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Asset Management & Investment Funds ESG Newsletter

February 2024 - June 2024

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This is a condensed version of our Asset Management and Investment Funds Legal and Regulatory Report setting out key environmental, social and governance ("**ESG**") developments during the period from 1 February 2024 to 30 June 2024.

Highlights during the period

Welcome to the latest edition of our ESG Newsletter. In this issue we identify a number of recent key European legislative and regulatory developments and advances in the global sustainable finance framework more broadly.

With ESG highlighted as one of the Central Bank of Ireland (the "**Central Bank**") main regulatory priorities, there remains increasing scrutiny of how investment funds, fund management companies ("**FMCs**") and asset managers are complying with their disclosure, reporting and governance obligations under the Sustainable Finance Disclosure Regulation ("**SFDR**") and the Taxonomy Regulation (EU) 2020/852) (the "**Taxonomy**").

In a busy period, in May 2024 **ESMA** released its long-awaited final guidelines on the use of ESG and sustainability-related terms in **fund names (item 1)**.

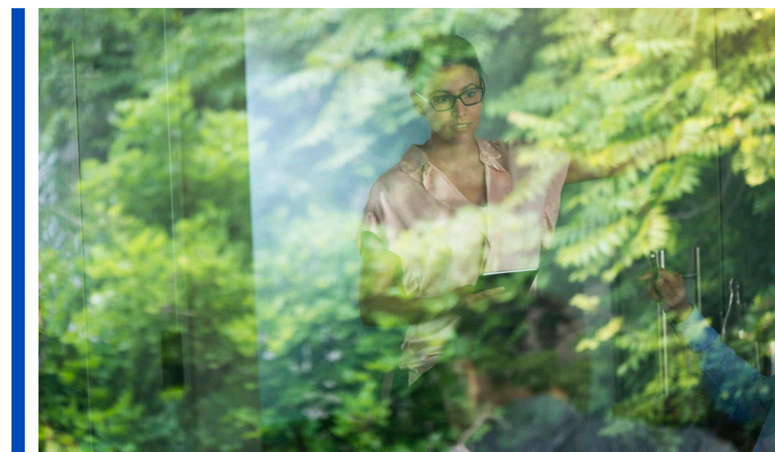
As expected, in early June 2024 the ESAs published their final reports to the European Commission (the "**Commission**") focusing on the role of greenwashing supervision in the financial sector (**item 2**).

As the Commission in early May 2024 continued its policy assessment of stakeholders' experience on the implementation of SFDR and published a summary of responses to its open and targeted assessment of SFDR reform (**item 3**), the ESAs issued a joint opinion in June focusing on its assessment of SFDR reform (**item 4**).

As work continues at a European and international level to develop corporate **sustainability reporting standards** the European Financial Reporting Advisory Group ("**EFRAG**") continues to support corporate implementation with non-authoritative guidance documents on key issues under the European Sustainability Reporting Standards (item 6).

Member states finally reached agreement on 5 July 2024 on a substantially amended text of the Corporate Sustainability Due Diligence Directive ("**CSDDD**") with national transposition due within two years and application for the first cohort of in scope undertakings due to commence on a phased basis beginning in July 2027 (**item 8**).

Finally, May 2024 also saw the UK government publish an UK Sustainable Disclosure Requirements update and noted its intention to consult on extending UK SDR to include funds recognised under the overseas fund regime in Q3 2024 (**item 17**).



ESMA Guidelines for use of ESG and sustainability terms in fund names

On 14 May 2024, ESMA published its final report containing guidelines on funds' names using ESG or sustainability-related terms (the "**Guidelines**").

Backdrop

ESMA launched a consultation in November 2022 with the aim of developing a set of guidelines on funds' names with ESG or sustainability-related terms. The proposed guidelines sought to address the potential risk of greenwashing in fund names by proposing quantitative thresholds criteria for the use of ESG- and sustainability-related terminology. The consultation was preceded by a supervisory briefing on sustainability risks and disclosures published in May 2022, which also referenced principles-based guidance for funds' names with ESG and sustainability-related terms.

ESMA had indicated in December 2023 that the Guidelines were delayed to ensure the outcome of the AIFMD and UCITS Directive reviews (culminating in Directive (EU) 2024/927) in relation to funds' names could be taken into account, as relevant, in the Guidelines. The final report containing the guidelines also provides a summary of the responses ESMA received to its consultation paper and an explanation of the approach taken to address the comments received.

ESMA perceives that the fund name can have a significant impact on an investor's investment decision. The objective of the Guidelines is to ensure that investors are protected against unsubstantiated or exaggerated sustainability claims in fund names, and to provide asset managers with clear and measurable criteria to assess their ability to use ESG or sustainability-related terms in fund names.

Minimum threshold

The Guidelines establish that to be able to use social-, environmental-, governance-, transition-, sustainability-related and impact-related terms, a minimum threshold of 80% of investments should be used to meet environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy.

Sustainability-related terms – meaningful investment in sustainable investments

During its consultation period, ESMA had proposed a minimum of 50% threshold in relation to "sustainable" investments referred to in Article 2(17) of SFDR, however, this was dropped in the final Guidelines in favour of the term "invest meaningfully" in sustainable investments for those funds with sustainability-related terms in their name. ESMA did not define "meaningfully" in the Guidelines, and we expect this will require further clarification.

Impact- and transition-related terms

When using any "impact"-related word, ESMA has noted that fund managers must ensure that the investments under the minimum threshold are made with the intention to generate positive, measurable social or environmental impact alongside financial return. When using any "transition"-related word fund managers should demonstrate that the investments are on a clear and measurable path to social or environmental transition. The introduction of the transition category was designed by ESMA so as not to penalise investment in companies deriving part of their revenues from fossil fuels, thus promoting strategies aimed to foster a path to transition towards a greener economy.

Exclusions

In addition to the minimum threshold of 80% of investments used to meet environmental or social characteristics or sustainable investment objectives, the Guidelines also apply exclusion criteria for different terms used in fund names:

- "Environmental", "Impact" and "sustainability"-related terms: exclusions according to the rules applicable to Paris-aligned Benchmarks ("PAB"); and
- "Transition, "Social" and "Governance"-related terms: exclusions according to the rules applicable to Climate Transition Benchmarks (CTB).

Combination terms

Where terms are combined, the provisions should apply cumulatively. ESMA has specified that where "environmental" terms are used in combination with "transition" terms in the name of a fund, the CTB exclusions should apply. ESMA notes that this would, however, not apply for "sustainable" terms, as "sustainable" terms would always give an impression of sustainability irrespective of any other terms used in the name.

Accordingly, fund names with combined sustainability-related terms will always need to comply with the PAB and invest "meaningfully" in sustainable investments.

We have set out below a summary of ESMA's recommendations on the use of ESG or sustainability-related terms in funds' names in table format below.

	80% minimum proportion of investments	Invest 'meaningfully' in sustainable investments	Paris-aligned Benchmark (PAB) Exclusions	Climate Transition Benchmark (CTB) Exclusions
Sustainability-related words	✓	✓	✓	
Transition-related terms	✓			✓
"E" terms	✓		✓	
"S" terms	✓			
"G" terms	✓			
Combined terms +transition terms	✓			✓

Index funds

Notably designating an index as a reference benchmark should only use terms as referred to in the Guidelines in their name, where they fulfil the relevant requirements of the Guidelines. ESMA notes in its feedback statement to the consultation paper included in the final report, that the mere reference to an index is not enough to ensure that the fund name is in line with the characteristics or objectives of the fund itself, precisely for the reasons illustrated by some stakeholders on the lack of common definitions and the subsequent comparability and transparency issues. ESMA acknowledges that there may be commercial considerations for fund managers to consider in relation to their license agreements with index providers but believe that investor protection considerations should prevail over commercial agreements.

Closed-ended funds

On foot of responses received, ESMA believes that the proposed requirements should apply without distinction to both open- and closed-ended funds.

"ESMA is of the view that it would be meaningful to ensure that the name of the fund matches with the underlying investments even for investors in a closed-ended fund (including existing investors). Furthermore, excluding unlisted closed-ended funds from the scope of these guidelines would create an inconsistency with the Guidelines on marketing communications under the Regulation on cross-border distribution of funds where such an exclusion does not exist."

Industry continues to argue that the rules should not be extended to those closed-ended funds which are no longer available for investment.

Supervisory expectations

ESMA believes that a temporary deviation from the threshold and the exclusions, should be treated as a passive breach and corrected in the best interest of the investors, provided that the deviation is not due to a deliberate choice by the fund manager.

ESMA has indicated that national competent authorities ("**NCAs**") should consider the below as warranting further investigation and supervisory dialogue with the fund manager:

- discrepancies in the level of quantitative threshold which are not passive breaches;
- a fund that does not demonstrate sufficiently high level of investments to use transition-, ESG-impact- or sustainability-related terms in its name; or
- where the NCA considers that using transition-, ESG-, impact- or sustainability-related terms in the fund name would result in investors receiving unfair or unclear information or in a failure of the manager to act honestly or fairly, thus misleading investors.

Application date and transitional period

The Guidelines will now be translated into all EU languages and will subsequently be published on ESMA's website. As currently drafted, the Guidelines will start applying three months after that publication (the 'application date'). The transitional period for funds existing as at the application date will be six months from that application date. Any new funds created after the application date should apply these Guidelines immediately in respect of those funds.

Within two months of the date of publication of the Guidelines on ESMA's website, competent authorities must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the Guidelines.

Over 500 Irish-domiciled funds which use ESG or sustainability-related terms are likely to be impacted by the Guidelines. Managers with existing portfolios which use these terms should commence an assessment of whether compliance with the Guidelines may necessitate either:

- a change the name of the relevant fund; or
- changes to the investment policy/strategy of the relevant fund in order to comply.

Key industry concerns and implementation process requests

Irish Funds' (comprising of Irish based asset management stakeholders) ("**Industry**") submission on foot of the finalisation of the Guidelines provides useful insights on industry's position and concern around the lack of clarity on specific elements of the Guidelines.

Delay in Application Date

Industry has raised the advantages of delaying the publication of the application date of the Guidelines so as to align with the timeframe for compliance with the revised draft SFDR RTS once implemented. Industry advocates that this would reduce the number of potential updates to the pre-contractual annexes in the coming year and associated additional costs being borne by the end investors, as well as allowing sufficient time for NCAs to engage with one another on the interpretation of elements of the Guidelines. Industry has also sought an extension of the Central Bank's SFDR fast-track process for changes to fund names or to fund documentation of existing funds which are required to comply with the Guidelines.

Treatment of green bonds issued by PAB-excluded companies

The submission raises that for the purposes of assessing compliance with the PAB exclusion criteria, PAB exclusions would not apply to investment in green bonds issued by otherwise PAB-excluded companies, as these instruments are specifically designed to finance environmentally sustainable projects. Industry requested that ESMA should confirm for the purposes of assessing compliance with the PAB exclusion criteria, assessment can be carried out at the economic activity level. Funds using an environmental-related, impact-related or sustainability-related term in its name which hold such investments could, in turn, be required to disclose this information to investors in the fund's pre-contractual documentation ensuring increased investor transparency.

Terms which trigger application of the Guidelines

Where a word which is not exclusively considered to be an ESG-related term (as it can also be used simply to refer to a "type" of company, or "sector" or strategy that a fund will invest in) is used in a fund name, Industry has recommended that the Guidelines should not be triggered unless that term is used in combination with an ESG/sustainability-related term. Industry has requested confirmation from the Central Bank that in each case, it will be a matter for the fund management company to carry out the relevant assessment and determine:

- that the name of the fund accurately reflects the investment strategy of the fund and consequently is fair, clear and not misleading;
- whether or not the Guidelines apply to a specific terms used in a fund name; and
- if so, whether to update the fund name or alternatively change the investment policy/investment strategy of that fund in order to comply with the Guidelines.

Investing 'meaningfully' in sustainable investments

Industry cautions against the imposition of a minimum threshold being set regarding the level of the sustainable investments commitment for funds using sustainability-related terms in their names. In light of the broad definition of "sustainable investment" set down in Article 2(17) of the SFDR, Industry requested that the Central Bank engage with ESMA and other NCAs to ensure that a consistent supervisory approach to interpreting this element of the Guidelines is taken across all member states.

ESMA publishes final report on greenwashing

On 4 June 2024, the ESAs published their respective final reports to the Commission focused on greenwashing in the EU's financial sector (ESMA, EBA, and EIOPA reports).

In each of their respective reports, the ESAs provide a stocktake of the current supervisory response to greenwashing risks under their remit and set out a forward-looking view of how sustainability-related supervision can be gradually enhanced in coming years.

Building on the findings of their Progress Report on Greenwashing 2023), the ESAs confirmed the common high-level understanding of greenwashing as:

"*a practice whereby sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants*".

The ESAs stress that financial market players have a responsibility to provide sustainability information that is fair, clear, and not misleading.

ESMA final report

The final report notes that NCAs and ESMA are increasingly taking steps to better monitor and detect greenwashing and to critically scrutinise sustainability-related claims in various sectors. Several CSAs have already been launched, with a view to ensure effective and consistent supervision. At the same time, ESMA acknowledges that NCAs still face constraints on their resources, as well as on their access to expertise and to good quality data.

ESMA identifies several priority actions in order to enable supervisors to better mitigate greenwashing risks. Section 2.5 of the report highlights the cross-sectoral recommendations and actions for market participants (in line with those set out in its earlier Progress Report), section 4.2.4 includes details of greenwashing occurrences identified by NCAs and section 4.4 lays out supervisory recommendations specific to the investment management sector.

NCAs are expected to gradually deepen their critical scrutiny of sustainability-related claims. To achieve this, they are invited to continue increasing human resources and expertise, making investments in supervisory tools such as supervisory technology ("**SupTech**") solutions and further embed greenwashing risks in their respective supervisory work programmes.

Investment management specific recommendations to NCAs on greenwashing supervision include:

- In response to the NCAs survey, thirteen NCAs identified occurrences of potential greenwashing with 1 NCA having identified actual greenwashing cases. These occurrences were detected via supervisory activities (8 NCAs), whistle blowers (1 NCA), other authorities (2 NCAs) and media reports (1 NCA).
- 4 NCAs found that unclear definition of 'sustainable investment' under Article 2 (17) of the SFDR as a challenge for the identification of occurrences of greenwashing.
- 5 NCAs also noted that they do not record instances where potentially misleading information is identified during the fund application process. These are addressed via amendment requests to supervised entities. Therefore, these were not reported as greenwashing occurrences.
- In response to the occurrences identified, 9 NCAs requested investment managers to change their sustainability related information, including funds names (5 NCAs), methodologies (1 NCA) or their investment processes (1 NCA). One of these NCAs have requested two managers to take immediate measures regarding lack of appropriate website disclosures and their principal adverse impact (known as PAI) statements at entity-level.
- Another NCA requested 40 managers to take various actions such as to identify the specific Sustainable Development Goals ("**SDGs**") and the most relevant SDG targets they wish to impact and through which indicators or metrics these targets will be achieved; to reinforce 42 exclusion policies; to improve website information under SFDR; to explain why the ESG objectives set out in the prospectus were not met.
- 1 NCA asked a manager to amend product disclosures on website and on the pre-contractual and periodic template. It also requested eight management companies' clarifications and/or amendments on ESG and sustainability profiles represented in marketing communications. It also addressed 19 AIFMs, in the context of marketing authorisation, to have a clearer representation of ESG profiles in the offering

documents. Another NCA engaged with an investment manager on its compliance with SFDR such as on pre-contractual disclosures and its statement under Art 4. Another NCA sent out 17 letters to banks providing investment management services, as a result of findings with regard to disclosure requirements.

- With regard to enforcement actions, in response to the NCAs survey, 2 NCAs reported having taken enforcement actions – i.e., by issuing orders. 2 other NCAs are in the process of taking actions. None of the NCAs reported to have submitted cases to law enforcement authorities.

Investment management specific recommendations to NCAs include:

- inviting NCAs to consider good practices identified including NCA supervisory actions such as:
  - a greenwashing screening tool on the funds market to supervised sustainability-related disclosures by financial products;
  - supervisory engagement with a fund's manager to better understand the methodology applied to forward looking climate claims in the context of a net zero investment policy and follow up review of the limitation of the sustainability-related disclosures in the fund's documentation; and
  - with a view to furthering access to ESG data, an NCA implemented a data management project to support its risk-based supervision, which covers data collection (partly via web-scraping), data analysis and reporting of findings. The solution aims at covering data from companies and funds under supervision (*i.e., UCITS, AIFs and pension funds*). The data is collected from various sources, including ESG data providers and based on that data, the NCA aims to develop a greenwashing risk scoring system.
- NCAs are invited to consider the deployment of SupTech tools to support supervision of the funds industry and to participate in the Commission's Technical Support Instrument project, to deploy tech tools based on common methodologies.
- Based on observed good practices related to access to data, NCAs are encouraged to maintain databases for effective supervision. Such databases may not only contain data subject to supervision (mandatory disclosures, certain advertisements), but also data useful to conduct effective supervision (portfolio-related data, market data).
- ESMA will continue to support the monitoring of greenwashing risks, the deployment of SupTech tools, and capacity building. In addition, ESMA will prompt CSAs where needed. ESMA may produce additional guidance for market participants and supervisors in high-risk areas of greenwashing.
- ESMA will work with NCAs on the development of methodologies and tools to assess the consistency between sustainability disclosures and the portfolio composition of funds disclosing under SFDR Article 8 and 9 SFDR.
- The Commission is invited to reinforce NCAs' and ESMA's mandates in certain areas, such as for benchmarks, and make sure all NCAs have the powers to promote retail investors' financial education. Whenever possible, the Commission should ensure the legislative framework supports NCAs' access to data.
- As regards developments in the investment management sector and recommendations to the Commission, ESMA invites the Commission to *swiftly adopt* the RTS which comprise of amendments to what is termed as the SFDR Level 2 proposed by the ESAs' joint committee in its recent Final Report on SFDR RTS.

A summary of the actions for consideration by NCAs, ESMA and the Commission to further enhance supervision, together with the remediation actions addressed to market participants in the Progress Report include:

- General recommendations outlined include the importance of sustantiating sustainability-related claims as well as communicating sustainability information in a manner that is fair, clear and not misleading.
- Specific recommendations are included in ESMA's final report such as upgrading firms' governance, processes, skills, IT systems and establishing reliable, comprehensive sustainable data.

Next steps

The ESAs acknowledge that addressing greenwashing requires a global response, involving close cooperation among financial supervisors and the development of interoperable standards for sustainability disclosures. ESMA will continue monitoring greenwashing risks and supervisory progress, including via the ongoing Union Strategic Supervisory Priority on "ESG Disclosures".

Commission SFDR consultation summary report

On 3 May 2024, the Commission published a summary of responses to its open and targeted consultations on the assessment of SFDR.

Respondents were asked whether they would support a system that splits categories in a different way than according to existing concepts used in Articles 8 and 9 SFDR (**approach 1**), or a categorisation system converting Articles 8 and 9 into formal product categories and clarifying and adding criteria to underpin the existing concepts of the SFDR (**approach 2**). The responses show that while there is strong support for a voluntary sustainable product categorisation system regulated at EU level, there is no clear preference for one of the two proposed approaches. Results indicate only a slight preference for the first approach, with 50% of respondents totally or mostly agreeing and 23% totally or mostly disagreeing. 77% of respondents highlighted key limitations of the SFDR framework such as lack of legal clarity regarding key concepts, limited relevance of certain disclosure requirements and issues linked to data availability.

Despite diverging views on the approach to be taken, many respondents indicated that they would support a hybrid approach combining established SFDR concepts with a voluntary categorisation framework. Irrespective of the chosen approach, most respondents emphasised the importance of the categories being focused on retail investors, incorporating international frameworks, and leveraging existing national labels. The majority (56%) of respondents' support setting uniform disclosure requirements for all financial products offered in the EU, irrespective of their sustainability claims.

Market views were split over the relevance of the SFDR entity-level disclosures, for example on remuneration policies (39% in support and 26% against) and adverse sustainability impacts (31% in support, 31% against). Responses showed some support for the current transparency requirements on the sustainability risk policies (49% in support, 15% against). A large majority of respondents called for these disclosure requirements to be simplified and streamlined across the sustainable finance framework.

Many respondents also expressed concerns about a potential overlap between the transparency requirements on principal adverse impacts under the SFDR and the reporting obligations under the Corporate Sustainability Reporting Directive (EU) 2022/2464 ("**CSRD**"). When asked if the SFDR disclosures are consistent with the CSRD requirements, more respondents disagreed (134) than agreed (42).

Publication of ESAs joint opinion on the SFDR

On June 17, 2024, the ESAs published a joint Opinion to the European Commission in the context of its assessment of the SFDR (the "**Opinion**").

The ESAs focus on ways to introduce simple and clear categories for financial products. The simplifications consist of two voluntary product categories, "sustainable" and "transition", that financial market participants should use to ensure consumers understand the purpose of the products. The rules for the categories should have a clear objective and criteria to reduce greenwashing risks.

The ESAs recommend that the Commission consider:

- the introduction of a sustainability indicator that would grade financial products such as investment funds, life insurance and pension products;
- appropriate disclosures for products outside the two voluntary proposed categories to reduce greenwashing;
- improvements to the definition of sustainable investments;
- simplification of the presentation of disclosures to investors;
- other technical suggestions including on which products should fall under the scope of SFDR and on how to improve disclosures regarding the negative impact of investments on people and the environment; and
- conduct consumer testing before putting forward any policy proposals to review the SFDR, such as to introduce a categorisation system and/or an indicator.

The Opinion was delivered on the ESAs' own initiative. It has been published in the context of a comprehensive review of the SFDR framework by the Commission. The Commission is currently assessing stakeholders' responses to support policy considerations to improve the EU framework for sustainable finance based on the experience on the implementation of the SFDR (see item 3 above).

Sector reporting requirements under CSRD delayed by two years

On 7 February 2024, the Council of the European Union and the Parliament announced a provisional agreement on a Directive amending the CSRD. The proposed amending Directive provides that the sector-based European Sustainability Reporting Standards ("**ESRS**") and specific standards for large non-EU companies will have an adoption deadline of 30 June 2026 rather than 30 June 2024. The agreement is intended to limit reporting requirements to the minimum and gives companies time to implement the ESRS and prepare for the sectoral ESRS.

The provisional agreement reached with the Parliament was formally adopted by the Council on 29 April 2024.

Application to Large Undertakings

CSRD will commence application for large undertakings for financial years starting on or after 1 January 2025 (in respect of financial reports due in 2026).

UCITS and AIFs as defined in Article 2 of SFDR (EU) 2019/2088 are expressly exempted from CSRD reporting but asset managers and FMCs are not exempted from the scope of the reporting standards.

Large undertakings are EU undertakings which exceed the limits of at least two of the following criteria:

- Balance sheet: €25 million.
- Turnover: €50 million.
- Employees (average number): 250.

The CSRD introduces more detailed reporting requirements for in-scope corporates on a broad range of environmental, social and governance matters in accordance with mandatory ESRS. There are 12 standards in total, and they are detailed and comprehensive – 2 cross-cutting standards and 5 on the environment, 4 on social matters and 1 on governance. Consolidated reporting rules which may also offer transitional benefits to the reporting obligations.

During the reporting period, Ireland's transposition of CSRD into Irish law remained to be finalised pending the outcome of the Dept. of Enterprise consultation on the implementation of CSRD (and transposition into Irish law was completed on 5 July 2024).

Even if not directly applicable to an FMC's own sustainability reporting, CSRD is expected to go a long way to remediate the long-standing data gap on the sustainability of investments. The impact of increased sustainability reporting received pursuant to CSRD should also be considered in the context of manager's sustainability practices, including on the integration of sustainability risk in the investment decision-making process and opportunities presented in leveraging the additional data in the investment due diligence and monitoring process.

EFRAG continues to provide non-authoritative guidance to questions posted on its ESRS Q&A platform, as outlined below.

EFRAG implementation guidance for ESRS

On 3 June 2024, EFRAG published its first three ESRS implementation guidance documents. These documents are non-authoritative and support implementation as follows.

- IG 1: Materiality Assessment Implementation Guidance (MAIG) and its associated feedback statement provides an illustrative materiality assessment process for undertakings, and it develops the concept of impact and financial materiality with a number of examples, including how these two concepts interplay. FAQs are provided on the double materiality assessment with practical implementation guidance on disclosing material impacts, risks and opportunities.
- IG 2: Value Chain Implementation Guidance (VCIG) and its associated feedback statement outlines the reporting requirements for the value chain from materiality assessment to policies and actions to metrics and targets. It illustrates the reporting boundary of the group for sustainability reporting, including the concept of operational control in environmental standards. FAQs are provided and a 'value chain map' summarising value chain implications per disclosure requirement across all ESRS.
- IG 3: List of ESRS Datapoints and its associated explanatory note and feedback statement translates the complete ESRS Set 1 list of detailed requirements in each disclosure requirement and related application requirements in excel format. The file contains additional information, such as the types of requirements (for example, quantitative or qualitative) or whether these are subject to transitional provisions. This list can form the basis for a data gap analysis or data collection exercise.

These documents provide essential guidance to ensure organisations effectively implement and comply with ESRS standards, promoting transparency and consistency in sustainability reporting.

These latest publications follow the EFRAG release on 29 May 2024 of 44 new explanations and of the compilation of technical explanations produced thus far, which comprises multiple batches of explanations that were already published in February and March 2024, to assist stakeholders in the implementation of the ESRS via the EFRAG ESRS Q&A Platform.

Explanations are grouped by topical area:

(a) ESRS general requirements and general disclosures;

(b) environmental ESRS;

(c) social ESRS; and

(d) governance ESRS.

International ethics standards for sustainability assurance ("IESSA") code

IOSCO and ESMA have responded favourably during the period and broadly welcomed a recent consultation of the International Ethics Standards Board for Accountants (IESBA) containing their 'Proposed IESSA and Other Revisions to the Code Relating to Sustainability Assurance and Reporting'.

The standards contained in the IEESA code are relevant in the context of the external assurance opinion on the compliance with the main pillars of the corporate sustainability reporting, i.e., the ESRS, as well as the disclosures pursuant to Article 8 of the Taxonomy. The CSRD contains requirements for the ESRS to be accompanied by a limited assurance regime for the sustainability statements for the first years, with the objective to move towards reasonable assurance at a later stage. ESMA notes that these requirements are aligned to those envisaged for the statutory audit of financial statements, but duly adapted to reflect the specificities of sustainability reporting.

IESBA expects to issue the final Code of standards in December 2024.

Corporate sustainability due diligence directive ("CSDDD") update

On 15 March 2024, following earlier unsuccessful attempts to endorse the provisionally agreed text the Council of the EU proposed a new compromise CSDDD text. The CSDDD establishes due diligence rules to ensure large EU companies effectively tackle adverse human rights and environmental impacts caused by their economic activities.

On 15 March 2024, following earlier unsuccessful attempts to endorse the provisionally agreed text the Council of the EU proposed a new compromise CSDDD text. The CSDDD establishes due diligence rules to ensure large EU companies effectively tackle adverse human rights and environmental impacts caused by their economic activities.

The revised text significantly reduces the companies in scope as thresholds for EU companies have more than doubled, with a requirement for more than 1,000 employees and a net worldwide turnover of more than EUR450 million. Regulated financial undertakings that meet the threshold criteria are required to comply. Although the recitals state that regulated financial undertakings are only subject to due diligence obligations for the upstream part of their chain of activities,

The compromise text also extends the timeframe for compliance, as the majority of companies will not be required to comply until five years after the CSDDD enters into force (which is likely to be 2029). On 24 April 2024, the revised CSDDD was successfully adopted by the European Parliament in plenary session. On 24 May 2024, the final text of the CSDDD was formally adopted by the Council.

On 5 July 2024, CSDDD was published in the Official Journal of the European Union (the "**OJ**") and will enter into force on 25 July 2024. Once in force, member states will have two years (by 25 July 2026) in which to transpose CSDDD into national law. By 25 July 2026, the Commission will assess the extension of due diligence requirements to the downstream part of the value chain for in scope financial institutions. Application of the CSDDD will be on a staggered basis, starting in 2027 for the largest companies.

ESMA speech-the role of ESG in building an effective CMU

On 29 May 2024, ESMA published a speech delivered by ESMA chair Verena Ross entitled '*The role of ESG in building an effective Capital Markets Union*'.

Ms Ross' remarks covered green bonds, CSRD the ESAP as well as the future direction of the CMU. Ms Ross also noted that ESMA will publish in the coming days its final report on greenwashing.

This report will provides a stocktake of the supervisory response to greenwashing risks and identifies ways to enhance the supervisory response, laying out actions for NCAs, ESMA and the Commission.

Central Bank speech on climate change adapting and planning

On 15 May 2024, the Central Bank released a press release covering the Governor's speech at the EPA's annual climate change conference entitled "*Climate change: adapting to avoid the prisoner's emissions dilemma*".

Themes covered in the Governor's remarks included:

- On the transition to net zero, he notes the depth of decarbonisation targets are unprecedented, but they are also technically feasible and, represent the lowest cost route for society in the long-run. The decarbonisation of the economy has financial sector risk implications. Businesses and households will need to do more with less energy, and switch to lower emission inputs and fuels. Such changes are only possible with new investments into new technologies, and these investments will probably require external financing. For the financial sector, these '*transition risks*' encompass the negative changes to business costs, revenues and profits as a result of future climate-related shifts in consumer or investor sentiment or of government policy.
- On public-private collaboration (whether it is through provision of expertise or another mechanism such as a partnership), it would enable insurers to retain a risk-based approach to pricing. He raises the potential benefits of risk sharing/solidarity schemes where funds are pooled to support insurance provision in risky areas.
- On the increasing data information flows in the financial sector, he notes we appear to be in the midst of a climate risk transparency revolution, Investment flows follow profitability expectations, and climate risks, both in terms of the costs of decarbonisation and the likelihood of physical damages, are growing investor considerations. With new disclosure regulations for business and investments, there is now a growing flow of climate data sources. He notes that this new information environment, coupled with strong government policy and commitments to targets, should align investment flows with transition goals.

On enforcement objectives, he remarked that the policy mechanisms within the current prudential framework will also be adapted to contain climate risks. The Central Bank have made it very clear it will use all the tools at its disposal to enforce appropriate climate risk management, strategy consideration and internal governance.

The availability of data and precision of risk forecasting is improving very fast and if risks are clear, large and quantifiable, it will have a strong case to act. Such changes would align financial flows with transition risks and support broader emission targets.

Concluding, Governor Makhlouf said: "The financial sector's role is clear. Failure to decarbonise financial flows will lead to a build-up of climate risks in the system. Central banks have a responsibility to monitor and forecast these risks, and then to act to maintain financial stability. Government's role is also clear, as it has to steer the real economy to net zero by creating an environment that provides the right incentives and favours low emission choices."

Finally, his key message is that the financial sector must also adapt from within, which means embedding climate risks into firms' models, systems, processes and policies. Climate change has forced the financial sector to consider risk over considerably longer time horizons. i.e. looking at risk over decades rather than years - this brings new challenges, and has required new data collections and new models.

Irish auditing and accounting supervisory authority ("IAASA") taxonomy survey

On 10 May 2024, the IAASA published a review paper *'EU taxonomy for Sustainable Activities'*, addressing findings from its review of the Taxonomy Regulation (EU) 2020/852 ("**Taxonomy**") disclosures for a sample of issuers' financial statements.

It was evident from IAASA's desktop review of disclosures that a majority of issuers are explicitly stating in their Taxonomy Regulation disclosures that their activities are not Taxonomy eligible activities. Two thirds of (non-financial undertaking) issuers reported that their total turnover was non-eligible under the Taxonomy Regulation.

IAASA echoed ESMA's call that issuers use the guidance and tools that the Commission has published, including guidance on the interpretation and application of certain criteria and disclosures, and online tools to assist undertakings in their Taxonomy reporting.

Regulation on ESG ratings

On 24 April 2024, the European Parliament adopted the Regulation on the transparency and integrity of ESG rating activities.

The Parliament has also published a press release on the agreement. The press release notes that the proposed Regulation will provide that financial market participants or financial advisers will be required to disclose the methodologies used in ESG ratings they use as part of their marketing communications. The proposed Regulation provides for this through an amendment of the SFDR.

Next Steps

The Regulation will apply 18 months after entering into force. Under the transitional period, providers that are operating in the EU at the entry into force of the Regulation must notify ESMA within 19 months following such entry into force, whether they wish to continue and apply for authorisation within 22 months (four months after the application). Providers classified as small undertakings or small groups under Article 3 of the Accounting Directive must notify ESMA within 22 months, or cease their activities.

Walkers recent briefing summarises the key elements of the Regulation.

Platform on sustainable finance (the "Platform") - Taxonomy Reporting for SMEs

On 27 May 2024, the Platform's published its response to the EFRAG consultation on SMEs that are public-interest entities ("**LSME**") and voluntary sustainability reporting standard for non-listed SMEs ("**VSME**").

The Platform supports a modular and gradual approach to reporting for SMEs, beginning with a basic module and allowing for the addition of relevant modules over time.

The Platform Chair also published a statement entitled "Facilitating Access to Sustainable Finance for SMEs" where the Chair outlines new simplified approaches being considered to help SMEs access sustainable finance.

The Platform is focused on creating simple, practical and user-friendly tools. These tools aim to improve data flow to entities with reporting responsibilities and allow unlisted SMEs to engage in sustainability efforts without increasing complexity or administrative burdens. Two distinct approaches are being considered.

Simplified Approach
This approach aims to simplify the demonstration of compliance with the Taxonomy criteria, addressing usability issues to facilitate Taxonomy uptake and reporting for SMEs subject to mandatory disclosures under the Article 8 of the Disclosures Delegated Act ((EU) 2021/2178).

Streamlined Approach
This approach is tailored for unlisted SMEs, enabling substantial environmental improvements by highlighting key environmental impacts relevant to their main activities. It supports unlisted SMEs in financing individual measures and those struggling with Taxonomy compliance or engaged in activities not yet covered by the Taxonomy. This approach would build on key metrics aligned with substantial contribution criteria and the voluntary reporting standards for unlisted SMEs developed by EFRAG. It could also be integrated into a future transition loan definition/standard for SMEs.

The Platform, with the support of the Commission, is developing a streamlined approach to help non-listed SMEs access sustainable finance and provide necessary sustainability information. This voluntary tool will focus on key metrics aligned with the Taxonomy's substantial contribution criteria for eligible activities and based on a very few metrics within the VSME ESRS for non-eligible activities.

Platform Reports

Report on a compendium of market practices

The Platform, an advisory body to the Commission released a report on a Compendium of Market Practices (the "Report"), which explores the impact of the Taxonomy and the wider sustainable finance framework on facilitating the transition to net zero for financial and non-financial actors. The Report constitutes voluntary guidance and is intended to set the direction for future priorities on the implementation of the EU sustainable finance framework. The Report focuses on seven stakeholder groups, including market practices for investors (*section 3*).

Highlights from the report include:

- Early evidence on the use of the EU sustainable finance framework for business strategy, transition planning and target setting suggests that the market has started using the EU sustainable finance framework to prepare for regulatory compliance, in addition to supporting their sustainable business and transition planning strategies on a voluntary basis.
- The trend of using financial products and instruments, including green and sustainability-linked bonds, loans and investment funds, is expected to accelerate in the future.
- Reporting, monitoring and assurance. Despite challenges, most market participants have started to adapt their practices to comply with the EU sustainability reporting requirements. Taxonomy alignment reporting for financial institutions is expected to improve in the future in parallel with corporate reporting, as data collection and verification processes are implemented.

The Report is accompanied by an annex, which includes concrete case studies for each stakeholder group, highlighting the practical application of sustainable finance tools. The case studies highlight the first evidence that the EU sustainable finance framework is working on the ground and shows how market actors are using it including beyond regulatory compliance.

The Report identifies data and implementation challenges regarding the Taxonomy and the wider sustainable finance toolkit, which need to be further improved to fully support actors in transitioning their business models to align with the EU's sustainability objectives. This includes the Platform's future work advising the Commission on how to improve the usability of the do no significant harm technical screening criteria, advising on the consistency and interoperability of transition plans and advising on the feasibility of a SFDR labelling or classification system.

Report on monitoring capital flows to sustainable investment

On 4 April 2024, the Platform published an intermediate report presenting a methodology for monitoring financial flows into sustainable investments, together with annexes to the report including an analysis of the European Green Deal investment gap, intended to serve as a reference for the implementation of the proposed framework.

The purpose of the report is to propose a comprehensive monitoring framework to measure the effective contribution of finance towards the objectives of the European Green Deal and considers transition finance for both financial and non-financial undertakings, as well as examining the trends shaping their relationships. It is primarily based on EU sustainable finance regulatory data and definitions, with market standards and definitions complementing the analysis where appropriate until regulatory frameworks are fully developed.

The first chapter outlines the conceptual framework underpinning the methodology. The report focuses on two categories of capital flows. The second chapter's focus is on capital expenditures by real economy entities, which shed light on progress towards filling the investment gaps. In the third chapter, focus is on capital flows into and from financial markets, as this represents an important source of capital in support of real economy investments.

The stocktake in the report builds on the early practices that market participants are employing to transition their business models and investments to a net zero and more resilient model, as documented in the Platform's compendium of market practices.

The Platform will publish a final report at the end of its mandate, including any refinements to the methodological approach and a proposal for operationalising periodical monitoring.

Climate risk and sustainable finance forum (the "Forum") – reports on capacity building & climate risk management

On 27 March 2024, the Central Bank published remarks by Deputy Governor, Sharon Donnery at the launch of the Report from the Climate Risk and Sustainable Finance Forum's Working Group on Capacity Building.

Ms Donnery noted the recommendations on training and capacity building status in Financial Market Participants. She outlined that building capacity by enhancing understanding of climate risk, seeking to address those risks through upskilling, identifying useable tools and frameworks, raising awareness, and taking leadership applies to all participants in the financial system – including regulators.

While the report is the work of the climate forum and does not represent Central Bank requirements or guidance the Central Bank are supportive of many of the recommendations contained in the report.

On 11 April 2024, the Central Bank in conjunction with the Banking & Payments Federation Ireland published the Forum's first Climate Risk Management Report.

The report provides a baseline of knowledge on the approach adopted across the financial industry on climate risk management and includes practical examples of industry-identified emerging good practice in addressing the risks and opportunities arising from climate change.

In relation to the role of asset managers in relation to climate risk the report discusses:

- what steps asset managers can take in relation to the products they offer;
- considerations in relation to greenwashing risks and net zero commitments;
- looking at climate risk measurement, management, monitoring, and stress testing in asset management;
- key role that advocacy plays in climate risk management; and
- how asset management companies can incorporate climate sustainability risks into their governance.

The report outlines key aspects of industry identified emerging good practice relate to portfolio alignment and engagement, ongoing climate risk monitoring as well as scenario analysis and stress testing.

Delegated regulation relating to sustainability impact disclosures for simple, transaparent and standardised ("STS") securitisations

On 5 March 2024, the Commission adopted a delegated regulation supplementing the Securitisation Regulation ((EU) 2017/2402) with regard to regulatory technical standards specifying, for simple, transparent and standardised non-ABCP traditional securitisation, and for STS on-balance-sheet securitisation, the content, methodologies and presentation of information related to the principal adverse impacts of the assets financed by the underlying exposures on sustainability factors.

Under the Capital Markets Recovery Package, the Securitisation Regulation was amended to introduce new optional disclosure provisions for STS securitisations. The Delegated Regulation aims to standardise the type and presentation of information an originator may opt to disclose about the adverse impacts of assets financed by underlying exposures, on the environment and other sustainability factors. An annex in the RTS provides templates, definitions and formulas to be used by originators when providing this information. Such disclosure is intended to ensure investors have all the necessary information to make informed decisions regarding the sustainability impact of their investments.

On 18 June 2024, Commission Delegated Regulation (EU) 2024/1700 was published in the OJ. The Delegated Regulation will enter into force on 8 July 2024.

UK sustainable disclosure requirements ("SDR") update

On 16 May 2024, the UK government published an SDR implementation update. The SDR update includes information on adoption of UK sustainability reporting, a UK green taxonomy, transition plan disclosures and UK investment labels.

The UK SDR and labelling regime is initially only applicable to UK asset management firms (UCITS managers and AIFMs) that manage UK-domiciled funds, although UK firms are required to capture both UK and non-UK funds under management when complying with the entity-level disclosure rules. The UK intends to consult on extending the UK SDR to include funds recognised under the overseas fund regime ("**OFR**") in Q3 2024. Separately the FCA is also consulting on extending the SDR to portfolio management of sustainability products.

In the event the government decides to legislate on the SDR and labelling for OFR funds, the FCA is likely to consult on rules to reflect this in 2025.

Further information

We are seeing an increase in the number of asset managers considering how to integrate ESG criteria in the investment strategies they employ for funds under management. Walkers has extensive experience advising on the impact that sustainable financing initiatives will have on such asset managers and investment funds.

This newsletter is for information purposes only, does not purport to represent legal advice and assumes a working knowledge of EU sustainable finance developments. Should you wish to discuss the implications on your business of the EU's sustainable finance framework or of the Central Bank's supervisory expectations regarding the implementation of the framework please speak to your usual contact in Walkers or any of the contacts in your region listed below.

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