Challenges and practical solutions to sustainable investing in the EU

Nadia Bonnet of **Arendt & Medernach** and **Antoine Peter** of **Arendt** Regulatory & Consulting describe how the EU is leading the way in sustainable finance and consider the impact of the changes on fund managers

The EU is implementing a major regulatory reform to ensure that the investment management industry supports the transition to a more sustainable economy, and that sustainability risks are adequately integrated into investment decisions.

These changes apply to a range of financial market participants, including investment fund managers, who find themselves subject to new transparency obligations towards regulators and investors. These obligations pertain to how the risks caused by climate or social change and failures in governance are incorporated into fund management processes.

Furthermore, the industry is also growing to expect greater transparency on the ESG credentials of financial products and their underlying investment strategies.

While some of these reporting requirements are still being finalised at EU level, investors around the world are already drawing on the emerging framework to shape their approach to sustainable investing, and to compare the impacts of different funds across regions.

Under Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the SFDR or Level 1 requirements), financial market participants must disclose the extent to which their financial products promote environmental or social characteristics, or make sustainable investments (as defined in the SFDR).

Under Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the Taxonomy Regulation), financial products must disclose how and to what extent they are aligned with the delegated act on climate and the forthcoming complementary delegated act on the environment.

In particular, this obligation to report on taxonomy alignment applies to financial products subject to Article

www.arendt.com

Nadia Bonnet
Counsel
Arendt & Medernach
T: +1 212 554 3546
E: nadia.bonnet@arendt.com

Nadia Bonnet is a counsel in the fund formation practice at Arendt & Medernach. Her practice focuses on alternative investment (funds) vehicles and their managers (AIFMs) addressing all relevant regulatory matters.

Nadia advises international clients on the structuring, setting-up, organisation and ongoing assistance of investment vehicles in the real estate, private equity, venture capital, private debt and infrastructure asset classes (both regulated and non-regulated investment structures). She also regularly advises international institutional clients on the formation of joint ventures, corporate restructurings, mergers and acquisitions.

Nadia is a Luxembourg qualified lawyer and studied law in France, the US and Luxembourg. She holds a master's degree in European business law from the Université de Besançon, France.

Antoine Peter
Manager
Arendt Regulatory & Consulting
T: +352 26 0910 7771
E: antoine.peter@arendt.com

Antoine Peter is a manager at Arendt Regulatory & Consulting SA. He gives regulatory and operational advice to clients in Luxembourg and abroad in the asset management and asset servicing businesses.

Antoine also assists clients by providing general compliance support and reviewing operating models related to governance, as well as to investment management, risk management frameworks and valuation models. Specialising in environmental, social and corporate governance (ESG) and sustainable finance solutions, he assists clients, among others, with the set-up and implementation of ESG strategies, the preparation of sustainability-related disclosures and the integration of sustainability risks in internal processes.

Antoine holds a master's degree in corporate finance and financial markets from the University of Strasbourg, and is a graduate of Sciences Po Strasbourg.

9 SFDR that pursue environmental objectives, or financial products subject to Article 8 SFDR that commit to partial investment in sustainable investment assets with environmental objectives.

Finally, the Regulatory Technical Standards (RTS or Level 2 requirements) that are currently being developed to enhance the SFDR and the Taxonomy Regulation, and that will come into force in January 2023, will further specify the format and content of the taxonomy alignment disclosures required of financial products, and will also introduce more detailed transparency requirements for disclosures under the SFDR.

The regulatory puzzle

Since its sustainable finance action plan a few years ago, the European Commission has been working on an ambitious agenda to lead the way in sustainable finance. As described above, the plan comprises numerous regulations that are progressively being implemented.

The SFDR, the Taxonomy Regulation, the NFRD or the CSRD are some of such regulations, with the intended combined effect of integrating environmental, social and governance issues into collective investment management in a consistent and harmonised manner.

Level 1 and Level 2 requirements

Level 1 requirements apply from March 10 2021 for the SFDR, and from January 1 2022 for the Taxonomy Regulation. By these dates, financial market participants and their products must meet high-level, principles-based disclosure requirements; for example, through prospectus updates and website disclosures. Level 2 requirements (the RTS mentioned above) supplement Level 1 requirements, and are due to enter into force from January 1 2023.

From that date, fund managers will need to make more detailed disclosures, using mandatory templates for some of them (see the annexes to the SFDR RTS). The RTS are intended to make more data available to end investors, in particular regarding investments in environmentally sustainable economic activities in terms of the Taxonomy Regulation. Their purpose is to give investors transparent and comparable information enabling them to make better-informed investment decisions.

Though more detailed, the Level 2 templates offer fund managers a comprehensive guide on the different factors to be established before launching a credible ESG strategy, and on how to limit greenwashing risks.

Interplay between the various texts

The Taxonomy Regulation (intended to create an EU-wide classification system by creating a list of sustainable economic activities) refers to and relies upon the SFDR, and vice-versa. The Taxonomy Regulation has amended the SFDR; in particular, it has supplemented the SFDR disclosure obligations to enhance transparency and provide financial market participants with an objective basis for comparison by which end investors can understand what proportion of a product's investments ultimately fund environmentally sustainable economic activities.

The industry is now awaiting the adoption of mandatory reporting standards under the proposed Corporate Sustainability Reporting Directive (the CSRD), set to replace the Non-Financial Reporting Directive.

This legislation will require many EU businesses to begin reporting reliable and comparable sustainability information, and is a crucial piece of the puzzle for enabling market participants to make accurate disclosures under SFDR and the Taxonomy

"Where regulatory solutions fail or are too slowly implemented, market initiatives and solutions flourish"

Regulation. This will be a critical tool for fixing the infamous data accessibility issues around non-financial information.

These texts are thus intertwined in a complex regulatory framework. It is important that asset managers familiarise themselves with this legislation, and plan how they will meet the new requirements efficiently from the operational, human, systems and data perspectives.

Reconciliation of existing approaches and frameworks with the framework

The puzzle pieces may be highly nuanced, but the end result does not always prove particularly flexible. Many fund managers are finding it difficult to make their pre-existing legacy frameworks for defining sustainable investments fit together with the new SFDR and taxonomy rules.

The texts do not reproduce concepts like 'impact investing', and industry players must find creative ways to bring existing SDG alignment strategies and other Impact Management Project (IMP) methodologies into step with the new regulatory framework. For many fund managers, this means changing the way they operate, in particular by learning to gather new data points. Still, it also means room for innovation and the development of new approaches to sustainable investing.

Challenges

Beyond the feat of deciphering the dense regulatory package, numerous practical challenges with respect to ESG await fund managers, and the financial sector as a whole, in the coming years.

Long-standing problems as yet unresolved – such as the lack of data noted above, timeline inconsistencies or the state of overall literacy on the topic (among fund managers and investors alike) – are now combined with new hurdles, such as the emergence of disparate national rules.

Lack of data

One great paradox of the EU framework is that the financial sector has been asked to indicate the taxonomy alignment of financial products by reporting certain information (including non-financial information) that the underlying companies themselves are not yet required to report.

Imposing more prescriptive and better harmonised non-financial reporting (including through the Taxonomy Regulation) on non-financial companies is now planned, but it will only happen gradually, over the coming years.

Data providers and the market are looking to solve this issue by developing new tools and products and creating more advanced and comprehensive databases. However, the results are still insufficient to instil end investors and fund managers with the necessary confidence in the figures provided (for example, because a significant standard deviation for taxonomy alignment continues to be observed across providers).

This sequencing issue leaves fund managers and the whole industry faced with significant operational challenges when attempting to calculate taxonomy alignment. It also impedes their ability to adequately integrate sustainability risks in investment decisions, and to assess the potential adverse impacts of their investments on sustainability factors. Because of this dearth of data on investee companies and the insufficient quality of what data is available, industry players welcome the work on non-financial reporting currently being carried out by actors such as EFRAG (the European Financial Reporting Advisory Group) and the ISSB (International Sustainability Standards Board).

Unfortunately, there are also other pieces in the regulatory puzzle whose timing could place the financial sector in a difficult position. For example, the proposed reform of the MiFID rules on suitability assessments is planned to come into force in August 2022. These revised rules include the need to take into consideration end clients' sustainability preferences when distributing financial products.

Such sustainability preferences are to be assessed on the basis of three strict criteria, and in order to be suitable, such assessments will require much more detailed information and disclosures at financial product level than are currently being produced. That level of detail will not be achieved until January 2023, when Level 2 enters into force.

Extremely detailed information is required under many of the emerging legislative provisions (for example, those on principal adverse impact indicators), and while there is often insufficient granularity of non-financial reporting to meet such a requirement within the EU, the situation is even worse outside of it. This renders some fund managers, such as impact managers, unable to demonstrate compliance with the framework of their investments in other parts of the world (especially in developing countries), despite having conducted successful impact investing actions in those regions for many years prior.

Talent management

"AIFMs shall retain the necessary resources and expertise for the effective integration of sustainability risks" and "ensure that its senior management is responsible for the integration of sustainability risks […]".

These are the revisions proposed by Commission Delegated Regulation (EU) 2021/1255 of April 21 2021 amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers (an identical obligation is also introduced for UCITS fund managers).

One objective of the proposed revision is to encourage fund managers to internally identify people to bear responsibility for sustainability-related issues, while also ensuring that they possess the necessary skills and knowledge to do so. In the wake of this proposal, training programmes, professional certification courses and even university degrees have flourished as the industry has scrambled to recruit staff with the right skillsets.

Indeed, one major challenge for today's fund managers is finding the right resources to handle the panoply of questions linked to sustainable finance (integration of sustainability risks, sustainable investments, etc.). The industry needs professionals that understand both the traditional fund structuring, legal and compliance framework, as well as ESG.

ESG and sustainability professionals coming from CSR universe have been dealing with these issues for years, but are often too busy conducting extensive sustainability or engagement campaigns with portfolio companies to cope with the sheer size of the regulatory agenda on the subject.

These profiles tend to be relatively unfamiliar with the greater regulatory ruleset that weighs on fund managers from a compliance point of view, while compliance professionals struggle to effectively assimilate sustainability topics. This can lead to burnout or bore-out among sustainability personnel if they are placed on the wrong tasks or given too many tasks. Collaboration between teams and experts is necessary in order to thrive in the ever-more-complex regulatory environment.

The same is also true for risk managers, who must now cooperate with sustainability professionals to understand and integrate sustainability risks into their traditional risk management framework, notably via materiality assessments or climate stress testing and scenario analysis.

Investor education and expectation management

Education

As described above, the framework is highly complex, with different regulatory texts introducing a multitude of concepts that may seem, to the various market participants, more or less apt to suitably encapsulate the changing reality. The concept of 'sustainable investment' is probably the best example of this. Of course, merely having a good ESG rating is not enough for an investment to qualify as sustainable under the SFDR framework – a fact which must be explained to investors that will often have their own understanding of what constitutes a sustainable investment.

Financial market participants must therefore be sufficiently knowledgeable, and in a position to explain to clients the regulatory definition of 'sustainable investment' and other concepts. They must also know enough about the regulatory framework to understand whether, and how, the client's expectations can fit comfortably within it.

Expectation

The need to manage client expectations is best exemplified by taxonomy alignment. Taxonomy alignment is difficult to achieve, and even very good investment funds and strategies can end up with an extremely low level of taxonomy alignment, for very good practical or operational reasons. This also has to be explained to investors, which will want their funds to have high levels of taxonomy alignment.

A fragmented EU market

Finally, asset managers currently have to deal with an increasingly fragmented market in terms of ESG rules. This true in the EU where the AMF, BaFin and other authorities have introduced gold-plating or local rules for sustainable/ESG financial products. Although these apply only to national products distributed to domestic retail investors and often focus mainly on marketing material, fund managers looking to distribute their products in these countries must still take them into account, and must find ways to accommodate them at the risk of being shut out of the market for misalignment with local rules or client expectations.

Such rules can introduce minimum sectoral exclusions, materiality thresholds for proposed ESG approaches, or minimum sustainable investment percentages, all of which can add onto the EU-level rules (which themselves ought to be seen as a transparency mechanism above all else).

In December 2021, the UK FCA even published its own sustainability-related disclosure framework (SRD) that is similar to the SFDR, but with key differences, creating further headache for fund managers with global operations.

Meanwhile, in the US (supported by, and in support of, the Biden administration), the SEC, the Commodity Futures Trading Commission, the Labor Department and the Federal Reserve have all announced ESG regulation projects, the creation of new ESG-related positions and task forces, or both.

Flourishing solutions

Many of the challenges presented in the second part of our article have already been identified by EU policymakers, who are working hard to propose regulatory solutions. The latest example of this is the work on ESG ratings initiated by ESMA.

Where regulatory solutions fail or are too slowly implemented, market initiatives and solutions flourish. Specialised actors looking to tackle specific topics and industry working groups, alliances or collaboration platforms are here to take some control and provide market participants with practical solutions to these – hopefully short-lived – issues.