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Stewart Investors
Sustainable Funds Group

Regulatory developments in sustainable finance

2020 saw regulatory developments in sustainable finance reach new levels globally, but particularly in Europe. These developments, combined with a global pandemic, unprecedented wildfires, and a renewed focus on social movements like Black Lives Matter, put sustainable finance under the spotlight more than ever.

Environmental, Social and Governance (ESG) and sustainability now form a central plank of the European approach to financial regulation. The intention is that financial services firms, particularly asset managers, play a key role in the allocation of capital to businesses that will drive the transition to a low carbon and more sustainable economy.

The policy agenda, known as the EU Sustainable Finance Action Plan, includes mandatory reporting and disclosure regulations in the form of the Sustainable Finance Disclosure Regulations (SFDR). This set of regulations has been an important focus for the Sustainable Funds Group over the last several months. The SFDR establishes a hierarchy of self-assigning fund categories based on investment focus. Two categories in the product hierarchy are relevant here.

- **Article 8** funds are those that promote environmental or social benefits, among other things, but whose core objective is not to achieve specific ESG impacts. Article 8 funds will have to state in certain fund documentation, including the legal fund offering document (know as the prospectus in European jurisdictions), that they do not have a sustainability objective.
- **Article 9** funds are those with a clear sustainable investment objective, incorporating both environmental and social aims, and that also meet various sustainability-related disclosure and reporting requirements.

The consultation on the legislation only closed last September. The technical guidance on implementation is only expected in the early part of 2021. Yet the EU Commission have made March 2021 the deadline for pre contractual (Level 1) disclosures regarding sustainability.

We are working to ensure all existing and planned funds in our vehicle for European clients are Article 9 compliant by the deadline. This does not require any change to our investment approach, but it does require us to change the way we explain and illustrate the sustainable development benefits of our approach. Examples of steps we have taken include our work on Project Drawdown, Human Development Indicators and our interactive map which provides information on the investment rationale for every company we invest in, the contribution it makes to sustainable development, key risks and engagement topics.

What does Article 9 require us to do?

We do not need to change our Investment Objective in the prospectus, but we will add to the descriptions of our Investment Policy and Strategy:

- A description of the sustainable investment objective
- An explanation of how the investments we make do not significantly harm the sustainable investment objectives. We refer to our Position Statement on harmful and controversial products and services which we published last year, in which we define the harmful business activities we avoid as a result of our bottom-up investment process.
- A list of sustainability indicators we will report against (these include carbon emissions, CEO pay ratios, board gender diversity and employee engagement). Our initial choice of indicators was based on relevance, data availability, and alignment with the core metrics we had already decided to start reporting against.

From January 2022 it will be mandatory to start periodic reporting on how Article 9 funds meet their sustainability objective (Level 2 disclosures).

We have updated and filed our European prospectus and will make further refinements if necessary when the SFDR legislation is finalised.

How does SFDR align with other ESG and sustainability regulatory developments?

We are very supportive of regulators addressing sustainability issues. We think they have a vital role to play in creating greater clarity for investors and encouraging more capital to flow towards sustainable investment. But without closer international collaboration and better integration of regulatory initiatives, the main outcome will be a simple proliferation of regimes, rules, definitions and acronyms.

A current example of the need for closer regulatory integration is the contradiction between the SFDR and the Hong Kong ESG regulation. Green or ESG funds authorised by the Securities and Futures Commission of Hong Kong must have as their key investment focus one or more of the globally recognised ESG frameworks or principles, such as the UN Global Compact and UN Sustainable Development Goals (SDGs), and these must be reflected in their name and investment objective or strategy. While we report against a number of these principles and frameworks, the results are very much an outcome of our investment approach rather than a key investment focus.

Our more eagle-eyed clients may notice that we have opted to include a statement in our European client vehicle prospectus that we do not meet the requirements for ESG status in Hong Kong. The reason for this is that we think sustainability investing is bigger and broader than just ESG investing as it is currently defined by the Hong Kong regulator. This may cause some confusion given our (hopefully) concurrent Article 9 status confirming we have social and environmental investment objectives at the heart of our investment approach.

The Hong Kong regulator acknowledges that their regulation is a first step to enhance disclosure standards, and that they want to be mindful of various local and international regulatory developments. We hope that their approach and that of the European Commission will converge, so that things become clearer and more consistent for clients and all other stakeholders.

What about Brexit and the UK?

In 2019 the UK government published its Green Finance Strategy, which declares the UK's intention to match the ambitions of the EU's Action Plan. Detailed initiatives have yet to be disclosed and we do not expect the SFDR regulation to be implemented prior to 2022. As a result, we expect there will be a temporary misalignment in the investment policy and strategy between our UK and European product platforms. This is not ideal, but we want to be as proactive as we can on every regulatory front, even if this risks the appearance of uneven progress and temporary variations in our messaging across different product platforms.

How does SFDR relate to the Green Taxonomy?

The Green Taxonomy regulation forms part of the disclosure requirements of the EU Sustainable Action Plan, but it is not the same thing. The EU Taxonomy Regulation is a unified classification system for business activities that can credibly be called 'green' or 'sustainable' without doing any significant harm or breaching minimum social safeguards. We hope to have Article 9 funds that are contributing to environmental objectives and from January 2022 we will also need to disclose whether they are contributing to climate change mitigation and adaptation according to the taxonomy, and the extent to which the underlying investments comply with the taxonomy.

The activities that count as contributing to climate change mitigation and adaptation comprise a very small proportion of many sustainable funds. As mentioned in our Project Drawdown article, the MSCI analysis of our Worldwide Sustainability strategy and its green/unsustainable revenue split found that we have zero exposure to unsustainable revenues but only 2.5% exposure to 'green' revenues. Having looked at this data more closely, we believe that the only plausible explanation for this very low number is an extremely narrow definition of what counts as 'green'.

In summary, we are very supportive of the ambitious European strategy to direct more capital to sustainable investment, and of the steps being taken to improve transparency around how funds disclose their sustainability characteristics. However, as mentioned in our response to the European Sustainable Finance Consultation last summer, we cannot iterate enough the importance of a coordinated global approach based on principles, rather than a prescriptive legislative framework.

We believe a combination of clear principles and sufficient room for diverse approaches is the best way to encourage innovation. It might also lead to improved transparency and more rigour around sustainability claims, which would be beneficial for the industry and the long-term future of sustainable investing.

Investment terms

View our list of investment terms to help you understand the terminology within this document.

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