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ESG Impact on Investment Compliance

ESG – A global perspective

As Environmental, Societal and Governance ('**ESG**') factors in Investment Management gain **momentum globally**, **regulators** are responding rapidly to changing investor preferences. So far, **EU** has been at the fore-front with the recent publication of the **Sustainable Finance Disclosure Regulation (SFDR)**

United Kingdom

The FCA (Financial Conduct Authority) said in March 2020 it was considering how it could enhance environmental disclosure requirements for UK asset managers. The FCA is **considering a comply-or-explain regime** rather than rules, but it has encouraged firms to take steps to improve their disclosures and reporting.

EU

The EU Commission published the **SFDR** in 2018 as part of its action plan for financing sustainable growth. The focus is to channelize capital flows towards a sustainable economy. It requires financial market participants to explain how they are taking **sustainability risks** and **adverse impacts on sustainability** into account.

China

AMAC (Asset Management Association of China) requested asset managers carry out a **self-assessment on their green investing practices** and submit their self-checking reports to the regulator every year. The focus areas include i) establishing green investing policies ii) operational aspects of green investment products, iii) examining risk controls for green investments and iv) relevant disclosure issues. It also plans to (1) require **ESG disclosures** from listed companies in China; and (2) develop more **ESG indices** to form market benchmarks.

United States

ESG related regulatory action has additional push under the new administration. The SEC (Securities and Exchange Commission) has announced an **Enforcement Task Force** on climate and ESG issues. The SEC has also modernized Regulation **S-K disclosure** requirements. The CFTC (Commodity Futures Trading Commission) calls for regulatory action on climate. Similarly, the US Federal Reserve's Financial Stability report talks about climate for the first time.

Singapore

The MAS (Monetary Authority of Singapore) issued final Guidelines on **Environmental Risk Management** for asset managers, banks, and insurers in December 2020. The Guidelines set out MAS' supervisory expectations for financial institutions' **governance, risk management, and disclosure of environmental risk**. The MAS-convended Green Finance Industry Taskforce (GFIT) has launched a leading practices handbook for asset managers, banks, and insurers on implementing MAS' Guidelines on Environmental Risk Management.

Taiwan

The FSC (Financial Supervisory Commission) launched its **Green Finance Initiative 2.0** in 2020, which encourages, among other measures, lenders to provide better financial support for green finance companies, facilitate green bond issuance and improve transparency of ESG disclosures.

Hong Kong

In 2019, the SFC (Securities and Futures Commission) issued a circular requiring Green or ESG funds to disclose, in the offering documents (incl. product key fact statements), information related to key investment focus, targeted objective, the investment strategies, exclusion policies, risks.

In 2020, the SFC began compiling a **list of verified ESG products** that have at least 70% of their total NAV in green or ESG-related investments.

SFDR Overview

The regulation on sustainability-related disclosures in the financial services sector ('**SFDR**') lays down harmonized rules on **transparency** regarding the **integration of sustainability risks** and the consideration of adverse sustainability impact

High Level Requirements

- Disclosure regarding the integration of **sustainability risks (SR)**
- Disclosure of **principal adverse impact (PASI)** when those risks are relevant
- Disclosure on financial products (products **promoting E or S characteristics** and/or products with **sustainable investment as objective**)

Scope and levels of application

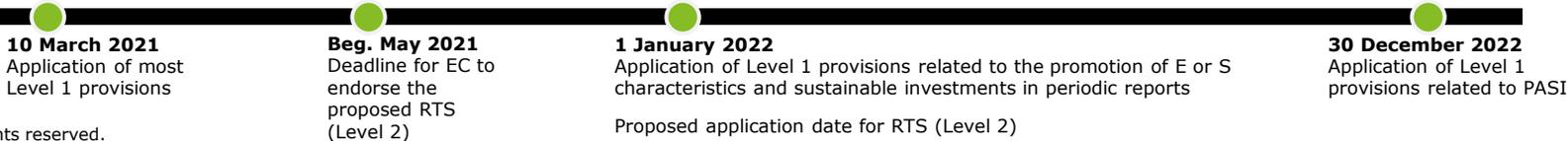
- Both financial market participants and financial advisors are subject to the regulation, impacting many financial players- **Asset Managers, Banks, Insurance Companies**
- Requirements affect both **product** and **entity levels**

SFDR Regulatory package

- The Disclosure Regulation is a **2-level** text
 - **Level 1** – Sets out the framework principles
 - **Level 2** - Supplements level 1 with greater details and structure, developed with the help of consultative bodies (ESAs)

	Ref.	Description
Entity Level	Art. 3	Transparency of sustainability risk policies at entity level
	Art. 4	Transparency of adverse sustainability impacts at entity level
	Art. 5	Transparency of remuneration policies in relation to the integration of sustainability risks at entity level
Financial Product Level*	Art. 6	Transparency of the integration of sustainability risks at product level
	Art. 7	Transparency of adverse sustainability impacts at financial product level
	Art. 8	Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures
	Art. 9	Transparency of sustainable investments in pre-contractual disclosures
	Art. 10	Transparency of the promotion of environmental or social characteristics and of sustainable investments on websites
	Art. 11	Transparency of the promotion of environmental or social characteristics and of sustainable investments in periodic reports

Regulatory Timeline



Note: For the purposes of this discussion on ICM, we will focus on Art. 6,8,9

What SFDR can mean for Investment Compliance

Based on the requirements of **SFDR**, we see a significant **impact** on the **Investment Compliance Monitoring** ('ICM') program, with a need to potentially re-evaluate the entire program **lifecycle**

		Activities	Description
Establishing	1	Client/Product Onboarding	<ul style="list-style-type: none"> Client contract/prospectus development consultation
	2	Contract Analysis	<ul style="list-style-type: none"> Investment restriction review & requirements generation
	3	Interpretive Issues	<ul style="list-style-type: none"> Validation of requirements and resolution of interpretive issues
	4	Data Availability, Integrity & Quality	<ul style="list-style-type: none"> Data availability and assessment prior to rule development
Maintenance	5	Rule Coding & Testing	<ul style="list-style-type: none"> Automated, hybrid, and manual rules development & testing Rule implementation
	6	Pre & Post-Trade Monitoring	<ul style="list-style-type: none"> Identifying and validating pre-trade and post-trade warnings and breaches Researching and overriding alerts
	7	Breach Management	<ul style="list-style-type: none"> Isolating and researching breaches Working with the front office / 1st Line of Defense to resolve breaches Reporting breaches issue & resolutions to management/clients/regulators
	8	Rules Library	<ul style="list-style-type: none"> Rule library maintenance Periodic review and retirement of restrictions
	9	ICM Personnel Management	<ul style="list-style-type: none"> Training new and existing investment compliance personnel Orienting and training investment management and client services personnel

Potential Impact

Good Governance structure should be in place to enforce leading practices and standardized application of ESG analysis across the organization

- Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures
 - Transparency of sustainable investments in pre-contractual disclosures
- Re-perform contract analysis to determine that any new investment restrictions arising from new disclosures are captured for investment monitoring purposes
- New terminology pertaining to the ESG factors will require a firm-wide standard definition
- New data attributes will come into play, which may require additional sources (for acquiring data) and models to calculate/track metrics associated with the new attributes
- Coders/testers to be updated on the new data attributes
 - Rule templates to include ESG related fields
- Pre and Post trade monitoring procedures to be updated to include ESG related monitoring
- Breach management procedures will have to be updated with new breach thresholds and monitoring as a result of changes to the client contracts
- Rule library to be updated to include ESG related rules
- Personnel to be trained on ESG regulations and impact, to factor in both qualitative and quantitative analysis when dealing with ESG funds

SFDR Article 8 Contract Analysis and Interpretative Issues Example

SFDR Article 8 applies to financial products that **promote ESG characteristics**. Below are examples of **plain language description** of investment compliance rules, and the corresponding **lexicons/ Global Interpretative Issues (GII)** that might be required for **rule coding**.

ABC Green Bond Fund

INFORMATION SHEET OF THE ABC GREEN BOND FUND

1. INVESTMENT OBJECTIVE

The objective of the fund is to achieve a return equal to or higher than that of the global investment-grade bond and credit market, while also giving investors the opportunity to contribute to the energy transition. The management policy will also take environmental, social and good governance (ESG) criteria into account in addition to the standard financial criteria when selecting the securities.

2. INVESTMENT POLICY

ABC GREEN BOND FUND invests:

- 1 • mainly in green bonds in accordance with the Bloomberg and Climate Bonds Initiative selection criteria; these bonds are investment-grade and denominated in the respective currencies of OECD member countries;
- 2 • on an ancillary basis, in other bond transferable securities, although total investments in non-investment grade bonds and bonds with no rating are limited to maximum 10% of net assets, as well as in other financial instruments stated in the investment restrictions, including liquid funds, IMM and/or UCITS/other bond and/or money market UCIs;
- 3 • no more than 5% of net assets in stocks of companies in emerging markets. The Fund aims at selecting stocks with relatively low environmental footprints compared to stocks with high environmental footprints.

The Fund promotes environmental and/or social characteristics within the meaning of Article 8 of the Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial sector. The Fund strives for economic results, while at the same time taking into account environmental, social and governance characteristics.

The Fund's reference currency is EURO. The Fund can also invest, without limitation, in assets denominated in currencies other than its reference currency.

Potential Plain Language Rule	GII
1 Min 51% of NAV invested in green bonds, rated Baa3/BBB- or higher by Moody's, S&P, Fitch, split low, at all times.	<ul style="list-style-type: none"> • Green bonds • Investment Grade • At time of purchase • Split Ratings • Concentration Denominators
2 No investments in green bonds unless in accordance with Bloomberg and Climate Bonds Initiative selection Criteria.	<ul style="list-style-type: none"> • Green bonds • Bloomberg and Climate Bonds Initiative Selection Criteria
3 No investments in green bonds unless denominated in currencies of OECD member countries.	<ul style="list-style-type: none"> • Green bonds • OECD countries • Denomination
4 Max 10% of NAV invested in unrated bonds and bonds rated below Baa3/BBB- by Moody's, S&P, Fitch, split low, at all times.	<ul style="list-style-type: none"> • Fixed Income vs Bond vs Debt • Investment Grade • At time of purchase • Split Ratings
5 Max 5% of NAV invested in stocks of companies in emerging markets, at all times.	<ul style="list-style-type: none"> • Emerging markets • Stocks • At time of purchase

SFDR Article 9 Contract Analysis and Interpretative Issues Example

SFDR Article 9 applies to financial products that have a **sustainable investment objective**. Below are examples of **plain language description** of investment compliance rules, and the corresponding **lexicons/ Global Interpretative Issues (GII)** that might be required for **rule coding**.

XYZ Emerging Markets Ecology Fund

INFORMATION SHEET OF THE XYZ EMERGING MARKETS ECOLOGY FUND

1. OBJECTIVE

Seeks to increase the value of your investment and to provide income over the recommended holding period through investment in Sustainable Investments pursuant to **Article 9** of the Disclosure Regulation.

2. INVESTMENT POLICY

1 **2** The fund invests at least 75% of its assets in a diversified portfolio of “Emerging Markets Green Bonds” denominated in USD or other OECD currencies.

“Emerging Markets Green Bonds” are defined as debt securities and instruments issued by companies that are headquartered, or do substantial business, in an emerging country, which fund eligible projects meeting the criteria and guidelines of the Green Bond Principles (as published by the ICMA). Whilst the investment manager aims to invest in ESG Rated securities not all investments of the fund will have an ESG rating and in any event such investments will not be more than 10% of the fund. The fund may also invest in bonds issued by companies, governments or institutions from any country that are denominated in other currencies and may invest up to 80% in high yield bonds. While complying with the above policies, the fund may also invest in other types of bonds, in money market instruments, in deposits, and in the following up to these percentages of assets:

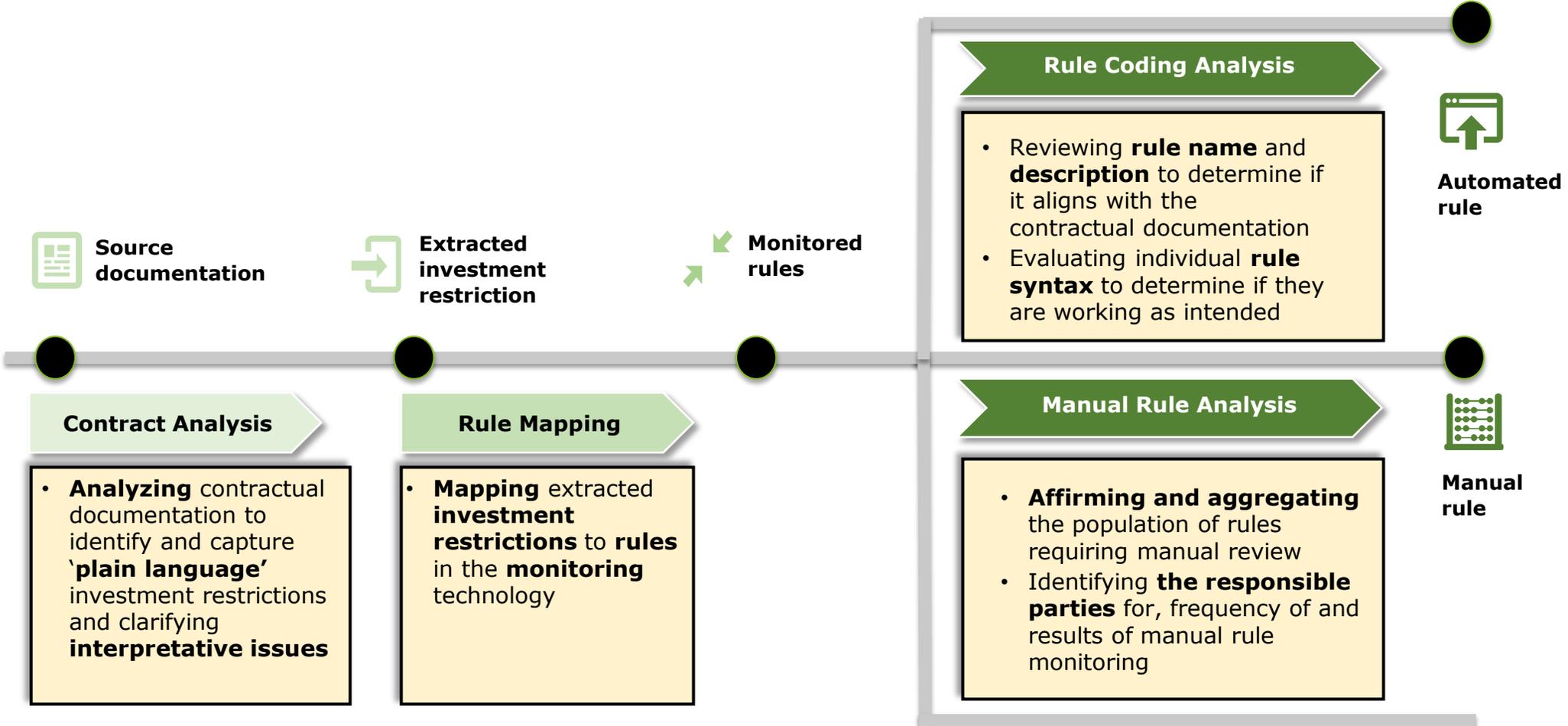
- 3** - convertible bonds: 25%
- 6** **7** - ABSs and MBSs: 20%
- equities and equity-linked instruments: 10%

5 **8** The overall currency exposure to emerging markets local currency may not exceed 10% of the fund's assets.

Potential Plain Language Rule	GII
1 Min 75% of NAV invested in Emerging Markets Green Bonds, at all times.	<ul style="list-style-type: none"> Green bonds Emerging Markets Green Bonds Net Asset Value (NAV) At time of purchase Concentration Denominators
2 No investments in Emerging Markets Green Bonds unless denominated in USD or OECD currencies.	<ul style="list-style-type: none"> OECD countries OECD currencies Denomination Emerging Markets Green Bonds
3 Max 10% of NAV invested in securities that are not ESG rated, at all times.	<ul style="list-style-type: none"> ESG rating At time of purchase Net Asset Value (NAV) Concentration Denominators
4 Max 80% of NAV invested in bonds rated below Baa3/BBB- by Moody's, S&P, Fitch, split low, at all times.	<ul style="list-style-type: none"> Fixed Income vs Bond vs Debt High yield bonds At time of purchase Split Ratings
5 Max 25% of NAV invested in convertible bonds, at all times.	<ul style="list-style-type: none"> Concentration Denominators Convertible bonds At time of purchase
6 Max 20% of NAV invested in ABS and MBS, at all times.	<ul style="list-style-type: none"> Concentration Denominators ABS; MBS At time of purchase
7 Max 10% of NAV invested in equities and equity-linked instruments, at all times.	<ul style="list-style-type: none"> Concentration Denominators Equities At time of purchase
8 Max 10% of NAV exposure to emerging markets local currency, at all times.	<ul style="list-style-type: none"> Concentration Denominators Exposure Emerging Markets At time of purchase

Deloitte's ICM Capabilities in Investment Rule Identification and Transparency

We can help **establish linkages** in **investment restrictions** from **source document** to **monitored rule** creating a verifiable **audit trail** and enhancing rule **monitoring** performance.



Appendix

Increasing US regulatory focus on ESG

With a deepening climate crisis, increase in social justice movements and growing awareness amongst industry stakeholders that sustainability is key, **regulators** are focusing on **increasing transparency** to ensure **investors** make **informed decisions**

SEC announces Enforcement Task Force focused on Climate and ESG issues

The task force will develop initiatives to proactively identify **ESG related misconduct**. It will initially focus on any material **gaps in issuers' disclosure of climate risks** under existing rules. It will also analyze disclosure and **compliance issues relating to investment advisers' and funds' ESG strategies**.



SEC Division of Examinations announces 2021 Examination priorities

Enhanced focus on climate risk – “This year, the Division is enhancing its **focus on climate and ESG-related risks** by examining **proxy voting policies and practices** to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change”.



Managing Climate Risk in the U.S. Financial System

To undertake climate risk analysis that can inform decision-making across the financial system, **regulators and financial institutions need reliable, consistent, and comparable data** and projections for climate risks, exposure, sensitivity, vulnerability, and adaptation and resilience. Public data will enable market participants to compare publicly available **disclosure information and sustainability-benchmarked** financial products.



Climate Risk Disclosures face increased scrutiny and potential changes to reporting requirements

Company disclosures of climate related risks and opportunities are likely to receive **increased scrutiny** from regulators. New climate **risk reporting rules** may soon be on the horizon. The following proposed bills in Congress, if passed, could direct the SEC to issue **rules for mandatory climate risk reporting**-

- [Climate Risk Disclosure Act of 2021](#)
- [Paris Climate Agreement Disclosure Act](#)



The recent publication of the SFDR in the EU requires financial institutions to make firm-level and product-level ESG disclosures and could be a crystal ball for potential regulations in the US.

Few statements by senior SEC representatives on ESG disclosures

Public Input Welcomed on Climate Change Disclosures

"In light of demand for climate change information and questions about whether current disclosures adequately inform investors, public input is requested from investors, registrants, and other market participants on climate change disclosure. I am asking the staff to evaluate our disclosure rules with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change."

-Allison Herren Lee, Acting Chair

ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets

"SEC policy on ESG disclosures will need to be both adaptive and innovative. We can and should continue to adapt existing rules and standards to the realities of climate risk, for example, and the fact that investors increasingly are asking for ESG information to help them make informed investment and voting decisions."

-John Coates, Acting Director, Division of Corporate Finance

Enhancing Focus on the SEC's Enhanced Climate Change Efforts

"The Division of Corporation Finance, per a recent statement by the Acting Chair, will enhance its focus on climate-related disclosure in public company filings and embark on the task of updating the Commission's guidance in this area. The new initiative is simply a *continuation* of the work the staff has been doing for more than a decade and not a program to assess public filers' disclosure against any *new* standards or expectations."

-Hester M. Peirce, Commissioner

-Elad L. Roisman, Commissioner

Statement on the Review of Climate-Related Disclosure

"The Commission in 2010 provided guidance to public companies regarding existing disclosure requirements as they apply to climate change matters. As part of its enhanced focus in this area, the staff will review the extent to which public companies address the topics identified in the 2010 guidance, assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks."

-Allison Herren Lee, Acting Chair

<https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>

<https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121>

<https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change>

<https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure>



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