

Memorandum

ESG Developments in the European Union—Sustainability Related Disclosures for AIFMs and AIFs

October 28, 2020

Compliance with the European Union’s (“EU”) regulation on sustainability-related disclosures in the financial services sector (the “EU ESG Disclosure Regulation”) will be required beginning March 10, 2021 for certain EU and non-EU alternative investment fund managers (“AIFMs”).¹ The EU ESG Disclosure Regulation requires transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in an AIFM’s processes and the provision of sustainability-related information with respect to alternative investment funds (“AIFs”).

The EU ESG Disclosure Regulation applies to EU and non-EU AIFMs that market AIFs in the European Union (such sponsors being referred to herein as “Covered Sponsors”), and to the AIFs managed by such Covered Sponsors.

Certain provisions of the EU’s regulation on the establishment of a framework to facilitate sustainable investment, and amending the EU ESG Disclosure Regulation (the “EU Green Taxonomy Regulation”) that will come into effect beginning either January 1, 2022 or January 1, 2023 and may be applicable to AIFs managed by Covered Sponsors are also set forth herein.²

¹ See Regulation (EU) 2019/2088 of the European Parliament and of the Council of November 27, 2019 at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A2019R2088>. While all “financial market participants” and “financial advisers” as defined in Article 2(1) and 2(11) therein are in scope of the EU ESG Disclosure Regulation, this memorandum summarizes the impact of the Level 1, high level and principles-based requirements of the EU ESG Disclosure Regulation on AIFMs and AIFs. Certain of the Level 1 requirements herein will be subject to supplemental, Level 2 regulatory technical standards (“Level 2 RTS”) which will provide further specifications for the content, methodology and presentation of the disclosures. The Level 2 RTS were originally expected to be in final draft form from the European Supervisory Authorities by December 30, 2020, to then be formally adopted by the European Commission prior to March 10, 2021. However, the European Commission has delayed the final draft form of the Level 2 RTS to an unspecified date.

² See Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852>.

A. Covered Sponsors

Covered Sponsors³ will be required to:

1. Publish on their websites information about their policies on the integration of sustainability risks⁴ in their investment decision-making process. This information needs to be kept current and a clear explanation of any amendments thereto also needs to be published on the website.
2. Publish on their websites: (a) a detailed statement on their due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors,⁵ taking into account their size, the nature and scale of their activities, and the types of AIFs they make available,⁶ or (b) clear reasons for why they do not consider adverse impacts of investment decisions on sustainability factors, including, where relevant, information as to whether and when they intend to consider such adverse impacts.
3. Publish on their websites and include in their remuneration policies maintained in accordance with sectoral legislation information on how remuneration policies are consistent with the integration of sustainability risks. This information needs to be kept current and a clear explanation of any amendments also needs to be published on the website.
4. Ensure that marketing communications do not contradict the information disclosed pursuant to the EU ESG Disclosure Regulation.

B. AIFs Promoting Environmental and/or Social Characteristics⁷

AIFs that promote environmental or social characteristics⁸ will be required to:

1. Include the following information in the pre-contractual disclosures made pursuant to Article 23(1) of the AIFMD:⁹

³ The policies set forth in this Section A are expected to apply by contract to any delegates or sub-advisers to the Covered Sponsor in order for the Covered Sponsor to satisfy the requirements of the EU ESG Disclosure Regulation—*e.g.*, U.S. investment advisers that provide portfolio management services to EU AIFs.

⁴ A “sustainability risk” is defined as an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment.

⁵ “Sustainability factors” are defined as environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

⁶ As of June 30, 2021, financial market participants with at least 500 employees must comply with Section A.2(a). Where a Covered Sponsor complies with Section A.2(a), additional pre-contractual disclosures will be required by its AIFs by December 30, 2022.

⁷ Current guidance from EU regulators suggests that most AIFs would be expected to comply with the Article 8 requirements of the EU ESG Disclosure Regulation set forth in this Section B. Covered Sponsors will need to analyze the strategies, marketing materials and ESG policies of each AIF to assess whether it is more likely than not that the relevant regulator would view the AIF as within scope of Article 8.

⁸ Provided that the companies in which the investments are made follow good governance practices.

⁹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the “AIFMD”).

- a. the manner in which sustainability risks are integrated into their investment decisions (or a clear and concise explanation of the reasons such risks are deemed not relevant);
- b. the results of the assessment of the likely impacts of sustainability risks on the returns of the AIF;
- c. a description of and details regarding how the environmental and/or social characteristics are met, and if an index has been designated as a benchmark, information on whether and how this index is consistent with those characteristics, and where the methodology used for the calculation of the index is found; and
- d. with respect to AIFs that promote environmental characteristics:¹⁰
 - i. information on the environmental objective(s) to which the investment underlying the AIF contributes;
 - ii. a description of how and to what extent the investments underlying the AIF are in economic activities that qualify as environmentally sustainable under Article 3 of the EU Green Taxonomy Regulation,¹¹ specifying the proportion of investments in environmentally sustainable economic activities selected for the AIF, including details on the proportions of enabling activities¹² and transitional activities¹³, as a percentage of all investments selected for the AIF;¹⁴ and
 - iii. the following statement: “The ‘do no significant harm’ principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining

¹⁰ Defined in the EU Green Taxonomy Regulation as: (i) climate change mitigation and climate change adaptation, and (ii) sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems. Where the characteristics relate to clause (i) of this footnote, effective as of January 1, 2022, and where the characteristics relate to clause (ii) of this footnote, effective as of January 1, 2023.

¹¹ The EU Green Taxonomy Regulation provides that an economic activity qualifies as environmentally sustainable where that economic activity: (i) contributes substantially to one or more of the environmental objectives in accordance with Articles 10 to 16 therein; (ii) does not significantly harm any of the environmental objectives in accordance with Article 17 therein; (iii) is carried out in compliance with the minimum safeguards laid down in Article 18 therein; and (iv) complies with technical screening criteria established by the European Commission.

¹² The EU Green Taxonomy Regulation provides that an economic activity qualifies as contributing substantially to one or more of the environmental objectives set out in Article 9 therein by directly enabling other activities to make a substantial contribution to one or more of those objectives, provided that such economic activity: (i) does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets; and (ii) has a substantial positive environmental impact, on the basis of life-cycle considerations.

¹³ The EU Green Taxonomy Regulation provides that an economic activity for which there is no technologically and economically feasible low-carbon alternative qualifies as contributing substantially to climate change mitigation where it supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1.5 degrees C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels, and where that activity: (i) has greenhouse gas emission levels that correspond to the best performance in the sector or industry; (ii) does not hamper the development and deployment of low-carbon alternatives; and (iii) does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.

¹⁴ This obligation has the potential to be administratively burdensome.

portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.”

2. Publish on their websites:
 - a. a description of the environmental or social characteristics;
 - b. information on the methodologies used to assess, measure and monitor the environmental or social characteristics selected for the AIF, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics of the AIF;
 - c. the information included in the pre-contractual disclosures referred to in Section B.1 above; and
 - d. the information included in the annual report referred to in Section B.3 below. This information needs to be clear, succinct and understandable to investors, and published in a way that is accurate, fair, clear, not misleading, simple and concise and in a prominent easily accessible area of the website.
3. Include in the annual report referred to in Article 22 of the AIFMD: (a) a description of the extent to which environmental or social characteristics are met, and (b) if applicable, the information set forth in Section B.1(d) above.¹⁵

C. AIFs With a Sustainable Investment¹⁶ Strategy

AIFs with a sustainable investment strategy will be required to:

1. Include the following information in the pre-contractual disclosures made pursuant to Article 23(1) of the AIFMD:
 - a. the information set forth in Section B.1(a) and (b) above;
 - b. where an index has been designated as a reference benchmark, information on how the designated index is aligned with the sustainable investment objective, an explanation as to why and how the designated index differs from a broad market index, and where the methodology used for the calculation of the index is found;
 - c. where no index has been designated as a reference benchmark, an explanation on how the sustainable investment objective is to be attained;
 - d. with respect to AIFs with an objective to reduce carbon emissions, include the objective of low carbon

¹⁵ Section B.3(b) is effective as of January 1, 2022 or January 1, 2023, as applicable depending on the environmental objective.

¹⁶ “Sustainable investment” is defined 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, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement,¹⁷ and where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 is available, include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement. If the foregoing benchmarks are available, include an explanation of where the methodology used for the calculation of the index is found; and

- e. with respect to AIFs that invest in an economic activity that contributes to an environmental objective:¹⁸
 - i. the environmental objective(s) to which the investment underlying the AIF contributes; and
 - ii. how and to what extent the investments underlying the AIF are in economic activities that qualify as environmentally sustainable under Article 3 of the EU Green Taxonomy Regulation, specifying the proportion of investments in environmentally sustainable economic activities selected for the AIF, including details on the proportions of enabling activities and transitional activities, as a percentage of all investments selected for the AIF.¹⁹

2. Publish on their websites:

- a. a description of the sustainable investment objective;
- b. information on the methodologies used to assess, measure and monitor the impact of the sustainable investments selected for the AIF, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the overall sustainable impact of the AIF;
- c. the information included in the pre-contractual disclosures referred to in Section C.1 above; and
- d. the information included in the annual report referred to in Section C.3 below. This information needs to be clear, succinct and understandable to investors, and published in a way that is accurate, fair, clear, not misleading, simple and concise and in a prominent easily accessible area of the website.

3. Include in the annual report referred to in Article 22 of the AIFMD: (a) a description of the overall sustainability-related impact of the AIF by means of relevant sustainability indicators, or where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the AIF with the impacts of the designated index and of a broad market index through sustainability indicators, and (b) if applicable, the information set forth in Section C.1(e) above.²⁰

¹⁷ The Paris Agreement sets out a global framework to avoid climate change by limiting global warming to below 2°C and pursuing efforts to limit it to 1.5°C above pre-industrial levels.

¹⁸ See footnote 10 above.

¹⁹ See footnotes 11-14 above.

²⁰ Section C.3(b) is effective as of January 1, 2022 or January 1, 2023, as applicable depending on the environmental objective.

D. AIFs Generally

AIFs which are not otherwise covered by Sections B and C above will be required to:

1. Include in the pre-contractual disclosures made pursuant to Article 23(1) of the AIFMD the information set forth in Section B.1(a) and (b) above; and
2. Include the following statement in pre-contractual disclosures and the annual report referred to in Article 22 of the AIFMD: “The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.”²¹

As stated above, the EU ESG Disclosure Regulation and EU Green Taxonomy Regulation will impact Covered Sponsors differently depending on the nature and scope of their business. While there is still uncertainty regarding the final form and effective date of the requirements that will be set forth in the Level 2 RTS, Covered Sponsors should begin to consider the implications of the EU ESG Disclosure Regulation and EU Green Taxonomy Regulation on their operations and fund documentation, noting the substantial lead time that may be needed to meet the March 10, 2021 deadline. In particular, Covered Sponsors should begin to analyze the strategies, marketing materials and ESG policies of each AIF they manage in order to assess whether it falls within Section B or C above and ensure that they have sufficient internal and external resources to satisfy the requirements set forth herein.

²¹ As of January 1, 2022.

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