How to avoid becoming lost in ESG compliance in the EU

Diana Ribeiro Duarte, Pedro Capitão Barbosa and Sofia Araújo Matias of Morais Leitão outline the daunting challenges that fund managers face as a result of the increasing focus on sustainability and transparency

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The fast pace at which the EU ESG regulatory framework is advancing, coupled with investors' changing demands and interests (notably regarding the ambition for widespread sustainable investing and transparency), has given rise to new challenges for fund managers.

EU fund managers are now directly and indirectly exposed to several ESG-related disclosure requirements, both for themselves and the undertakings they manage. These are provided for in the Sustainable Financial Disclosure Regulation (SFDR), the EU Taxonomy Regulation (Taxonomy Regulation), the Non-Financial Reporting Directive (NFRD), and (eventually) the Corporate Sustainability Reporting Directive (CSRD) once it is approved. As a result, fund managers have to comply with multiple regulatory regimes which often overlap.

There are doubts about the interpretation, application and compatibility of these regulations. Furthermore, there are rules that still need to be complemented by technical standards and there is a lack of accessible data and methodologies that are essential to comply with the relevant disclosure obligations. Therefore, it is not uncommon for fund managers to get lost in compliance (and it is expected that this phenomenon will increase in the future).

This article aims to highlight some of the main ESG challenges for fund managers wishing to market their products in the EU, namely those within the scope of the EU legal instruments mentioned above.

The SFDR requirements

The SFDR refers to sustainability-related disclosures in the financial services sector and applies to EU undertakings for the collective investment in transferable securities (UCITS) fund managers, alternative investment fund managers (both below and above the thresholds of Directive 2011/61/UE),

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On the fund formation front, Diana advises on every regulatory and governance aspect of fund formation, operation, restructuring and liquidation. Fund incorporation and liquidation, structuring of alternative governance arrangements to facilitate outside sponsor involvement (within the context of immigration programmes or otherwise), transformation of real estate companies into regulated vehicles and replacement of management entities are just some of the examples of the work performed by Diana.

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portfolio account managers and certain non-EU funds.

The SFDR is perhaps the most significant ESG legislation affecting fund managers, and imposes complex disclosure requirements on them.

Sustainable funds

At the product level, if fund managers wish to pursue sustainable investing, the requirement to classify their funds as Article 8 (promotes environmental or social characteristics) and/or Article 9 (has a sustainable investment objective based on a non-market index designated as a reference benchmark) represents a significant challenge.

This is especially the case under Article 8. What makes a fund 'sustainable'? And what does it mean to 'promote' environmental or social characteristics? The characteristics that are relevant for its characterisation are still uncertain, and the existing guidelines are vague and ambiguous. Due to this lack of clarity and the confusion created, funds with similar characteristics are being classified differently.

Because the EU legislator has not issued any specific guidance on this categorisation, fund managers are relying solely on their own understanding and interpretation of the fund's characteristics, which can result in different views from those of their stakeholders (regulators, investors, etc.) regarding the quality of sustainability-related disclosures of the funds being marketed. Hence, there are many different perspectives and approaches in the industry on how to categorise funds and they may end up being mislabelled.

Difficulties in characterisation may also push fund managers to classify their funds as 'not sustainable' (neither Article 8 nor Article 9) due to fear of being labelled 'greenwashers' or of being the target of mis-selling allegations.

A fund manager willing to comply with the SFDR's complex disclosure requirements will struggle to do so also because technical standards either do not exist (one example being technical standards for social or governance disclosures) or have yet to be definitively settled.

The SFDR's regulatory technical standards (RTS) are a vast and complex regulatory body whose adoption has been delayed and for which final and detailed technical guidance has not yet been approved. As such, while fund managers are scrambling to meet these standards (most of which are applicable from 2023), their ambiguity and sometimes failure to provide useful guidance may lead to further inaccuracies in fund labelling.

As a result of these challenges, fund managers may unintentionally or deliberately greenwash their products, and investors could be deceived. This can erode confidence in fund management classifications, leading to costly and inefficient litigation. The reverse situation may also be true and managers may avoid classifying their products as 'sustainable' for fear of reputational and/or litigation risk materialising.

Principal adverse impacts

Under the SFDR, pursuant to a 'comply or explain' methodology, fund managers must disclose the principal adverse impacts (PAI) of their investment decisions on sustainability factors. These PAI have been developed (in significant detail) in the projected SFDR RTS.

This is a task that is daunting in its own right. Without data availability and guidance, fund managers may be using different metrics and information based on dissimilar criteria, making it very difficult for the disclosed data to be reliable and comparable. For instance, the PAI indicators of a fund can be reported differently compared to those of another fund with a similar portfolio just because they are managed by different entities with different data sources.

The SFDR and MiFID II

Another noteworthy challenge for managers comes from the SFDR's interaction with the Markets in Financial Instruments Directive (MiFID) II. There is a certain inconsistency and ambiguity regarding the compatibility of MiFID II with the 'sustainable fund' provisions of the SFDR (Articles 8 and 9, mentioned above).

Among other aspects, MiFID II establishes the characteristics that a financial product must have in order to be offered as a sustainable investment and for the client or potential client to choose to integrate it into their investment strategy ('sustainability preferences'). But this categorisation is not fully aligned with the classification of financial products under the SFDR.

The problem is especially acute when confronting the MiFID II classification with the financial products foreseen in Article 8, as there could be doubts as to whether all products covered by this article fulfil one of the MiFID II sustainability preferences.

This could lead to the awkward conclusion that certain funds may be marketed as promoting environmental and/or social characteristics under Article 8 of the SFDR, but intermediaries subject to MiFID II may not sell them on to clients (or potential clients) that express sustainability preferences. Ultimately, this could provide a dent in the credibility of the European capital markets.

Taxonomy Regulation

The Taxonomy Regulation establishes a framework to facilitate environmentally sustainable investment by financial market participants and amends the SFDR. It also applies to 'financial market participants', which include UCITS and alternative investment funds. Entities subject to the NFRD (see below) are also covered by the Taxonomy Regulation.

The Taxonomy Regulation poses some challenges to fund managers, particularly in its interconnection with the SFDR. In particular, the Taxonomy Regulation modifies the SFDR to include additional disclosure obligations for Article 8 and 9 products that promote environmental characteristics. Yet the legislator created some inconsistencies, many of them conceptual, that have been raising interpretative doubts and creating difficulties in assessing the compatibility of the two legislative instruments.

Although these instruments are related and sometimes independent of each other, they are not conceptually synchronised and lack clarity and harmonisation. The inconsistencies in definitions, methodologies, labelling and classifications, as well as the absence of transparency in methodology and approved ratings and approaches, remove the desirable interconnection and may even weaken the value of having a wider panorama in ESG reporting.

First, while the Taxonomy Regulation only refers to environmentally sustainable investments, under the SFDR the definition of sustainable investment is broader: "an investment in an economic activity that contributes to an environmental objective or to a social objective.". This means that, while environmentally sustainable investments are supposed to be integrated into the SFDR, the standards for compliance with disclosure requirements are not exactly the same under both pieces of legislation.

Furthermore, the Taxonomy Regulation focuses on specific economic activities, whereas the SFDR concentrates on the big picture. As a result, two distinct dimensions of analysis that often do not coincide will have to be applied simultaneously.

In a nutshell, fund managers that manage sustainable products may have to comply with overlapping or conflicting SFDR and Taxonomy Regulation disclosure requirements, which increases compliance costs.

Moreover, environmental disclosures that are imposed by the Taxonomy Regulation for entities subject to the NFDR will necessarily be used by fund managers to comply with their environmental disclosure obligations for Article 8 and 9 products under the SFDR. However, this articulation will be difficult due to the lack of harmonisation of the methodologies used by fund managers vis-à-vis reporting portfolio companies and the absence of guidance.

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SFDR and NFDR, the Taxonomy Regulation only requires environmental disclosures and not disclosures related to the three ESG factors. Although there have been some recent initiatives in that direction (for example, the report from the Platform on Sustainable Finance released on February 28 2022 on the addition of a social taxonomy to the current EU taxonomy), a social or governance taxonomy has yet to be approved. The few social and governance taxonomies that exist are relevant only as prerequisites for environmental compliance.

Lastly, the Taxonomy Regulation's technical screening criteria, which define when a specific economic activity is deemed environmentally sustainable, increase reporting uncertainty as they are supposed to be a set of standards that will be in permanent flux, with more sectors and activities being added to the scope as time passes. The aim is for the technical screening criteria to be dynamic and subject to frequent review.

The screening criteria are drafted under a one-size-fits-all approach, making it very difficult to adapt them to certain economic activities.

These issues mean that fund managers' efforts to meet the relevant criteria will require constant updating and therefore additional compliance efforts (especially for managers who are highly diversified in terms of sectors and asset classes).

The NFRD and the CSRD

The NFRD sets the rules on the disclosure of non-financial and diversity information by certain EU public-interest companies with more than 500 employees and that have a balance sheet of more than €20 million or a net turnover of more than €40 million.

As mentioned above, information fed through the NFRD is essential for fund managers (at least those who manage funds invested in traded equities and corporate debt) to complete their ESG reporting. However, as it applies only to large companies, the NFRD concerns only a subset of fund managers' portfolio companies, creating discrepancies in reporting. Notably, UCITS fund managers can usually count on non-financial sustainability-related disclosures and ESG ratings and metrics from their portfolio companies, unlike alternative fund managers, who are usually invested in smaller, non-traded companies or in non-financial assets such as real estate.

The NFRD has several drawbacks:

- The misalignment of the SFDR and the Taxonomy Regulation with the scope of the NFRD in what concerns reporting requirements and data;
- The lack of uniformity and specificity on disclosure obligations, which therefore imperils the goal of having greater transparency and standardisation of non-financial disclosure;
- The reporting thresholds that create discrepancies between types of asset managers (big versus large, mainstream versus alternative).

This led the European Commission on April 21 2021 to adopt a proposal for the CSRD, which is intended to replace the NFRD by broadening the number of entities subject to it and adjusting its reporting requirements.

The CSRD enlarges the NFDR's scope to include all companies listed on regulated markets (except micro-enterprises that have a turnover or total assets of less than €2 million or that employ fewer than 10 individuals) and all large public-interest companies with at least two of the following requirements: 250 or more employees; net turnover of €40 million; and assets worth €20 million.

Nevertheless, this proposal is not devoid of pitfalls for fund managers. For instance, the vague and complex concepts of the NFDR remain, and the new reporting requirements seem to be disproportionate and burdensome for smaller entities to comply with. Additionally, double materiality standards (i.e. companies have to report on how sustainability issues affect their business and on their own impact on people and the environment) have fallen short of expectations due to the lack of clarity in their application.

Thus, it is not clear that this new directive will necessarily translate into more reliable data being transmitted to fund managers to support their own ESG reporting. It would help if there were more proportionality and flexibility in CSRD application, coherence with the other ESG regulations and more detail on the information to be provided.

Cross-cutting challenges

Besides the challenges mentioned above which are distinctive to each of the main pieces of legislation affecting EU fund managers, there are others which are more cross-sectional. These should also be addressed.

Data collection and processing

Another challenge for fund managers when complying with EU regulatory reporting (and scoring) requirements is the limited quality of reliable data available. The lack of data standardisation and methodological transparency are also raising concerns.

Fund managers must gather and aggregate data from their portfolio companies and other assets in order to disclose the information that ESG regulations require, relying on data from multiple sources, especially non-financial data. However, there is a worrying scarcity of data as it is not always accessible or may not be of the required quality or there may be a discrepancy between the provided data and the required data.

Occasionally, due to the lack of guidance, fund managers are unsure which data to collect, leading to different data selections for the same disclosure piece. As a result, disclosures based on the same data can even lead to opposite conclusions.

The issue leads to difficulties in data comparison and benchmarking, making ESG corporate performance comparability extremely challenging. The collection of reliable data from multiple sources forms one of the pillars of EU ESG regulatory instruments, but the differences in materiality interpretations, the variety in ESG third-rating providers and the proliferation of data sets are often of little help to address this problem.

Undoubtedly, the process of collecting the required and credible ESG data, particularly at the portfolio company level, synchronising it with the Taxonomy Regulation and using it in accordance with the SFDR is complex. The difficulty increases for SFDR fund managers (especially alternatives) that hold participations in companies/assets not covered by the NFRD; since it was never requested, non-financial data may not be available as fund managers have not gathered this kind of data before and are not familiar with the proceedings. But one thing is clear: it will take time for ESG data to become widely available and easily accessible to fund managers who were not under the NFDR scope in order for them to be able to collect the data required by the SFDR.

In addition, fund managers may be disregarding data on certain metrics and asset classes and, on the other hand, disclosing just descriptive data, which does not efficiently report a portfolio's performance, thus losing an effective comparison and allowing disclosures to become biased. In the worst case, errors in the handling (or mishandling) of the required data may lead to the non-fulfilment of the regulatory obligations and incomplete disclosures.

Another challenge is related to the ambitious timeline for the necessary data updates and disclosures and its associated costs, particularly compliance costs.

Although there have been standardisation efforts by the EU legislator, these data challenges seem to be a lingering issue and inevitably affect the ability to analyse and compare fund managers' data disclosures. This leads to ineffective disclosures and ultimately increases fund managers' regulatory risk.

Other issues

In addition to the challenge concerning data, there are other problematic topics that fund managers may face as a result of the interconnection of the EU legal instruments:

- Implementation timelines: interacting with all the applicable legislation can be problematic as the application deadlines are not fully aligned and are constantly changing. For instance, the European Commission has postponed the SFDR level 2 implementation twice, first from January 1 2022 to July 1 2022, and now to January 1 2023.
- Accrued costs with regulatory compliance: the possibility of having to comply with these legal instruments simultaneously may lead fund managers to disclose the same information in several ways, duplicating work and resources and increasing compliance costs and time spent. The publication of the Taxonomy Regulation RTS and the SFDR RTS, especially those related to PAI, with their reporting differences and details in disclosure obligations, exemplifies the difficulty and work burden that fund managers will soon face.
- Greenwashing: for all that remains to be defined and clarified by the European regulator, in the short term the risk of greenwashing is real and could trigger an adverse selection problem if investors are not able to distinguish which fund managers are reliably promoting sustainable investments and those which are not. This risk has been mitigated in some ways by the publication of the mentioned RTS and the CSRD proposal, but there is still much work to be done. For example, reliance on information collected or analysed by portfolio companies could be a serious risk for fund managers, and this should be addressed by direct shareholder engagement with management (in the case of mutual funds) or in the relevant investment documentation (in the case of alternative funds).
- Cross-border investment decisions: due to the lack of coherent international standards and metrics in ESG reporting and transparency, fund managers who invest outside the EU may also be subject to conflicting ESG taxonomies and different frameworks and definitions. This amplifies the regulatory complexity of ESG compliance.

What now?

ESG EU legislation compliance will be in the spotlight for the asset management industry in the coming years. There is no doubt that managers are trying to overcome ESG challenges, but while some of them are being mitigated, new ones will continue to appear as the regulatory environment evolves.

When viewed separately, dealing with these challenges may appear simple. However, when taken as a whole, with detailed disclosure obligations from various legal instruments that imply complex data collection processes, as well as with the new wave of upcoming legislation and regulatory standards, such challenges will no doubt start to appear daunting. It is critical that fund managers plan for the future.