds under Article 8*

The disclosure requirements in Disclosure Regulation Article 8 cover any financial product that "promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices." We understand that the EU intends this to capture existing ESG investing strategies such as best in class, thematic, norms-based screening, and negative screening.

The Disclosure Regulation requires detailed prospectus, annual report, and website disclosure on how a fund's "environmental or social characteristics" are met. This information includes methodologies used to assess, measure, and monitor the environmental or social characteristics, including data sources, screening criteria for the underlying assets, and the relevant sustainability indicators or metrics used to measure the environmental or social characteristics.

3. *Disclosure Requirements for "Dark Green" Funds under Article 9*

The disclosure requirements in Disclosure Regulation Article 9 cover any financial product that "has sustainable investment as its objective." We understand that the EU intends this category to capture a narrower subset of ESG funds that have some element of focus on sustainability outcomes.

In addition to similar disclosure applicable to "light green" funds, Article 9 products also must disclose the overall sustainability-related impact of the financial product, using relevant sustainability indicators and metrics. The legislation also requires significant disclosure around any use of reference benchmarks or indices.

**B. Taxonomy Regulation**

The Taxonomy Regulation defines economic activities that qualify as "environmentally sustainable" for the purposes of establishing the degree of environmental sustainability of an investment. The Taxonomy also includes mandatory financial product disclosure requirements that will have a significant impact on funds. Large listed companies will be required to disclose how their activities align with the Taxonomy.

The disclosure requirements related to the Taxonomy's first two environmental objectives (climate change mitigation and adaptation) will apply from 31 December 2021, with requirements related to the other four objectives applying on 31 December 2022.

Looking forward, EU legislators expect the Taxonomy to serve as the definitional basis for future action in the domain of sustainable finance and sustainability more broadly. The Taxonomy could have broad and far-reaching implications by being incorporated in both voluntary standards and mandatory requirements.

1. *Definition of "Environmentally Sustainable" Economic Activities*

To qualify as environmentally sustainable under the Taxonomy, an economic activity must meet four elements:

1. "Substantially contribute" to one of six environmental objectives: climate change adaptation, climate change mitigation, sustainable water use, circular economy, pollution prevention, or healthy ecosystems.
2. "Do no significant harm" to any of those six objectives.
3. Meet certain minimum "social standards," such as compliance with international labor

conventions.
4. Meet the European Commission's "technical screening criteria." This is secondary legislation that the Commission will adopt, detailing metrics and screening criteria for determining whether an economic activity meets the first three elements to qualify as environmentally sustainable.[9]

2. *Disclosure Requirements for Financial Products and Companies*

The Taxonomy requires "light green" and "dark green" financial products (as defined in Disclosure Regulation Articles 8 and 9) to describe in the prospectus and annual report how and to what extent the fund is invested in "environmentally sustainable" economic activities (i.e., Taxonomy-aligned activities). This disclosure must include the percentage of the product's investments that are Taxonomy-aligned, including the respective proportions of "enabling" and "transition" activities.[10]

This means that all ESG funds will need to determine the percentage of taxonomy alignment of each portfolio investment and then aggregate those percentages and disclose an overall percentage for the fund. It is unclear at this juncture to what extent companies in which funds invest will have a meaningful percentage of revenue from Taxonomy-aligned economic activities. As a result, an ESG fund might have to disclose a very low percentage of Taxonomy alignment.

Even products that are not ESG-related will be required to make some form of Taxonomy disclosure. Funds that do not fall into "light green" or "dark green" categories must disclose the following statement in the prospectus and annual report: "The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments."

One of the key implementation challenges will be obtaining Taxonomy-alignment data from companies in which funds are invested. The Taxonomy requires large listed companies subject to the Non-Financial Reporting Directive (NFRD) to disclose how and to what extent their revenue can be attributed to environmentally sustainable economic activities as defined by the Taxonomy.[11] The European Commission is reviewing the NFRD and considering whether to expand the scope of companies subject to these requirements and the information that would be required to be disclosed.[12] Although companies not subject to EU law will not have a legal obligation to disclose the extent to which their revenue is Taxonomy-aligned, EU UCITS that invest in those companies nevertheless will still be required to disclose the percentage of alignment of their portfolio investments.

The Taxonomy does not address this data challenge in a meaningful way. One of the legislative recitals notes that "there could be exceptional cases" where financial market participants cannot reasonably obtain the relevant information to reliably determine the degree of an investment's Taxonomy alignment.[13] In those cases, the text notes that asset managers "may make complementary assessments and estimates on the basis of information from other sources," such as third-party data providers, but they would be required to explain the basis for their conclusions.

## III. Implementation Timeline

The implementation timeline for these new disclosure requirements is expected to be challenging. The compliance date for these provisions is 10 March 2021, and it is possible that the Commission will not adopt the corresponding regulatory technical standards (RTS) until shortly before the compliance date. The Disclosure Regulation directs the European

Supervisory Authorities (ESAs), including the European Securities and Markets Authority (ESMA), to draft RTS with further detail on several disclosure provisions. ESMA then must submit its draft RTS to the European Commission by the end of 2020 for the Commission to adopt. The RTS will be critical for how firms can comply with these requirements.

There are similar concerns with the timeline for the Taxonomy Regulation's financial product disclosure requirements. The disclosure requirements related to the Taxonomy's first two environmental objectives (climate change mitigation and adaptation) will apply from 31 December 2021, with requirements related to the other four objectives applying from 31 December 2022.

Similar to the Disclosure Regulation, the Taxonomy directs the ESAs (led by ESMA) to develop RTS by 1 June 2021 for disclosure on Taxonomy's environmental objectives of climate change mitigation and adaptation and by 1 June 2022 for the Taxonomy's other four environmental objectives. The Commission is still working with its Technical Expert Group, however, to finalize the screening criteria that will be needed to determine the percentage of an investment that is "environmentally sustainable" according to the Taxonomy.

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Attachment

**endnotes**

[1] 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, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32019R2088&from=EN#d1e1268-1-1. A "Regulation" is legislation that has binding legal force throughout every EU Member State and enters into force on a set date in all the Member States.

[2] The EU legislators reached political agreement on the text of the Taxonomy Regulation in December 2019, but the final text has not yet been published in the Official Journal. The provisional version of the text is *available at* https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf. Further substantive changes to the text are not anticipated.

[3] Other financial market participants in scope are managers of European venture capital funds and European social entrepreneurship funds; investment firms which provide portfolio management under the Markets in Financial Instruments Directive II (MiFID II); credit institutions that provide portfolio management under the Credit Institutions Directive; and manufacturers of pension products and providers of certain insurance-based investment products. Financial advisers are also in scope, including credit institutions, investment firms and AIFMs and UCITS management companies providing investment advice and insurance intermediaries and insurance undertakings providing insurance advice. *See* Disclosure Regulation, Article 2.

[4] Appendix A contains compliance dates for each disclosure requirement.

[5] *See* Disclosure Regulation, Articles 3 and 4. Article 4 refers to financial market participants which are parent undertakings of a large group as referred to in Article 3(7) of the Accounting Directive.

[6] *See* Disclosure Regulation, Recital 20. The recitals also reference the work of the Organisation for Economic Co-operation and Development (OECD) work on due diligence around "adverse impacts," and the term "adverse impact" can be found in the Non-Financial Reporting Directive (NFRD) as well.

[7] This provision would cross-reference the Disclosure Regulation's requirement to disclose due diligence policies on adverse sustainability impact of investments, capturing large asset managers subject to mandatory "adverse impact" disclosure.

[8] *See* Disclosure Regulation, Article 2.

[9] The Commission has asked the Technical Expert Group (TEG) to develop recommendations for technical screening criteria on how to determine that an economic activity is "substantially contributing" or "doing no significant harm" under the taxonomy. The TEG released a July 2019 technical report that contains technical screening criteria for 67 activities across eight sectors that can make a substantial contribution to climate change mitigation; a methodology and worked examples for evaluating substantial contribution to climate change adaptation; guidance; and case studies for investors preparing to use the taxonomy. The TEG consulted on this report in summer 2019 and intends to use the input received to advise the Commission on how to draft legislative acts that will eventually turn this classification into screening criteria. Further details are *available at* https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en#190618.

[10] The Taxonomy Regulation defines "enabling" activities in Article 11a and "transitional" activities in Article 6(1a).

[11] More specifically, companies that are subject to the NFRD obligation to publish non-financial information must disclose (a) the proportion of their turnover derived from products or services associated with environmentally sustainable economic activities; and (b) the proportion of their total investments (Capital Expenditure) and/or expenditures (Operating Expenditure) related to assets or processes associated with environmentally sustainable economic activities. *See* Taxonomy Regulation, Article 4delta.

[12] The European Commission launched a consultation on 20 February, *available at* https://ec.europa.eu/info/consultations/finance-2019-non-financial-reporting-guidelines_en.

[13] *See* Taxonomy Regulation, Recital 16e.

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