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THE CAPCO INSTITUTE  
**JOURNAL**  
OF FINANCIAL TRANSFORMATION

ESG

Shaping a sustainable economy:  
A bird's eye view of the  
E.U.'s ESG reform project

CAITLIN McERLANE

**WEALTH & ASSET  
MANAGEMENT**

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**DEAR READER,**

Welcome to edition 51 of the Capco Institute Journal of Financial Transformation.

The global wealth and asset management industry faces clear challenges, and a growing call for innovation and transformation. Increased competition, generational shifts in client demographics, and growing geopolitical uncertainty, mean that the sector needs to focus on the new technologies and practices that will position for success, at speed.

There is no doubt that technology will be at the forefront of a responsive and effective wealth and asset management sector in 2020 and beyond. The shift to digitization, in particular, will see the speeding up of regulatory protocols, customer knowledge building, and the onboarding process, all of which will vastly improve the client experience.

This edition of the Journal will focus closely on such digital disruption and evolving technological innovation. You will also find papers that examine human capital practices and new ways of working, regulatory trends, and what sustainability and responsible investment can look like via environmental, social and corporate governance.

As ever, I hope you find the latest edition of the Capco Journal to be engaging and informative. We have contributions from a range of world-class experts across industry and academia, including renowned Nobel Laureate, Robert C. Merton. We continue to strive to include the very best expertise, independent thinking and strategic insight for a future-focused financial services sector.

Thank you to all our contributors and thank you for reading.

A handwritten signature in black ink, appearing to read 'Lance Levy', with a stylized, flowing script.

Lance Levy, **Capco CEO**

# SHAPING A SUSTAINABLE ECONOMY: A BIRD'S EYE VIEW OF THE E.U.'S ESG REFORM PROJECT

CAITLIN McERLANE | Partner, Financial Services Regulatory, Baker & McKenzie LLP

## ABSTRACT

In March 2018, the European Commission published an ambitious Action Plan on Sustainable Finance<sup>1</sup>, which proved to be the first step in a series of regulatory reforms aimed at fundamentally reorienting capital flows towards sustainable investment and managing perceived financial risks stemming from climate change. While the resulting reform framework is sprawling in nature, and adds to a disparate set of pre-existing regulations, the overall design forms a blueprint that will touch almost every aspect of the financial services industry and profoundly alter the language of sustainable investment. In this article, we will examine the major features of the reform project and how the new regulatory architecture will impact financial institutions based in the E.U. and further afield, alongside the question of how the reforms will flow through to commercial companies.

## 1. TIMING: HOW LONG DOES THE MARKET HAVE TO PREPARE?

The European Commission's (E.C.'s) eventual aim is to revise the E.U. corporate disclosure framework in line with a new "taxonomy" that is designed to create a common language around sustainability for financial institutions and corporates alike. For this reason, two key pillars of the regulatory reform agenda have been labeled the "Disclosure Regulation"<sup>2</sup> and the "Taxonomy Regulation"<sup>3</sup> respectively; it is these regulations that will set E.U. standards for disclosure and classification relating to sustainable investment. Although the Disclosure Regulation technically entered into force on December 29, 2019, it is only set to apply from March 10, 2021. However, the key provisions of the Taxonomy Regulation (the text of which has now been agreed but not yet formally published

in the Official Journal of the E.U.) will begin to apply from December 31, 2021, creating a nine-month disconnect between the two sets of requirements. Amendments to the Benchmarks Regulation will also create a new regulatory framework applying to sustainability-linked benchmarks.

A number of other proposed regulatory reforms discussed in this article are yet to be finalized (including proposals to amend major E.U. regulations including MiFID II (the revised Markets in Financial Instruments Directive and Regulation), the AIFMD (Alternative Investment Fund Managers Directive), and the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive). Nonetheless, the E.C. has indicated that firms should be readying themselves for the introduction of these new standards.<sup>4</sup>

<sup>1</sup> See communication from the Commission, "Action Plan: Financing Sustainable Growth", dated March 8, 2018.

<sup>2</sup> Regulation (E.U.) 2019/2088 on sustainability-related disclosures in the financial services sector.

<sup>3</sup> Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (currently in draft form).

<sup>4</sup> See European Commission Press Release of 04/ 01/2019.

## 2. A GLOBAL DRIVER FOR CHANGE?

One feature of the reforms worth noting at the outset is that their impact will not be confined to the E.U. Instead, it will extend outward to a host of non-E.U. firms with some kind of nexus to the E.U. (as a result of, say, E.U. investors or an E.U. affiliate).

### 2.1 Impact on non-E.U. financial institutions

In line with the E.U.'s overall aim of encouraging buy-side capital to flow towards and promote sustainable economic activity, the reforms have a particular impact on the global asset management industry. For example, where a non-EEA (European Economic Area) manager markets funds directly to EEA investors under a European national private placement regime, it may need to make certain pre-contractual disclosures in line with the Disclosure Regulation. Similarly, non-EEA sub-managers of EEA investment managers may need to assist in providing data necessary for the required ESG (environmental, social, and governance) disclosures.<sup>5</sup> Finally, European distributors of financial products will require issuers or “manufacturers” of those products to disclose sustainability data, regardless of where the issuer or manufacturer is based, so that the E.U. firm can comply with its own disclosure obligations.

While non-E.U. firms with no direct nexus to the E.U. will be better insulated from the impact of the new requirements, it is entirely possible that the new sustainability data required to be disclosed by E.U. firms could shape the disclosure expectations of non-E.U. investors. The effect on investor expectations may, for example, be comparable to what we have recently observed with implementation of the E.U. research unbundling rules, following which there have been calls from U.S. investors for greater transparency over research spending.

### 2.2 Impact on non-E.U. corporates

The E.U. reforms will undoubtedly result in a greater appetite for ESG disclosure from non-E.U., as well as E.U. issuers, although in some cases companies may find that this data is being collated by intermediary specialists rather than by financial firms themselves. Ultimately, E.U. financial institutions will need to ensure that whatever they disclose to their investors and to the market more generally can be backed up by data from investee companies; otherwise, they could be leaving themselves open to accusations of misrepresentation or mis-selling (i.e., greenwashing). In addition, it is possible

that the E.U. taxonomy will become the key point of reference for corporate disclosures required to be made to E.U. investors, despite its limitations.

Non-E.U. corporates should also bear in mind that the new disclosure rules form only one part of a wider reform project that will require E.U. asset managers in particular to take sustainability risk into account in due diligencing investment opportunities and developing corporate engagement strategies. In other words, they may see an increase in activism and direct engagement as well as just data gathering.

### 2.3 Impact on overseas regulators

The E.U. may succeed more generally in setting a standard that other regulators seek to replicate (albeit that there appears to be little prospect of the U.S. embarking on a similarly full-scale reform following U.S. Congress' recent rejection of proposals on increased climate change disclosure). The U.K., for example, has already indicated that its post-Brexit regulatory framework intends to “match the ambition” of the E.U.'s sustainable finance action plan. However, as is often the case, the market is moving at a far swifter pace than the legislative response, partly due to demand from institutional investors; as a result, the investment landscape may itself look different at the point that overseas regulators respond with regulatory frameworks of their own.

### 2.4 E, S or G?

Although the new regulatory framework does not define ESG as a concept, the definition of “sustainable investment” set out in the Disclosure Regulation clearly envisages that the concept of sustainability covers all three aspects of responsible investment, as follows:

- **Environmental investment:** described as an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy.
- **Social investment:** described as an investment in an economic activity that contributes to a social objective, in particular tackling inequality or fostering social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities.

<sup>5</sup> This is a particularly common structure for UCITS.

- **Good governance investment:** here, the Disclosure Regulation indicates that, rather than good governance investments forming a specific sub-category of sustainable investments, governance will instead form a “baseline”, such that an investment in an investee company may not be labeled sustainable unless the corporate itself demonstrates good governance practices (in particular with respect to sound management structures, employee relations, remuneration of staff, and tax compliance).

Notably, the Disclosure Regulation also defines “sustainability risk” as an “environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.” As we will explore below, this concept of managing risk is central to much of the reform effort, and for good reason; international bodies like the Financial Stability Board have been pressing regulators to limit the systemic risk that climate change may ultimately pose to the financial markets.

### 3. THE TAXONOMY REGULATION: CONSTRUCTING A COMMON LANGUAGE

The E.U.'s regulatory reform initiative is underpinned by a “Taxonomy Regulation”, which is intended to establish an E.U.-wide taxonomy on environmental sustainability, and to give both corporates and financial institutions a common language to identify which activities and financial instruments may be considered to be environmentally sustainable.

Pursuant to the Taxonomy Regulation, in order for an economic activity to be classified as “environmentally sustainable” it must substantially contribute to one or more specified environmental objectives, and must not simultaneously cause significant harm to another environmental objective.

These environmental objectives, as specified in the Taxonomy Regulation, are as follows:

- Climate change mitigation.
- Climate change adaptation.
- The sustainable use and protection of water and marine resources.
- The transition to a circular economy, waste prevention, and recycling.
- Pollution prevention and control.
- The protection of healthy ecosystems.

In order to qualify as environmentally sustainable, the activity must also be carried out in accordance with certain baseline governance and social safeguards, and must comply with “technical screening criteria” to be mandated by the E.C. With a view to fleshing out the features of the new taxonomy, a technical expert group on sustainable finance (TEG) was set up by the Commission that has now published a Technical Report on Taxonomy.<sup>6</sup> This report is intended to be the first step in developing a unified classification system for sustainable economic activities and the TEG has noted that, over time, it intends for the classification system to be “as comprehensive as possible and cover all relevant parts of the economy.”<sup>7</sup>

#### 3.1 Who will need to adopt the taxonomy?

The taxonomy will primarily drive classification and disclosure standards in relation to “green” or environmentally sustainable investment products. It will ultimately also drive disclosure standards for large corporate issuers (see below). Where a financial product does not have sustainable investment as its objective and does not promote environmental characteristics, in-scope firms will need to clearly state that the E.U. criteria for environmentally sustainable investments (as set out in the Taxonomy Regulation) have not been taken into account.

The dividing line between those financial products that fall within scope of the sustainable investment category and those that do not is likely to become a key issue once the Taxonomy and Disclosure Regulations apply, not least because the percentage share of any product's investment into environmentally sustainable economic activities will need to be disclosed where that product is marketed as being “sustainable” in nature. This disclosure threshold could be challenging to meet in practice, given that it will involve a careful analysis of all underlying investments against the new taxonomy.

#### 3.2 What does it say on the tin?

The TEG's Technical Report does not set out to produce an exhaustive list of activities classified as “sustainable” in nature. Instead, it sets out a series of guiding principles and “technical screening criteria” (i.e., performance thresholds) intended to assess whether specific activities contribute to climate change adaptation or to an increase in climate resilience. The criteria specified under the taxonomy are not intended to function in a vacuum; rather, they will look at the wider system in which economic activities operate and take into account resources used and the infrastructure underpinning the activity.

<sup>6</sup> See <https://bit.ly/2Tp8Eeh>. Note that since this article was written, the TEG's Final Technical Report on the Taxonomy was published, which incorporates certain sector-specific feedback, but which advocates a generally similar design. See: <https://bit.ly/2TFEweZ>

<sup>7</sup> See page 23 of the Technical Report.

It is important to bear in mind that a key aim of the taxonomy is to provide firms with a means of identifying which proportion of investee companies' activities are environmentally sustainable in nature. As such, the taxonomy is intended to help firms to assess which activities will ultimately remain viable in a net-zero emissions economy, alongside activities that will assist with adaptation to changing climate conditions such as rising sea levels.

### 3.3 How well will it function in practice?

In putting together its technical guidance, the TEG had to grapple with the question of how to put in place a workable framework enabling financial professionals with no background in natural sciences to incorporate sustainability factors into their investment decision-making processes. This is reflected in the membership of the TEG itself, which is largely made up of firms that are active in the financial services sector (e.g., banks and insurers) alongside environmental consultancies and benchmark providers. Notably, only one major corporate and one utility company is represented in the TEG.<sup>8</sup>

However, although the TEG has successfully constructed a methodology that is comprehensible outside of the specialist scientific communities, actually building the taxonomy into trading decisions will be another matter entirely. The TEG's technical guidance builds on existing NACE codes in particular (i.e. the existing European industry standard classification system), and in this current form it may simply not be sufficiently granular for effective incorporation into trading decisions, particularly on an automated basis. In other words, it will likely take some time for the market to construct a workable solution enabling codes and classifications based on the taxonomy to be factored into trading systems. In addition, even after firms get over the hurdle of building internal systems and controls to assess compliance with the taxonomy, ongoing maintenance will be required as new data is published and as the taxonomy itself is updated. This may ultimately require a substantial investment in time and resources for those institutions that wish to demonstrate the environmental sustainability of their investment strategies.

Another issue that may arise in applying the taxonomy is a disconnect between the data that financial firms require in order to demonstrate that an investment fits the profile of the taxonomy on the one hand, and the data that issuers are practically able to provide on the other. As we will explore below, data availability is likely to remain a serious

concern for the industry in the short term at least. There is a particular issue in that financial institutions will not simply need to assess whether corporates engage in business practices that promote one specific environmental objective, but also that their activities do not "cause significant harm" to another environmental objective. Assessing this at the level of economic activities involving a complex supply chain or a number of jurisdictions may simply not be possible, and as any firm that has attempted to implement the UNPRI (United Nations-supported principles for responsible investment) will attest, different sustainability goals can at times become incompatible.

Finally, although European corporates should eventually be in a better position to disclose in line with the taxonomy (particularly given that the E.C.'s guidelines on non-financial reporting are set to reference the taxonomy), this is less likely to be the case for non-E.U. corporates. Again, this will lead to a disconnect between the new needs of E.U. financial institutions and the corporate community.

### 3.4 The law of unintended consequences

A key concern raised by many in the market was that codifying "best practice" around sustainability via the taxonomy could lead to firms approaching investment decisions in a binary manner by categorizing corporates as either "green" or "brown". Perhaps unsurprisingly, however, the end result is likely to be more nuanced.

Once it operates effectively, the taxonomy should in theory function simply as a yardstick to gauge where companies are on their individual journeys towards sustainable business practices. That should not in itself alter the manner in which firms incorporate ESG into their investment strategy, and financial institutions will in theory continue to be free to use ESG data in the same manner as they do currently. However, as will become clear from the regulatory reforms discussed elsewhere in this article, the taxonomy is intended to sit within a broader regulatory ecosystem that, when combined with investor pressure, will push investment strategies towards a greater consideration of ESG and sustainability risk.

The result of this is that the potential rewards attaching to stewardship and investor engagement with corporates currently ranking lower on the sustainability scale may ultimately increase (i.e., as investee companies' value becomes more intrinsically linked to their sustainability profile). However, it is also entirely possible that screening practices drawing

<sup>8</sup> See <https://bit.ly/39nx9hK>

from the taxonomy will proliferate, particularly amongst firms operating passive strategies, but also amongst those firms operating as non-bank credit providers or investors. Thus, if the European taxonomy achieves its goal of becoming a key baseline for sustainability data, it could conceivably contribute to overpricing of securities in certain sectors (e.g., renewables) simply because their issuers fit the parameters set by the taxonomy, whilst having a negative impact on access to funding by those entities that are not sufficiently sophisticated to disclose in line with the taxonomy.

#### 4. GOVERNANCE REFORM: MIND OVER MARGINS?

The E.U. has set itself a major challenge of reorientating investor capital towards sustainable investment, given the ambitious targets it has set (which include closing a stated annual investment gap of almost €180 billion).<sup>9</sup> One method that the European Securities and Markets Authority (ESMA) is proposing to adopt in order to help achieve this aim is to embed a consideration of sustainability into the organizational requirements applying to E.U. asset managers and investment firms. For example, ESMA has proposed that E.U. asset managers (of both alternative investment funds and UCITS) be required to take sustainability risks into account when establishing decision making procedures, allocating responsibilities, and ensuring compliance with their internal procedures.<sup>10</sup> Asset managers will also need to consider whether they have the necessary internal expertise for the “effective integration of sustainability risks” into their governance structure, and that there is ultimate oversight of sustainability risk by senior management.

E.U. investment firms (a category that covers a wide range of regulated firms, from major broker-dealers through to retail investment advisors) would also need to build “ESG considerations” into their organizational framework under a similar set of proposals.<sup>11</sup> Notably, and unlike in the asset management space, this requirement is only set to apply where ESG considerations are actually relevant to the provision of investment services to clients. However, given

that reforms to other aspects of the regulatory framework will incentivize both regulated firms and their clients to consider the ESG profile of investments in a wider range of scenarios, ESG considerations are increasingly likely to become relevant to investment advisory and portfolio management services in particular.

These “organizational” reforms indicate that E.U. regulators are seeking to effect a cultural shift at the heart of financial institutions. Rather than simply requiring firms to put in place an ESG policy for their trading personnel, the aim is to require decision-makers and senior managers to engage with the issue in a top-down manner. Although ESMA has indicated that regulated firms do not all need to go out and hire sustainability officers,<sup>12</sup> there will be some work to do around assessing whether firms have requisite expertise to interrogate ESG-linked data, and that they have the right governance arrangements around the purchase of third-party research. At the same time, however, issues around the climate impact of investments cannot simply be examined in a silo within the business; board-level and senior management must be in a position to interrogate their firm’s overall approach to sustainability and what it ultimately means for clients and investors.<sup>13</sup>

The aim here is not by any means, however, to force all asset managers down a narrow path of activist investment. The choice of wording around sustainability “risk”<sup>14</sup> rather than ESG issues more generally suggests that the aim is instead to ensure that the investor community is not seen to be contributing to overall macroeconomic risk deriving from climate change. Eventually, however, it is conceivable that this assessment of sustainability risk could extend outward to encompass other longer-term issues facing the real economy, such as digitalization and automation. This all fits in with the E.U.’s more general drive to address what regulators perceive as “short-termism” in the capital markets, which has itself arisen from a concern that current decision-making within corporates does not take a sufficiently long-term view of the business (thus reducing the incentives for corporates to move towards a more sustainable operating model).<sup>15</sup>

<sup>9</sup> The E.C. has calculated that in order to make the E.U. climate-neutral by 2050, Europe needs to secure between €175 to €290 billion in additional yearly investment in the next decades.

<sup>10</sup> See ESMA final report on technical advice to the European Commission on integrating sustainability risks and factors into the UCITS Directive and the AIFMD (ESMA34-45-688).

<sup>11</sup> See ESMA final report on technical advice to the European Commission on integrating sustainability risks and factors into MiFID II (ESMA35-43-1737).

<sup>12</sup> See ESMA Final Report

<sup>13</sup> See ESMA Final Report

<sup>14</sup> Defined in the Disclosure Regulation as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.”

<sup>15</sup> See ESMA’s survey on short-term pressure on corporations from the financial sector.



## 5. CREATING A DIALOGUE: HOW WILL THE REFORMS FLOW THROUGH TO THE REAL ECONOMY?

Pursuant to ESMA's proposed reforms, asset managers will be required to take sustainability into account when performing due diligence on and monitoring investments. Specifically, they will be required to consider sustainability risks and the principal adverse impact of investment decisions on "sustainability factors" (defined in the Disclosure Regulation as environmental, social, and employee matters, respect for human rights, anti-corruption, and anti-bribery matters) when making investment decisions.

Embedding a regulatory obligation to take the sustainability profile of investments into account when making investment decisions, alongside the regulatory push for ESG disclosure detailed above, will likely lead to more active engagement between corporates and the investor community. There will also be increased demand for corporate disclosure around ESG. The E.U. is aware of this need for disclosure, however, and is considering various options to improve standardization of disclosure within the corporate sector. The Taxonomy Regulation, for example, will require larger listed companies that are within scope of the E.U. Non-Financial Reporting Directive to indicate the proportion of their turnover, capital expenditure, or operating expenditure that is associated with activities classified as environmentally sustainable according

to the E.U. taxonomy. Corporates may also find themselves subject to increasing state-level intervention, particularly following the publication of the so-called "European Climate Law", which is set to make cutting greenhouse gas emissions to net zero legally binding by 2050.

Nonetheless, this new corporate disclosure regime will have limitations. In particular, while it is a move towards a common set of standards, there will likely still be an initial lack of standardization in corporate disclosures as the corporate community attempts to apply the taxonomy in a practical context. There is also the issue that smaller corporates will simply fall outside of the disclosure regime. Although the Recitals to the Taxonomy Regulation note that SMEs may voluntarily decide to disclose against the standards, many will simply not have the technical expertise or resources necessary to produce quality ESG and non-financial data disclosures, which could ultimately have a negative impact on their ability to seek out financing opportunities.

Over time, however, a move away from ad-hoc qualitative disclosures that are prepared using a variety of methods by a multiplicity of third-party intermediaries will not only be an improvement on the current position, it will be crucial to achieving the E.U.'s goal of moving capital towards sustainable investments while limiting the potential for inadvertent mischaracterization of the sustainability profile of investments.

## 5.1 Voting for change?

ESMA has proposed that, “where applicable”, asset managers will also be required to develop corporate engagement strategies (including the exercise of voting rights) with a view to reducing the principal adverse impact of investee companies on sustainability factors. It is currently unclear, however, how far this proposed requirement is intended to extend. For example, there is no definition of “investee company” given for these purposes, or any shareholding threshold beyond which firms will need to begin engaging around ESG issues (or even whether a substantial investment in a debt issuance rather than equity would, for example, result in an “investee company” relationship).

This new language also suggests that asset managers could in the future be faced with situations where their regulatory obligation to engage with investee companies over long-term sustainability issues begins to conflict with the manager’s commercial need to demonstrate profits to investors over a far shorter time horizon. In an environment where investors contact their manager after a few bad weeks, it is easy to envisage the tensions that may arise.

## 6. A NEW DISCLOSURE REGIME

Pursuant to the Disclosure Regulation, a range of E.U. financial institutions, including asset managers, banks, and investment firms, along with certain insurers and pension providers, will be required to post a number of sustainability-linked disclosures on their websites. These disclosures will include:

- A policy on the firm’s approach to sustainability risk.
- Data on whether, and if so how, the firm takes into account the “principal adverse impacts” of its investment decisions or advice on sustainability.
- How the firm’s remuneration policies are consistent with the integration of sustainability risks.

As with much of the revised regulatory framework, this new requirement will largely bite where firms provide either advice or portfolio/asset management services, and the required disclosures will need to summarize the integration of sustainability risks into the firm’s investment decision making processes, investment advice, or insurance advice, as relevant.

In-scope firm will also need to include disclosures on sustainability risks in their pre-contractual disclosures, describing the manner in which sustainability “risks” have been integrated into the firm’s investment decisions or advice, and the “likely impact” on the returns of financial products made available or advised upon by the firm.

## 6.1 Potential disclosure pitfalls

Whilst the remuneration framework may not at first glance appear the most natural means of advancing the E.U.’s ESG agenda, the reference to remuneration policies is consistent with an increasing trend towards the use of remuneration to promote compliance culture within firms. In this case, the aim is to discourage “excessive risk-taking with respect to sustainability risks.” Nonetheless, in an environment where sustainability risk is itself challenging to quantify and price into investment strategies, it is unclear what bar would need to be met in order to apply changes to an individual’s remuneration (e.g., by reduction in a bonus prior to vesting) as a result of exposing the firm to unacceptable sustainability risk.

A more pervasive concern for firms caught by the scope of the Disclosure Regulation will no doubt be the potential for inadvertent misrepresentation around the ESG profile of products or services being offered, and the potential for clients or investors to hold firms to account regarding statements on sustainability. Assessing the likely impact of sustainability risks on the returns of financial products is, in particular, a rather subjective analysis and clearly open to challenge. The best defense will be to ensure that any investment decisions or advice is given on the basis of sound data and monitoring practices relating to sustainability, although this again raises the issue of access to quality datasets. Even for those firms that regard issues with data quality as opportunities to deliver alpha (i.e., by employing their own quantitative solutions to price sustainability risk more accurately than their competitors), making a public disclosure to the market around strategy will always come with a risk.

Given that short selling strategies are viewed by a number of market players as an effective means of managing sustainability risk, another specific concern may arise in relation to disclosure of short sales. For example, a failure to effectively disclose shorting of screened assets could create issues with investors who have been operating on the assumption that certain assets are effectively excluded from a portfolio.

Finally, although there is scope for firms to avoid making the detailed disclosures referred to above by stating that sustainability risks are not relevant to their investment decisions, they will need to provide a clear explanation of why this is not the case. Simply stating that sustainability is not relevant to the service being provided will prove tricky, however, where firms have had interactions with individual

clients or investors such as institutional investors around the integration of sustainability into their investment strategies. In other words, signing up to the UNPRI and assuring major investors that an investment strategy takes sustainability into account will not sit comfortably with a public statement that sustainability risk is irrelevant.

## 6.2 Products promoting ESG

The Disclosure Regulation also contemplates that certain additional transparency requirements will apply to any financial product that “promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics,” and to financial products that have sustainable investment as their “objective”. It is at present, however, rather unclear where the dividing line sits between products where sustainability risk is “relevant”, and products which actively “promote” or have as their “objective” ESG goals, and which are therefore subject to a higher degree of compliance. Indeed, as issues of sustainability grow in relevance across the market, the dividing line between investments that “promote” or “seek to achieve” sustainability and those that simply have regard to, or incorporate a consideration of sustainability risk may grow increasingly murky.

## 6.3 Scope creep

Given the scope of application of the Disclosure Regulation, this is an area where E.U. law could inadvertently end up colliding with local regulation. Where non-EEA asset managers market funds to EEA investors under the AIFMD regime, for example, it appears that they will need to comply with the pre-contractual disclosure requirements mentioned above.<sup>16</sup> Where they use E.U. intermediaries to market their funds, they may also need to supply those intermediaries with ESG data as a result of the revised product governance framework outlined below. However, asset managers established outside of the EEA may well have concerns around providing only one sector of their investor base with ESG data in the standardized format required under the revised regulatory framework. There has already been a fair amount of thinking done in the U.S. around when and how incorporating sustainability risk and ESG considerations into investment advisory relationships could coexist with, or alternatively conflict with, the advisor's fiduciary duty, for example; this delicate balancing act may not sit particularly comfortably with the E.U.'s push for sustainability to be incorporated into investment decisions.

## 7. GREENWASHING RISK

In the midst of this move towards greater levels of transparency, E.U. and non-E.U. financial institutions and corporates alike would be well advised to consider the risks inherent in ESG disclosure. Greenwashing (i.e., the practice of making unsubstantiated or misleading claims about the environmental benefits of a product, service, technology, or company practice is likely to become an increasing concern in light of the reforms discussed in this article. Indeed, the E.U. conflicts of interest regime is set to be updated to refer to conflicts inherent in the misrepresentation of products or investment strategies as fulfilling ESG preferences where in fact they do not. This will provide an additional “hook” for regulators to enforce against perceived greenwashing.

“  
*As issues of sustainability grow in relevance across the market, the dividing line between investments that “promote” or “seek to achieve” sustainability and those that simply have regard to, or incorporate a consideration of sustainability risk may grow increasingly murky.*”

Alongside the proposal to require larger E.U. issuers to disclose in line with the E.U. taxonomy, however, there are a number of new features of the regulatory framework that should in theory assist firms with accessing reliable data on sustainability. This will be key to limiting regulated firms' potential exposure to greenwashing risk. For example:

- ESMA has proposed new guidelines on ESG disclosure requirements for credit ratings agencies (CRAs), which aim to increase transparency around whether ESG factors are a key underlying element of credit ratings. So, for example, where ESG factors have been taken into account by a CRA, the CRA will need to indicate how ESG considerations have been factored into its rating.

<sup>16</sup> This is because the requirement would sit within Article 23 of the AIFMD, which applies to any alternative investment fund manager (AIFM) that markets its funds to EEA investors under national marketing regimes permitted by AIFMD, regardless of whether the manager is established in the EEA or in a non-EEA jurisdiction.

- The E.U. Technical Expert Group on Sustainable Finance has produced a report proposing an “E.U. Green Bond Standard”,<sup>17</sup> which is intended to be a voluntary code applying to any type of listed or unlisted bond issued by an E.U. or international issuer.<sup>18</sup> Pursuant to the proposed standard, any proceeds from the sale of E.U. green bonds (or an amount equivalent to the proceeds) would need to be used to finance or refinance “green projects” (i.e., projects contributing substantially to at least one of the environmental objectives set out in the Taxonomy Regulation) in order for the debt issuance to be classed as an E.U. green bond issuance. In addition, an accredited “verifier” would need to verify the alignment of the bond issuance with the E.U. Green Bond Standard. This proposal would provide some market discipline in an area where issuers are not at present subject to particularly rigorous constraints around use of proceeds etc.
- Amendments to the E.U. Benchmarks Regulation will result in the creation of two new categories of benchmarks, which are designed to reflect portfolios of assets with lower carbon emissions than standard benchmarks (an “E.U. Paris-aligned benchmark” and an “E.U. climate transition benchmark”). These new benchmarks should do the job of tracking whether securities included in the benchmarks are truly “green” in nature. There will also be a more general obligation for administrators of ESG-focused benchmarks to provide an explanation of how the key elements of their methodology reflect ESG factors.

The above revisions to the Benchmarks Regulation will be key in particular for ESG-focused or green funds that use a benchmark to measure their performance, given that they will need to disclose information on how any such benchmark is consistent with the environmental or social characteristics of the fund (e.g., where the benchmark is used by the fund as a reference to measure performance). If the revisions to the Benchmarks Regulation do not perform as intended, there is a real risk of a disconnect arising between the information on benchmark administration that managers require and the data that administrators are willing to disclose to the market.

More generally, as ESG data becomes increasingly price sensitive, we may well see regulatory authorities globally becoming increasingly focused on the quality of, and supporting

evidence for, data being disclosed to the market. Steven Maijor (Chair of ESMA), for example, recently stated that ESG ratings are not currently subject to an “optimal” level of public scrutiny, noting that the lack of clarity underpinning scoring mechanisms and the diversity of approaches to assessment make it more challenging to effectively compare sustainable investments.<sup>19</sup>

## 8. TRACKING THE PREFERENCES OF END-INVESTORS

The E.U.’s goal is for ESG data to flow throughout the financial system; in other words, it should not simply be reserved for consumption by sophisticated professional investors, but should also be available in some form to retail end-investors. The E.C. has expressed concern that, at present, only a minority of clients receiving investment advice proactively raise ESG issues, and that there is currently a limited understanding amongst clients around the impact of ESG factors on risk and performance.<sup>20</sup> Two key methods that the E.U. is proposing to adopt in order to rectify this lack of engagement with end-clients are:

- Requiring firms to define a “target market” for financial products by reference to ESG preferences.
- Incorporating an assessment of each end-client’s ESG preferences into the suitability test applying to investment advice, advice on insurance-based investment products, and portfolio management services.

Requiring firms to engage with the expectations and preferences of end clients in this way could ultimately prove a powerful tool in shaping the focus given to ESG issues in the retail market. This will in turn form one of many drivers pushing corporate issuers towards a greater consideration of ESG, particularly given increasing industry moves to open up the equities market to retail investors.

### 8.1 Assessing end-client preferences

Pursuant to E.U. product governance rules, when banks or investment firms sell or “distribute” financial instruments to their clients, they need to establish what the “target market” for those financial instruments should be. Pursuant to ESMA’s proposed reforms,<sup>21</sup> E.U. distributors will need to define

<sup>17</sup> See TEG’s report on E.U. Green Bond Standard.

<sup>18</sup> The E.U. Green Bond Standard seems likely to supplant the ICMA (International Capital Markets Association) Green Bond Principles, which are currently considered to set market-standard criteria for green bonds.

<sup>19</sup> See <https://bit.ly/2liyJ8A>

<sup>20</sup> See Explanatory Memorandum to the Final Report.

<sup>21</sup> See ESMA final report on technical advice to the European Commission on integrating sustainability risks and factors into MiFID II (ESMA35-43-1737).

target markets by reference to their ESG preferences “where relevant”. ESMA appears to have left this test of relevance deliberately vague, however, noting that the amendments to the product governance regime “are currently just a first step of a more extensive project,” and that this more flexible approach is “meant as a starting point” that “allows market participants to accommodate themselves to ESG-requirements in the context of Product Governance.”

## 8.2 Engaging with end-clients

When providing investment advice or portfolio management services, E.U. investment firms and banks are required to obtain information from each of their clients on matters such as their financial situation and investment objectives, in order to assess whether the product or service in question is suitable for that client. However, under the current regime, the information sought by firms about their clients' investment objectives will generally relate to financial objectives, while non-financial objectives (including ESG preferences) are rarely addressed. The E.C.'s proposed reforms, therefore, aim to build an assessment of each client's ESG preferences into the suitability test.<sup>22</sup> Firms undertaking a suitability test will, for example, need to disclose information on the ESG characteristics of products offered to clients, and explain how the client's ESG preferences have been taken into account in selecting the product or providing the portfolio management service.

## 9. CONCLUSION

Whether the E.U.'s regulatory reforms will accomplish what they have set out to do and close the substantial investment gap needed to move Europe towards carbon neutrality remains to be seen. Ultimately, although regulators can come up with a set of best practices and lawyers can advise on them, it will be left to the market to come up with solutions to pricing, disclosing, and incorporating sustainability risk into investment decisions.

The scale of reform may well be unpopular amongst those firms that do not perceive themselves as activist investors and that are still struggling to adjust to the substantial compliance burden of post-crisis regulatory reform. For those firms that do already operate green funds or investment strategies, compliance with the new reforms may come at an unwelcome cost. However, the shift towards sustainable investments is already happening, and it is unarguably important for regulators to provide greater certainty and more effective supervision of the negative practices that could spring up in this new environment.

One thing that is certain is that in this new world, there will undoubtedly be some winners, some losers, and some casualties, and those firms that do not aim to get ahead of the agenda may simply find that they are left behind.



<sup>22</sup> See draft Delegated Regulation amending Delegated Regulation (EU) 2017/565 as regards the integration of ESG considerations and preferences into investment advice and portfolio management, and draft Delegated Regulation amending Delegated Regulation (EU) 2017/2359 as regards the integration of ESG considerations and preferences into investment advice for IBIPs.

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