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Update on ESMA Work to Develop Regulatory Technical Standards for EU Disclosure Regulation

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MiFID, EMIR, AIFMD, UCITS V RE: Update on ESMA Work to Develop Regulatory Technical Standards for EU Disclosure Regulation

The EU co-legislators agreed on a final legislative text for the Disclosure Regulation earlier this year as part of implementing the EU's Sustainable Finance Action Plan.[\[1\]](#) The Disclosure Regulation applies to financial market participants, including UCITS management companies and alternative investment fund managers (AIFMs). It will require asset managers to provide:

1. Entity-level website disclosure around ESG integration policies and due diligence policies related to sustainability impact, and
2. Product-level prospectus, website, and annual report disclosure for financial products (e.g., UCITS) that "promote environmental or social characteristics" or have an objective of "sustainable investments" or reducing carbon emissions.[\[2\]](#)

The Disclosure Regulation includes several provisions that direct the European Securities and Markets Authority (ESMA) and the other European Supervisory Authorities (ESAs) to develop draft regulatory technical standards (RTS) on the content, methodologies, and presentation of certain disclosure requirements. ESMA is leading the ESAs' work on this and expects to issue a formal consultation on draft RTS in Q1 2020. ESMA will need to submit the RTS to the Commission likely by October 2020.[\[3\]](#) There are concerns that the Disclosure Regulation will enter into application in winter 2020 without sufficient time for RTS implementation.[\[4\]](#)

Below is a more detailed summary of the RTS that ESMA is developing for the Disclosure Regulation.

I. RTS for Entity-level Website Disclosure on Due Diligence Policies on “Principal Adverse Impact”

The Disclosure Regulation (Art. 3gamma) requires asset managers to provide website disclosure of their due diligence policies around consideration of “principal adverse impacts” on environmental and social sustainability in the investment process (mandatory for entities with over 500 employees; “comply or explain” for less than 500 employees). ESMA characterizes this as requiring disclosure of what due diligence policies asset managers have in place to determine the “principal adverse impacts” of investments and what actions the asset manager has taken to address those impacts.

Art. 3gamma(6) and (7) direct ESMA and the other ESAs to develop details on the content, methodologies, and presentation of this due diligence policy disclosure, including “sustainability indicators” for environmental and social impact. Encouraging ESMA to take a high-level, principles-based approach without prescribing specific methodology will be key to making this provision workable.

“Adverse impacts” is not defined, although the Disclosure Regulation (Recital 4-a) cites the Organisation for Economic Co-operation and Development (OECD) due diligence guidance for responsible business conduct. We understand that ESMA is using the OECD’s work on due diligence guidelines as a basis for developing the content of the required disclosure.

Under the OECD guidelines, “due diligence” is a process for identifying, preventing, mitigating, and accounting for so-called “adverse impacts” on the environment, human rights, labor, bribery, and other impacts that the guidelines cover.^[5] The OECD guidance for responsible business conduct in the financial sector recommends screening investee companies against adverse impact indicators, prioritizing to determine principal adverse impacts, and then taking action to reduce impacts.^[6]

We also understand that ESMA is looking to the EU Technical Expert Group’s Final Report on Climate Benchmarks and Benchmarks’ ESG Disclosures to inform its development of adverse impact indicators.^[7] This report includes a list of ESG indicators against which benchmark providers will have to disclose.

Below is a detailed summary of the RTS that the Disclosure Regulation directs ESMA to develop regarding entity-level disclosure of due diligence policies around “principal adverse impacts.”

A. Art. 3gamma: Website entity-level disclosure for financial market participants (including UCITS management companies and AIFMs) on due diligence policies related to considering “principal adverse impacts of investment decisions on sustainability factors.”

[Paragraphs 6 and 7] Directs ESAs to develop RTS in relation to “sustainability indicators” on (1) climate and other environment-related adverse impacts and (2) adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and bribery matters, further specifying the details of the content, methodologies, and presentation of the following required disclosure:

- Comply or explain website disclosure for financial market participants with less than 500 employees—
 - [Paragraph 1] Where financial market participants consider principal adverse impacts of investment decisions on sustainability factors, they must publish on

their website a statement on due diligence policies with respect to these impacts.

- [Paragraph 2] Statement must include information on:
 - policies on identification/prioritization of principal adverse sustainability impacts/indicators;
 - description of these impacts and actions taken (and planned, if relevant);
 - summary of engagement policies in line with the Shareholder Rights Directive (SRD);
 - reference to commitment to codes of conduct/recognized standards for due diligence/reporting, and alignment with Paris Agreement targets, where relevant.
- [Paragraph 1] If not considering these impacts, financial market participants must disclose clear reasons for not doing so, and where relevant, whether/when they plan to consider them.
- [Paragraph 3] Mandatory website disclosure for entities with over 500 employees – must publish a statement on due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors.
 - [Paragraph 4] This also includes participants that are parent undertakings of a large group as defined under the Accounting Directive Art. 3(7) (*i.e.*, a group that consists of parent and subsidiary undertakings to be included in a consolidation and that (on a consolidated basis) exceed two of the following three criteria – balance sheet total of EUR 20 mil, net turnover of EUR 40 mil, or an average number of employees of 250).
- 12 month deadline for environmental impact RTS. [Paragraph 6] ESAs to submit draft RTS to the Commission by 12 months after the date of entry into force of the Disclosure Regulation.
- 24 month deadline for social impact RTS. [Paragraph 7] ESAs to submit draft RTS to the Commission by 24 months after the date of entry into force of the Disclosure Regulation.

II. RTS for Product-level Prospectus, Website, and Annual Report Disclosure for Green/ESG-oriented Financial Products

The Disclosure Regulation also directs ESMA and the other ESAs to draft RTS on the presentation and content of required prospectus, website, and annual report disclosure in Articles 4a, 5, 6, and 7. These disclosure requirements will apply to a fund that: (1) “presents, among other characteristics, the promotion of environmental or social characteristics;” (2) “has as its objective sustainable investments;” or (3) “has as its objective the reduction in carbon emissions.”

Below is a detailed summary of the RTS that the Disclosure Regulation directs ESMA to develop regarding product-level disclosure for certain types of financial products, such as UCITS and alternative investment funds (AIFs), but also including discretionary client mandates,^[8] certain insurance products, pension products and pension schemes.

A. Art. 4a: Prospectus disclosure for a fund that “presents, among other characteristics, the promotion of environmental or social characteristics, or a combination thereof, provided the companies in which the investments are made follow good governance practices.”

[Paragraph 3] Directs ESAs to develop RTS further specifying the details of the presentation

and content of the following required disclosure:

- [Paragraph 1] Information on how those E and S characteristics are met;
- [Paragraph 1] If an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.
 - [Paragraph 2] An indication of where to find the methodology used for the calculation of the index.
- [Paragraph 3] When developing the draft RTS, the ESAs shall take into account the various types of financial products, their characteristics referred to in paragraph 1 and differences thereof and the aim of accurate, fair, clear, not misleading, simple and concise disclosures.
- 12 month deadline. [Paragraph 3] ESAs to submit draft RTS to the Commission by 12 months after the date of entry into force of the Disclosure Regulation.

B. Art. 5: Prospectus disclosure for a fund that “has as its objective sustainable investments.”

[Paragraph 5] Directs ESAs to develop RTS further specifying the details of the presentation and content of the following required disclosure:

- Where an index has been designated as a reference benchmark, disclosure must include:
 - [Paragraph 1] information on how the designated index is aligned with that objective;
 - [Paragraph 1] an explanation as to why and how the designated index aligned with that objective differs from a broad market index; and
 - [Paragraph 4] an indication of where to find the methodology used for the calculation of the index.
- Where a fund “has as its objective sustainable investments and no index has been designated as a reference benchmark,” disclosure must include:
 - [Paragraph 2] an explanation on how that objective is attained.
- Where a fund “has as its objective the reduction in carbon emissions,” disclosure must include:
 - [Paragraph 3] the objective of low carbon emission exposure in view of achieving the long-term global warming targets of the Paris Climate Agreement.
 - [Paragraph 3] Where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark (under the Low Carbon Benchmarks Regulation) is available, include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming targets of the Paris Climate Agreement.
 - [Paragraph 4] Also include an indication of where to find the methodology used for the calculation of the EU Climate Transition and EU Paris-aligned Benchmarks.
- [Paragraph 5] When developing the draft RTS, the ESAs shall take into account the various types of financial products, their objectives and differences as well as the aim of accurate, fair, clear, not misleading, simple and concise disclosures.
- 12 month deadline. [Paragraph 5] ESAs to submit draft RTS to the Commission by 12 months after the date of entry into force of the Disclosure Regulation.

C. Art. 6: Website disclosure for each fund that: (1) “presents, among other characteristics, the promotion of environmental or social characteristics;” (2) “has as its objective sustainable investments;” or (3) “has as its objective the reduction in carbon emissions.”

[Paragraph 2] Directs ESAs to develop RTS further specifying the details of the content of the following required disclosure:

- [Paragraph 1] a description of the environmental or social characteristics or the sustainable investment objective;
- [Paragraph 1] information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product;

Also further specifying the details of the presentation of the information:

- [Paragraph 1] The information to be disclosed shall be clear, succinct and understandable for investors. It shall be published in an accurate, fair, clear, not misleading, simple and concise way and in a prominent easily accessible area of the website
- [Paragraph 2] When developing the draft RTS, the ESAs shall take into account the various types of financial products, their characteristics, and objectives and differences. The ESAs shall update the RTS in the light of regulatory and technological developments.
- 12 month deadline. [Paragraph 2] ESAs to submit draft RTS to the Commission by 12 months after the date of entry into force of the Disclosure Regulation.

D. Art. 7: Annual report disclosure for each fund that: (1) “presents, among other characteristics, the promotion of environmental or social characteristics;” (2) “has as its objective sustainable investments;” or (3) “has as its objective the reduction in carbon emissions.”

[Paragraph 4] Directs ESAs to develop RTS further specifying the details of the presentation and content of the following required disclosure:

- [Paragraph 1(a)] For each fund that “presents, among other characteristics, the promotion of environmental or social characteristics, or a combination thereof, provided the companies in which the investments are made follow good governance practices,” disclose the extent to which environmental or social characteristics are attained.
- [Paragraph 1(b)] For each fund that “has as its objective sustainable investments” or “has as its objective the reduction in carbon emissions,” disclose:
 - the overall sustainability-related impact of the financial product by means of relevant sustainability indicators, or
 - where an index has been designated as a reference benchmark, a comparison between the overall impact of the financial product with the designated index and a broad market index through sustainability indicators.
- [Paragraph 4] When developing draft RTS, the ESAs shall take into account the various types of financial products, their characteristics, and objectives and differences. The

- ESAs shall update the RTS in the light of regulatory and technological developments.
- 12 month deadline. [Paragraph 4] ESAs to submit draft RTS to the Commission by 12 months after the date of entry into force of the Disclosure Regulation.

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endnotes

[1] The EU co-legislators agreed on the text of a final Disclosure Regulation in March 2019, and we expect it to be officially published and enter into force within the next month or so. The legislative text is *available at* <https://data.consilium.europa.eu/doc/document/ST-7571-2019-ADD-1/en/pdf>. See also the European Commission's sustainable finance webpage at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#implementing.

[2] See ICI Memorandum No. 31696 summarizing the EU Disclosure Regulation, *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo31696>.

[3] ESMA will have 12 months from the entry into force of the Disclosure Regulation (likely October 2019) to submit draft RTS to the Commission for adoption, followed by a period for review by Parliament and Council.

[4] Financial market participants subject to the Disclosure Regulation will have 15 months from the date of publication in the Official Journal of the European Union (likely October 2019) to comply.

[5] The 2011 OECD Guidelines for Multinational Enterprises provide non-binding principles and standards for responsible business conduct. These guidelines recommend that enterprises conduct "due diligence" in order to identify, prevent or mitigate and account for how actual and potential adverse environmental and human rights impacts are addressed. See OECD, *Due Diligence Guidance for Responsible Business Conduct* (2018), at <https://mneguidelines.oecd.org/due-diligence-guidance-for-responsible-business-conduct.htm>.

[6] The OECD has released several sector-specific implementation papers, including the 2017 paper on "Responsible business conduct for institutional investors," which provides guidance on how institutional investors (including asset managers) should identify and respond to an investment's "adverse impacts"—defined as an investee company's real and potential negative impacts on society and the environment. See OECD, *Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises* (2017), at <https://mneguidelines.oecd.org/rbc-financial-sector.htm>.

[7] See EU Technical Expert Group, *Final Report on Climate Benchmarks and Benchmarks' ESG Disclosures* (30 Sept 2019), *available at* https://ec.europa.eu/info/publications/sustainable-finance-teg-climate-benchmarks-and-disclosures_en#next.

[8] See Disclosure Regulation Art. 2(j)(i), referencing Art. 2(f) definition of 'portfolio management' to mean portfolio management as defined in Article 4(1)(8) of Directive 2014/65/EU (MiFID II).

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