JONES DAY | One Firm Worldwide℠

WHITE PAPER

February 2019

Sustainability in EU Capital Markets: New Rules for Fund and Asset Managers Ahead

Currently in the European Union, no level playing field exists for asset management and rating agency activities when it comes to ensuring sustainability. The European Securities and Market Authority ("ESMA") is proposing amendments to certain Level 2 legislation and guidelines to make integration of environmental, social, and governance ("ESG") factors mandatory for asset managers, investment advisors, and credit rating agencies ("CRAs"). If implemented, EU-based asset managers and investment advisors will need to review their existing investment and advisory processes with regard to ESG. If they have not yet implemented such processes, they will need to develop adequate investment and advisory processes integrating ESG factors. EU-based CRAs also may need to disclose ESG factors when these are considered as part of a credit rating action.

This *White Paper* examines each of the new ESG integration proposals and outlines their possible impact on asset managers, investment advisors, and CRAs.

TABLE OF CONTENTS

UCITS and AIF Managers 1

Discretionary Portfolio Managers and Investment Advisors Under MiFID II 2

CRAs: ESG Disclosure Process 3

Lawyer Contacts 3

Endnotes 3

Just before the end of last year, the European Securities and Market Authority ("ESMA") launched three consultations[1] in further pursuit of the implementation of the European Commission's Action Plan on Sustainable Finance, which was published in early March 2018. We commented on a first package of legislative proposals back in October 2018. Two of the three new consultations aim at including environmental, social, and governance ("ESG") preferences in the asset management and advisory processes. They are, therefore, addressed to the asset management sector—namely, Undertakings for Collective Investment in Transferable Securities ("UCITS") and Alternative Investment Fund ("AIF") managers—as well as investment firms within the meaning of MiFID II legislation, to the extent they provide investment advice and portfolio management services. Due to the size of the asset management sector and the considerable number of market players in this sector, we expect the latest proposals to have the largest impact in this area. The third proposal is addressed to credit rating agencies ("CRAs") and requires CRAs to disclose ESG factors when these are considered as part of a credit rating action. Each of the proposals and their possible impact will be outlined in more detail in the following paragraphs. They are taking a principles-based approach.

While it may be too early to state that ESG is now mainstream, as suggested by some market participants, we would *not* bet against ESG becoming an increasingly important aspect of the financial industry. If the new proposals are implemented, asset managers in particular will need to review their investment and advisory processes in regard to ESG. If they have not yet implemented such processes, they will need to develop adequate investment and advisory processes integrating ESG factors.

UCITS AND AIF MANAGERS

The focus of this proposal is on sustainability risks, which would need to be taken into account by UCITS and AIF managers, not only in their due diligence and investment processes but also on an ongoing basis (i.e., sustainability risks would need to be assessed, monitored, and managed along with any other relevant risks, such as market, interest, or credit risk). While the exact meaning of the term "sustainability risks" has not been defined, ESMA interprets the term as the risk of fluctuations in the value of positions in a fund's portfolio due to ESG factors. Such considerations would impact the following elements of fund management:

- **Organizational Requirements**: Organizational procedures, systems, and controls would need to incorporate sustainability risks in order to ensure that these risks are taken into account in the investment and risk management processes.
- **Available Resources**: The relevant entity would need to have the requisite resources and expertise for the integration of sustainability risks.
- **Senior Management Responsibilities**: Part of senior management's responsibilities would be the integration of sustainability risks.
- **Conflicts of Interests**: Any conflicts of interests arising in connection with the integration of sustainability risks would need to be considered.
- **Due Diligence**: The selection and monitoring of investments would require the adaptation of written policies and procedures.
- **Risk Management**: The risk management policy would need to integrate sustainability risks.

As a consequence of the above, for example, we would expect that as a matter of principle, UCITS and AIF managers would be required to reflect ESG considerations in connection with their investment committee approvals. We would expect that the members of such investment committees would not only need a certain degree of knowledge and expertise in line with the second bullet point above, but also that the actual decision would probably need to clarify if, which, and to what extent ESG factors have been taken into account. Another area of investment management that is likely to be affected by the new legislative proposal is the portfolio monitoring process, where ESG risks would probably need to be identified and monitored, not only in respect to any individual investment but also in respect to the portfolio taken as a whole.

There are, however, two factors that might help UCITS and AIF managers to comply with the above. First, due to the principles-based approach taken in the proposals, no particular way or method of integrating sustainability risks is prescribed. Second, the concept of proportionality, widely found in financial market regulation elsewhere, would also apply in respect to the need to reflect sustainability risks. Despite any flexibility offered by

these two factors, the main challenge remains the question of how to measure sustainability risks. Data availability and quality continues to be perceived as a major obstacle to the implementation of ESG considerations, but a steady improvement in this respect over the medium to long-term is expected.

DISCRETIONARY PORTFOLIO MANAGERS AND INVESTMENT ADVISORS UNDER MIFID II

On one hand, the proposed amendments to existing MiFID II legislation and certain guidelines are similar to those proposed in respect to fund managers. On the other hand, differences between the activities of MiFID II firms and fund managers require and justify a different regulatory treatment. In this respect, it is, therefore, not surprising that only some of the proposed amendments to the fund legislation are found in the proposal covering to MiFID II firms; that the wording differs despite similar subjects concerned; and that the MiFID II package addresses certain aspects which are not applicable to fund managers.

Areas common to both types of asset managers relate to general organizational requirements, such as:

- The need to incorporate ESG considerations within their processes, systems, and controls; and
- Requirements for staff with sufficient skills, knowledge, and expertise to address sustainability risks within the risk management system, including in the compliance and internal audit function, and to deal with conflicts of interest in an adequate manner. Proposals relating to product governance and suitability checks are reserved for MiFID II firms.

In respect to product governance, ESMA proposes, for example, that ESG preferences shall not only be taken into account by distributors of financial products when determining the target market, but also by manufacturers of such products. Interestingly, where an investment product fulfils ESG preferences, the categorization currently developed by the European Commission under the taxonomy regulation is to be used. However, until such work has been finalized, investment firms should take into account the current market standards and preparatory works in respect to the ESG taxonomy, thereby suggesting the amendments pursued by the current consultation will apply before the work on the taxonomy regulation has been finalized. To a certain extent, this makes sense, as the European Commission's work in the context of an ESG taxonomy currently focuses only on the "E" of ESG, while social and governance aspects are to be dealt with and developed at a later stage. Nevertheless, investment firms may, therefore, face an extended period in which they would need to adapt their classification system.

Another noteworthy aspect in this context is that the proposed amendments do not require that all investment products always need to have a reference as to whether they fulfill ESG preferences or not, but that manufacturers will in any event be required to assess ESG characteristics of the product. However, only positive ESG characteristics must be identified; there is no need to identify negative ESG products. As a consequence, ESMA acknowledges that this will lead to target markets for ESG positive and non-ESG products. At the same time, ESMA emphasizes that no negative target market needs to be defined and that products showing ESG characteristics are not, per se, ineligible for investors with no ESG preferences. Subject to the ongoing consultation process, it remains to be seen how this will be implemented and work in practice.

In respect to the suitability assessment required under MiFID II and the relevant ESMA guidelines—which already encourage investment firms to consider nonfinancial elements when gathering information on the client's investment objectives, including ESG preferences—ESMA suggests a tweak of the existing wording. Instead of stating that it "would be a good practice" to consider such nonfinancial elements, the new wording clarifies that investment firms "should" collect information on ESG preferences. As elsewhere, no specific approach will be prescribed for how this needs to be done.

Noteworthy in this context is ESMA's attempt to balance ESG preferences with the other suitability criteria, stating that "sustainability considerations do not outweigh the relevance of the other suitability criteria in a way that might not result in the client's best interest." According to the proposed methodology, investment firms should, therefore, take a two-step approach: First, the range of suitable products should be identified in accordance with the criteria of knowledge and experience, financial situation, and investment objectives. Then, in a second step, the product that best fulfils the client's ESG preferences should be chosen.

This concept would apply to all types of clients, including retail clients. Just as there is no automatism in relation to ESG and product governance, no automatism in respect to ESG and suitability should take place. In other words, a product with ESG characteristics will not be automatically unsuitable for clients not having demonstrated ESG preferences and vice versa.

CRAS: ESG DISCLOSURE PROCESS

The proposed amendments to the CRA regime relate to the form and content of press releases, which CRAs typically use to comply with transparency requirements and to improve disclosure in respect to ESG factors when they are a key element behind the issuance of a credit rating. Only the latter aspect shall be briefly addressed here. It is, however, connected to the former, as explained below.

One point to note is that due to a lack of competence of ESMA and the European Commission, the proposal does not recommend or mandate that ESG factors be considered by CRAs in the course of their creditworthiness assessment. Notwithstanding this limitation, ESMA's declared intention is to offer users of credit ratings greater clarity and information regarding whether and how ESG criteria have been considered as part of a credit rating or outlook. As a starting point, the ESG disclosure, therefore, only applies when ESG factors are a key underlying element behind the issuance of a credit rating. In this way, ESMA acknowledges that ESG factors may not be a key underlying element of a credit rating action if the CRA does not consider them relevant according to the applicable methodology. On one hand, this seems to leave it to CRAs, to a large extent, to decide whether they want to integrate ESG factors in their rating activity. However, on the other hand, it should be noted that, pursuant to a market screening performed by ESMA, several CRAs have already developed, to a greater or lesser extent, ESG guidance in respect to their ratings. Thus, ESMA's proposal is expected at least to contribute to the transparency and comparability of credit ratings that already reflect ESG factors.

In more practical terms, ESMA proposes that each press release produced in connection with a credit rating includes a link to either an explanatory document or a section of the CRA's website that contains guidance on how ESG factors are taken into account in its credit ratings. In addition, a positive *or* negative identification of ESG factors (i.e., whether ESG factors were a key underlying element of the credit rating action in line with the relevant CRA's categorization of ESG factors) should be included. In case of a positive identification, CRAs should additionally list the relevant ESG factors and identify as to whether they are considered by the relevant CRA as an environmental, social, or governance factor.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Linda A. Hesse
Paris
+33.1.56.59.38.72
lhesse@jonesday.com

John MacGarty
London
+44.20.7039.5933
jmacgarty@jonesday.com

Florence Moulin
Paris
+33.1.56.59.39.39
fmoulin@jonesday.com

Mathias Raabe
Düsseldorf
+49.211.5406.5500
mraabe@jonesday.com

ENDNOTES

1 Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD, dated December 19, 2018 (ESMA34-45-569); Consultation Paper on integrating sustainability risks and factors in MiFID II, dated December 19, 2018 (ESMA35-43-1210); Consultation Paper Guidelines on Disclosure Requirements Applicable to Credit Ratings, dated December 19, 2018 (ESMA33-9-290).

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.

© 2019 Jones Day. All rights reserved. Printed in the U.S.A.