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New Proposals to Require AIFMs and UCITS Managers to Implement Sustainability Risks in their Organisations

Under new proposals to amend UCITS Directive and AIFMD, ESMA proposes changes that will require AIFMs and UCITS managers to implement sustainability risks within their organisation. Sustainability in this context encompasses environmental, social and governance measures.

The European Union is committed to taking a leading role in the global effort against climate change and contributing to these efforts, the European Commission (Commission) has developed an action plan (entitled "Action Plan: Financing Sustainable Growth") with the primary objective of mobilising capital for sustainable projects, integrating sustainability factors into risk management and fostering transparency on sustainability issues

To assist the Commission in developing its environmental and sustainable objectives, the Commission has requested ESMA to provide technical advice on how to integrate sustainability risks and sustainability factors into the UCITS Directive and AIFMD. In response to this request, ESMA published a Consultation Paper which sets out a series of measures dealing with sustainability risks and sustainability factors that managers of both UCITS and AIFs (fund management companies or FMCs) should integrate in the day-to-day management of their organisations.

In developing its proposals ESMA explains that "sustainability risks" should be understood as the risk of fluctuation in the value of positions of a fund's portfolio due to environmental, social and governance (ESG) factors.

New requirements

ESMA proposes changes to the text of the UCITS Directive and AIFMD that govern the activities of FMCs. In particular ESMA's proposals will impose new requirements on FMCs to integrate sustainability risks within their organisations and will apply to the organisational structure, resourcing, senior management oversight, conflict of interests, investment due diligence and risk management processes of FMCs.

Organisational structure

ESMA proposes that FMCs be required to incorporate sustainability factors in their internal organisational structures. In practical terms, this may mean that FMCs will be required to (i) consider ESG factors in the decision-making processes (ii) integrate ESG factors with the organisation's internal reporting procedures and (iii) ensure that the internal control function monitors compliance with the firm's ESG policies and procedures.

Resourcing

FMCs will also need to consider the necessary resourcing and expertise for the assessment of sustainability risks within their organisation. Taking into account the nature, scale and complexity of the organisation, this may require the employment of personnel with appropriate knowledge and expertise.

Senior management responsibility

FMCs, it is proposed, will need to ensure that senior management are responsible for the integration of sustainability risks and factors within their business. This may require senior management to implement an internal control framework and put systematic processes in place to ensure ESG risks and factors are considered on an ongoing basis.

Conflict of interests

In relation to the management of conflict of interests, ESMA proposes that FMCs should take account of conflicts that might arise due to the integration of sustainability risks within their organisation. ESMA expects FMCs to ensure that their conflicts of interests policy addresses how relevant conflicts will be identified and managed.

Investment due diligence

It is proposed that FMCs will be required to take into account sustainability risks and factors when carrying out due diligence, in particular when selecting investments and for the ongoing monitoring of investments. This means that FMCs should consider sustainability risks in the context of their investment analysis and implement procedures to ensure that investment decisions are carried out and monitored by reference to analysis performed on environmental, social and governance risk factors. Written policies and procedures on due diligence ought to provide for this, and effective arrangements to monitor compliance with policies on sustainability risks should be adopted.

Risk management

ESMA recommends that sustainability risks be integrated and managed within an FMC's risk management framework in a similar way as other relevant risks such as market risk, interest rate risk and credit risk. To manage sustainability risks, ESMA suggests that a FMC carry out a formalised assessment of sustainability risks and their materiality, including an appraisal of the correlation of sustainability risks with investment positions, probability of loss and an understanding of the time horizon when sustainability risk could materialise.

We note that the Commission is currently developing a classification system or "taxonomy" on what can be considered an environmentally sustainable economic activity. This should assist FMCs identify what economic activities, market sectors and companies are environmentally sustainable.

Conclusion

ESMA is due to provide its technical advice to the Commission by 30 April 2019. ESMA's proposals, if implemented, are quite far reaching, and will require FMCs to review their policies and procedures to ensure that sustainability risks and factors are fully integrated in their decision making processes, including integration with the FMC's risk management framework and its investment due diligence processes.

The changes that ESMA proposes to the UCITS Directive and AIFMD should be seen as part of a broader series of regulatory initiatives that are designed to promote investment activity that takes into account ESG considerations. As the Central Bank recently commented on, ESG will be a growing focus for the Central Bank over the coming years and industry is advised to be proactive in considering and adopting new models of activity to take account of sustainability risks, and environmental, social and governance considerations.

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