

# ESG regulation 2021 and beyond

How investment banks can advise their clients

# ESG regulation – 2021 and beyond

2021 marked the end of the previous, primarily voluntary, regime for ESG matters and the start of regulation for issuers, sponsors and nomads. This note details key regulations coming into force this year, updates to existing regulation and the important issues for investment banks and their listed clients.

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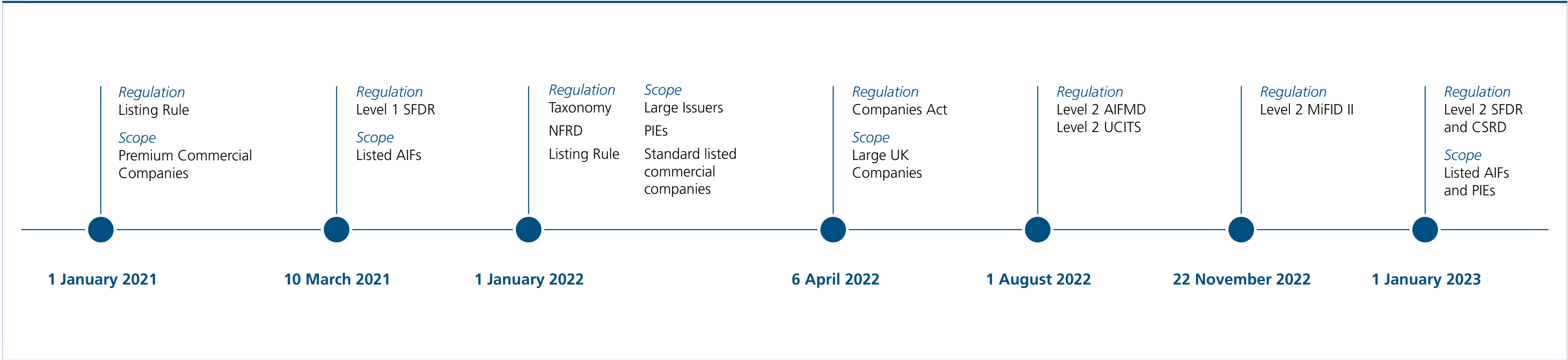
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## We will help you answer these questions

1. How do the new regulations apply to your clients (AIFs and large issuers) and their securities?
2. What actions should your clients take, including in respect of their next fundraising, to ensure compliance with the new regulations?
3. How do the new regulations apply to sponsors and nomads, and what is required?
4. How can you assist your clients with navigating the new regulations and, in light of investor sentiment, finalising their strategy on ESG matters?



# Legislative pipeline



## Jargon buster

<b>AIF</b>	Alternative Investment Fund	<b>PAIs</b>	Principal Adverse Impacts
<b>AIFM</b>	Alternative Investment Fund Manager	<b>PIEs</b>	Public Interest Entities
<b>CSRD</b>	Corporate Sustainability Reporting Directive	<b>SFDR</b>	Sustainable Finance Disclosure Regulation
<b>ESG</b>	Environmental, Social, and Corporate Governance	<b>TCFD</b>	Task Force on Climate-related Financial Disclosures
<b>NFRD</b>	Non-Financial Reporting Directive		

# Listing Rule – Commercial Companies 1 January 2021 and 2022

## Statement in Annual Financial Report

The existing Listing Rule requires commercial companies with a premium listing, but not closed-ended investment companies, to include a statement in their annual financial report for periods beginning on or after 1 January 2021 setting out, on a comply or explain basis:

1. Whether disclosures consistent with the TCFD recommendations and recommended disclosures have been made in their annual financial report.
2. Where disclosures are inconsistent with some or all of the TCFD’s recommendations or recommended disclosures, or some or all of the disclosures are included in documents other than their annual financial report, an explanation of why.
3. Where in their annual financial report (or other relevant document) the various disclosures can be found.

## New Listing Rule

The new climate-related disclosure rule for companies with a standard listing of shares came into effect on 1 January 2022. The rule is an extension of the existing Listing Rule requirements for commercial companies and the scope of the new Listing Rule includes issuers of standard listed equity shares, standard listed issuers of global depositary receipts (GDRs) and shares other than equity shares. Standard listed investment entities and shell companies (including SPACs) are excluded from the new Listing Rule.

## TCFD disclosure guidance

The TCFD’s final report, published in 2017, sets out a framework that divides disclosures into four overarching themes:

<b>Governance</b>
The organisation’s governance around climate- related risks and opportunities.
<b>Strategy</b>
The actual and potential impacts of climate- related risks and opportunities on the organisation’s businesses, strategy and financial planning where such information is material.
<b>Risk management</b>
The processes used by the organisation to identify, assess and manage climate-related risks.
<b>Metrics and Targets</b>
The metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

The general disclosure recommendations for the four key themes are supported by 11 more granular recommended disclosures.

The TCFD has published new guidance on [metrics, targets and transition plans](#) and the updated [implementation annex](#). The FCA has referenced both materials in the guidance provisions for both the existing and new Listing Rules.

The FCA has also introduced an additional guidance provision which applies to issuers in scope of the existing and new Listing Rules. The guidance provides that, where making disclosures on transition plans as part of its strategy disclosures under the TCFD’s recommendations and recommended disclosures, a listed company headquartered in, or operating in, a country that has made a commitment to a net zero economy (such as the UK) should assess the extent to which it has considered that commitment when developing and disclosing its transition plan. If the listed company has not done so, it is encouraged to explain why.

As such, premium listed issuers in scope of the existing Listing Rule will also need to consider the new and amended guidance provisions which will apply for accounting periods beginning on or after 1 January 2022.

## Future developments

The first financial reports made by standard listed issuers in scope of the new Listing Rule to include the required statement would be published in 2023. Many standard listed issuers have already started making some of the relevant disclosures on a voluntary basis. For those that did not, and in particular GDR issuers that are being required to deal with climate-related disclosures for the first time, there is not much time to get the necessary systems in place to comply with the new rule.

## Obligations for sponsors

Sponsors will need to understand the TCFD’s framework, provide guidance on the Listing Rules and be able to analyse whether the issuer has the ability and necessary procedures in place to comply with the Listing Rules along with the issuer’s other ongoing disclosure obligations (see [here](#) for further detail).

# Companies Act – Large UK Companies

6 April 2022

## Statements in Strategic Report

For financial years beginning on or after 6 April 2022, the UK Companies Act 2006 will require large UK companies, being companies that have more than 500 employees and are either traded companies, banking companies, insurance companies, AIM companies or with more than GBP 500m in turnover, to include a non-financial and sustainability information (NFSI) statement in their strategic report.

The content requirements vary depending on the nature of the company. All relevant companies will need to make climate related financial disclosures (CRFD), while traded companies, banking companies and insurance companies will also have to make disclosures relating to certain other matters.

### *CRFD disclosures*

Although not specifically referred to, the CRFD disclosures are broadly in line with the four pillars of the TCFD recommendations with some differences in the detail.

### *Additional disclosures*

Traded companies, banking companies and insurance companies must also include in their NFSI statement information to provide an understanding of the company's development, performance and position and the impact of its activity relating to:

- environmental matters and the impact of the company's business on the environment;
- the company's employees;
- social matters;
- respect for human rights; and
- anti-corruption and anti-bribery matters.

The information should include a description of the company's business model, the policies pursued and their outcome, due diligence processes implemented, the principal risks and non-financial KPIs relevant to the company's business in connection with the above matters. If the company does not pursue policies in relation to any of the above matters, the NFSI statement must provide a clear and reasoned explanation of why.

These requirements have been extended to a certain extent to large LLPs.

## Future developments

BEIS is expected to review the case for expanding the above requirements in 2023.

# Taxonomy – Large Issuers

## 1 January 2022

### Action Plan on Financing Sustainable Growth

The European Commission’s Action Plan on Financing Sustainable Growth, published in 2018, identified 10 key action points which can be summarised into the following categories:

- Reorienting capital flows towards sustainable investment.
- Managing financial risks from environmental and social issues.
- Building transparency and a long-term focus in financial activity.

### Categorising economic activity

The purpose of the Taxonomy is to mitigate against “greenwashing” by setting out some objective criteria that seek to categorise economic activities across a broad range of sectors and enable the market to assess whether such activities are environmentally sustainable. PIEs are public interest entities, namely large issuers that are required to publish a non-financial statement under the Accounting Directive, as amended by the Non-Financial Reporting Directive. This includes listed companies in Europe with over 500 employees and a balance sheet total of over EUR 20m or a net turnover of over EUR 40m.

### Disclosure obligations

Organisations covered by the Non-Financial Reporting Directive will need to disclose in non-financial statements what proportion of their turnover, capital expenditure and operating expenditure is related to sustainable economic activities, as defined in the Taxonomy. Companies with economic activities that are not sustainable will need to make a negative statement in relation to those assets/activities.

The Taxonomy does not require entities to invest in Taxonomy eligible activities but rather to disclose information on how and to what extent the Taxonomy has been applied in assessing the sustainability of their business against six environmental objectives.

### Phased implementation

The Taxonomy also has a phased implementation. As of 1 January 2022, companies are required to disclose the relevant data in relation only to sustainable economic activities contributing regards to climate change mitigation and climate change adaptation objectives. The disclosure requirements with regards to the four other environmental objectives of the Taxonomy will enter into force on 1 January 2023.

### *The definition of ‘sustainable’ under the Taxonomy Regulation*



**Substantially contribute to an environmental objective**  
An activity must substantially contribute to at least one of six environmental objectives, either inherently or by enabling other activities to do so. The objectives are climate change mitigation, climate change adaptation, sustainable use of water, transition to a circular economy, pollution prevention and control, and protection of biodiversity.



**Comply with governance safeguards**  
These include the OECD’s Guidelines for Multinational Enterprises, the UN’s Guiding Principles on Business and Human Rights, and the International Bill of Human Rights.



**Do no significant harm to other environmental objectives**  
While substantially contributing to at least one of the six environmental objectives, the activity must do no significant harm to any other objectives. What is classed as significant harm is separately defined for each environmental objective.



**Adhere to technical screening criteria**  
Each economic activity will be attributed with a set of specifications that must be met if it is to be defined as sustainable under the Taxonomy Regulation. These criteria are set out in delegated regulation.



## NFRD – PIEs

1 January 2022

### Review of non-financial reporting

The NFRD has been in place since 2014 but, given the introduction of the Taxonomy and the SFDR, the EU has committed to reviewing the NFRD to align it with the SFDR and the Taxonomy. The NFRD applies to PIEs in Europe with over 500 employees and a balance sheet total of over EUR 20m or a net turnover of over EUR 40m. The Corporate Sustainability Reporting Directive (CSRD) is proposed to replace the NFRD, with an expected application date on 1 January 2023, for the reporting period starting on or after 2023. The CSRD proposal is not yet adopted. In the meantime, the regime under NFRD continues to apply.

### Disclosure obligations

The NFRD requires in-scope PIEs to have a non-financial statement in their annual report. The statement must contain information to allow an understanding of the development, performance, position and impact of its operations with regards to environmental affairs, social matters, employees, respect for human rights, anti-corruption and bribery. As a minimum, the statement must outline:

- The PIE's business models. This includes listed companies in Europe with over 500 employees and a balance sheet total of over EUR 20m or a net turnover of over EUR 40m.
- Related policies and due diligence process.
- Policy outcomes.
- The key risks stemming from the non-financial aspects of the PIE's operations.
- Non-financial key performance indicators.

If the entity does not make disclosures on these matters the statement must explain why not. PIEs that are subsidiary companies do not need to make a statement as long as the information is contained in their parent company's report.

One of the most significant changes introduced by the SFDR and the Taxonomy is the need for in scope entities to collate quality data in order to make the necessary disclosures. AIFMs, AIFs and PIEs caught by the SFDR and Taxonomy should be able to look to the practice and disclosures historically made under the NFRD to assist them in developing disclosure and data-gathering processes.

### Regime under CSRD

- CSRD intends to extend the scope of the non-financial reporting obligations by removing the threshold of 500 employees, triggering the obligation for non-financial statement under the NFRD regime.
- Under the CSRD, companies would be required to report on more details, based on reporting standards to be developed.

Additional disclosures on sustainability factors would be required namely to understand the impact of the activities of the companies on sustainability factors, and how sustainability factors affect the companies' development and performance.

## SFDR – Listed AIFs

10 March 2021 and 1 January 2023

### Disclosure obligations

SFDR imposes a series of new disclosure obligations that requires, among other, listed AIFs and their AIFMs to make sustainability-related disclosures at a product (listed AIF) and entity (AIFM) level. Before these disclosures can be made, there are material business and policy decisions that in scope firms will need to make, particularly around the impact of sustainability on their investment processes.

### Phased implementation

The main disclosure obligations of SFDR Level 1 apply from 10 March 2021. Level 2 requirements are expected to apply from January 2023.

# Impact on AIFs and AIFMs

## AIFMs

### Disclosure obligation

An AIFM will be required to disclose the following information on its website:

1. Its policy on the integration of sustainability risks in its investment decision-making process.
2. A statement on its due diligence policy with respect to the PAIs of its investment decisions on sustainability factors (see below).
3. Updated remuneration policies, including information on how these are consistent with the integration of sustainability risks.

### Principal Adverse Impacts

PAIs are essentially negative, material or likely to be material effects on sustainability factors that are linked to investment decisions. AIFMs need to make a business decision whether to comply or explain in relation to the PAI disclosure. This requirement will be onerous as AIFMs will need to report on PAIs using a prescribed template and publish amongst other things, quantitative data in relation to a number of sustainability indicators.

### Phased implementation

For large entities, the option to “opt-out” of PAI reporting is no longer available as of 30 June 2021. For such entities, and entities who decide to “opt-in”, it is expected that the first mandatory reporting will be required by 30 June 2023 for the reference period in 2022.

## AIFs

### Disclosure obligation

SFDR imposes new obligations on AIFs for product disclosures in relation to sustainability. This impacts not only ESG-related funds but also for those that do not purport to promote any kind of ESG objective. AIFs are classified into three categories for purposes of the product disclosure obligations:

- Funds that have sustainable investment as their objective.
- Funds that promote an environmental or social characteristic.
- Funds that do not purport to promote any kind of ESG objective.

### Documentation

As a result of SFDR, the following documentation will be affected:

#### Fund pre-contractual disclosure

All funds will need to have a pre-contractual disclosure document that sets out (on a comply or explain basis) either the likely impact of sustainability risks on the financial return of that fund or, where sustainability risks are deemed to be irrelevant, an explanation of the reason for this.

Linked to the PAI disclosure at the AIFM level:

- If an AIF chooses to implement the AIFM’s due diligence policy on the PAIs of its investment decisions on sustainability factors, it must further disclose whether and how this applies to itself.

- If an AIF chooses not to implement the PAI policy, it must disclose for itself an explicit negative statement that the AIF does not consider PAIs and the reasons for not doing so. AIFMs falling within the mandatory compliance regime will have to make the positive disclosures at a fund level also and so the AIF will in practice have to follow suit.

Funds promoting environmental or social characteristics (so called “Article 8”) and products with sustainable investment objectives (so called “Article 9”) must make pre-contractual disclosures in a mandatory template, provided by the draft regulatory technical standards (RTS). SFDR disclosures are included in the pre-investment disclosure required by Article 23 of the AIFMD, and usually consist of an annex to the prospectus for listed funds with an ESG focus and therefore the prospectus standard of liability will apply.

As is currently the case for AIFMD disclosures, the SFDR disclosures need to be made available in a separate document on the issuer’s website to ensure secondary market investors can easily access the disclosures without relying on the prospectus.

#### Fund website disclosure

Funds promoting environmental or social characteristics and funds with sustainable investment objectives must supplement the pre-contractual disclosures with a more detailed, product specific website disclosure.

The entity-level website disclosure will also follow a mandated template and will need to include, where applicable, a description of the characteristics/objective of the ESG-related fund, information on the methodologies

for assessing, measuring and monitoring of the ESG characteristics, due diligence on the underlying assets, data sources, screening criteria for the underlying assets and relevant sustainability indicators and limitation to methodologies and data.

#### Fund periodic reports

Periodic reports for funds promoting environmental or social characteristics and funds with a sustainable investment objective must describe the extent to which the ESG characteristics have been met, or the overall sustainability- related impact. Such periodic disclosures will need to be captured in a mandatory template, as per Annex II of the draft RTS.

There are additional disclosure requirements for such funds to which the Taxonomy applies. Further information must be provided which sets out whether the investment makes a “substantial contribution” to the Taxonomy objectives.

#### Sustainable investment objectives

Funds marketed as environmentally sustainable and contributing to one of the six ‘environmental objectives’ set out in the Taxonomy must disclose details of the environmental objective(s) to which the underlying investment contributes and a description of the extent to which the underlying investments are in sustainable economic activities. Such disclosure will have to follow the content and presentation provided in the template contained in the draft RTS, as of their application date.

Funds that do not have sustainable investment objectives must make a negative disclosure statement in pre-contractual and periodic reporting disclosures.



# AIFMD and MiFID amendments

On 2 August 2021, the European Commission published the MiFID, AIFMD and UCITS Level 2 measures. The measures made under AIFMD and the UCITS Directive will apply from 1 August 2022. The measures made under MiFID II will apply from 22 November 2022.

There are some technical differences between the proposed changes to the three regimes, but in summary the main amendments are that firms must:



**1. Organisational structure:** expressly take into account sustainability risks when complying with documented decision-making procedures, organisation structures, reporting lines and control mechanisms.



**2. Conflicts of interest:** identify conflicts of interest which may arise from the integration of sustainability. For example, firms will need to identify conflicts arising from the risk of greenwashing.



**3. Due diligence:** update their investment due diligence processes to take into account sustainability risks, including principal adverse impact policies under SFDR.



**4. Suitability assessment:** take into account clients' sustainability preferences when giving investment advice. This will impact investment managers subject to MiFID.



**5. Product governance:** take into account the sustainability preferences of an identified target market. This will impact manufacturers and distributors of financial products subject to MiFID.

# Implementation and BREXIT

The SFDR and the Taxonomy did not enter into force before the end of the Brexit implementation period, being 31 December 2020, and as a result will not form part of 'retained EU law'.

However, non-EU AIFMs (e.g. UK-AIFMs) that market their products in Europe have been subject to the SFDR and Taxonomy from March 2021. This means that, in practice, many UK and non-EU listed funds will have to comply to a certain extent with the new disclosure obligations and where the fund manager operates across Europe this is likely to be done for operational consistency.

It may also act as a disincentive to market UK AIFs in the EU, except where significant orders are expected.

The UK Government has recently published their Roadmap to Sustainable Investing which sets out their proposed approach to tackling climate-related financial risks, encouraging UK investors and businesses to consider ESG risks in their decision-making processes. It sets out how the UK will implement their own Sustainability Disclosure Requirements and UK Green Taxonomy. Find out more here – Greening Finance: A Roadmap to Sustainable Investing ([cms-lawnow.com](https://www.cms-lawnow.com)).



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