

# ESG regulations, rise in trading errors, and the changing nature of risk management

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# ESG Standards – A Quagmire

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- The UN Principles for Responsible Investment which has 2500 signatories currently.
- The UN Environment Programme Finance Initiative (UNEP FI) which operates the Sustainable Real Estate Investment – Implementing the Paris Climate Agreement: An Action Framework which has requirements specific to each of:
  - Asset Owners and Trustees, and their Investment Advisors
  - Direct Real Estate Investment Managers and Property Companies, and their Real Estate Consultants
  - Real Estate Equity and REITs, Bond and Debt Investors, and their Financial Advisors
- The UN Sustainable Development Goals which set out 169 specific targets to be achieved by 2030.
- Task Force on Climate Related Financial Disclosures Reporting.
- The IFC’s Policy and Performance Standards on Social and Environmental Sustainability.

# ESG Standards – A Quagmire

- The IFC Environmental and Social Management Toolkit for Private Equity Funds.
- The Equator Principles.
- The US Private Equity Council Responsible Investment Guidelines.
- The CFA Institute's Guide to ESG Investing for Investment Professionals.
- The European Development Finance Institutions (EDFI) Principles for Responsible Financing.
- The American Investment Council's (AIC) Guidelines for Responsible Investing which cover environmental, health, safety, labor, governance and social issues and are explicit and prescriptive regarding what member firms are called to do.
- The Walker Principles, a joint effort led by Sir David Walker and the British Private Equity and Venture Capital Association to craft Guidelines for Disclosure and Transparency in Private Equity. The resulting "Walker Report" made specific recommendations for improving the level of public disclosure, including environmental, by private equity firms operating in the UK.



# ESG Standards – A Quagmire

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- The Global Sustainable Investment Alliance composed of the national sustainable alliance bodies of Europe, Australasia, Canada, the UK, the US, the Netherlands and Japan.
- CDC (a division of the British development finance institution (DFI) and owned by the UK government's Department for International Development (DfID)) which has published a Toolkit on ESG for Fund Managers.

# ESG Reporting – A Quagmire

- CDP (formerly the Carbon Disclosure Project)
- Climate Disclosure Standards Board (CDSB) Framework
- European Bank for Reconstruction and Development (EBRD) and the Global Centre for Excellence on Climate Adaptation (GCECA) – Advancing TCFD guidance on physical climate risks and opportunities
- Framework for Impact Statements (FIS), Impact Institute
- Global e-Sustainability Initiative (GeSI)
- Global Reporting Initiative Sustainability Reporting Standards (GRI Standards)
- Greenhouse Gas (GHG) Protocol
- International Integrated Framework, International Integrated Reporting Council (IIRC Framework)
- Recital 9 of the NFRD – The Introduction to the EC Guidelines on non-financial reporting

# ESG Reporting – A Quagmire

- Section 2.5 of the EC Guidelines on non-financial reporting: Supplement on reporting climate-related information
- IPIECA, API and OGP (IPIECA) Oil and gas industry guidance on voluntary sustainability reporting
- Polish Non-financial Information Standard (Standard Informacji Niefinansowych, SIN)
- Principles for Responsible Banking, UNEP Finance Initiative
- Principles for Responsible Investment (PRI)
- Responsible Care Management Framework
- Sustainable Development Goals, 2030 Agenda for Sustainable Development – United Nations General Assembly (UN SDGs)
- Sustainability Accounting Standards Board (SASB) Standards
- The Sustainability Code, German Council for Sustainable Development
- United Nations Global Compact (UNGC)

# ESG Fund Level Requirements – EU

EU/UK legislation/proposals	Timing	Key impact
<p><b>EU legislation</b> Disclosure Regulation (Regulation (EU) 2019/2088) Applies to ‘financial market participants’, including AIFMs, UCITS ManCos and MiFID investment firms providing portfolio management advice</p>	<p>Came into force at the end of December 2019. The main provisions will apply 15 months later (from 10 March 2021) From 2021 asset managers with over 500 employees (or that are the parent of a group that has) will have to publish their DD policies with respect to the principal adverse impacts of investment decisions on sustainability factors Also applies to s well as to non-EU fund managers marketing their funds in the EU</p>	<p>Firms will be required to integrate sustainability risks into their operating models, provide more detailed disclosures on ESG policies and sustainability risks and increase due diligence on the ESG profile of funds. Disclose how sustainability risks (environmental, social or governance considerations) are part of their investment decision-making process and how their investment decisions impact on sustainability factors ( “adverse impacts statement”).</p>

# ESG Fund Level Requirements – EU

EU/UK legislation/proposals	Timing	Key impact
<p><b>EU pending legislation</b> <b>Taxonomy Regulation</b> (2018/0178(COD)) Applies to 'financial market participants', including AIFMs, UCITS ManCos and MiFID investment firms providing portfolio management advice</p>	<p>Expected to come into force in 2020 (awaiting European Parliament approval) Level 2 measures/technical input awaited Phased implementation expected (end 2021/2022)</p>	<p>Establishes an EU-wide classification system or taxonomy of environmentally sustainable activities. Assessment against 6 environmental objectives e.g. climate change mitigation. Imposes supplemental disclosure obligations on fund managers e.g. a statement of whether or not a financial product has an environmental-sustainable investment objective (and if so, to what extent the criteria are met). Required updates to pre-contractual documentation and periodic reports for ESG-focused products.</p>



# ESG Fund Level Requirements – EU

EU/UK legislation/proposals	Timing	Key impact
<p><b>EU proposed delegated legislation</b>            Delegated Regulation integrating sustainability into operating conditions for MiFID investment firms            Delegated Directive integrating sustainability into product governance obligations</p>	<p>Draft Delegated Regulation and Directive published on 8 June 2020 and open for feedback until 6 July 2020            For the Regulation, to apply 12 months after coming into force            For the Directive, a transitional period of 12 months will apply</p>	<p>Firms to carry out a mandatory assessment of sustainability preferences of their clients and take these into account when selecting financial products to be offered            Firms to prepare a report explaining how the recommendation meets a retail client’s investment objectives, risk profile, capacity for loss bearing and sustainability preferences            MiFID firms are also required to integrate sustainability preferences into the product oversight and governance process</p>

# ESG Fund Level Requirements – EU

EU/UK legislation/proposals	Timing	Key impact
<p><b>EU proposed delegated legislation</b> Additional Level 2 delegated acts re sustainability risks and factors to be taken into account for MiFID, AIFMD and UCITS regimes</p>	<p>Draft Regulations and Delegated Directive published on 8 June 2020 and open for feedback until 6 July 2020 Timing as above for other proposed delegated legislation</p>	<p>To ensure that sustainability risks and sustainability factors are integrated within a manager’s organisational, operating, risk management and product governance processes. For instance: AIFMs to take into account sustainability risks and adverse impacts of investment decisions on sustainability factors in their DD policies and processes; and AIFMs to have the necessary resources and expertise for the effective integration of sustainability risks.</p>

# ESG Fund Level Requirements – EU

EU/UK legislation/proposals	Timing	Key impact
<p><b>UK proposals on governance of climate decision-making</b> FCA's work plan on climate change and green finance (as set out in its Consultation Paper on new climate-related disclosures for large asset owners and listed issuers)</p>	<p>To be implemented for accounting periods beginning on or after 1 January 2021 (therefore applying to reports published in 2022) on a 'comply or explain' basis</p>	<p>These proposals are aligned with the Taskforce for Climate-related Financial Disclosures' (TCFD) recommendations The FCA is separately considering how best to enhance climate-related disclosures by regulated financial services firms</p>

# ESG – ERISA Funds

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- Department of Labor on June 23, 2020 proposed a new rule for ERISA funds relating to the consideration of non-pecuniary factors that would have a pointed impact on the use of ESG factors in the context of investment decisions by fiduciaries of employee benefit plans (“Plans”) subject to the Employee Retirement Income Security Act of 1974 .
- The proposal is designed to make clear that ERISA Plan fiduciaries “may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of non-financial objectives.”

# ESG – ERISA Funds

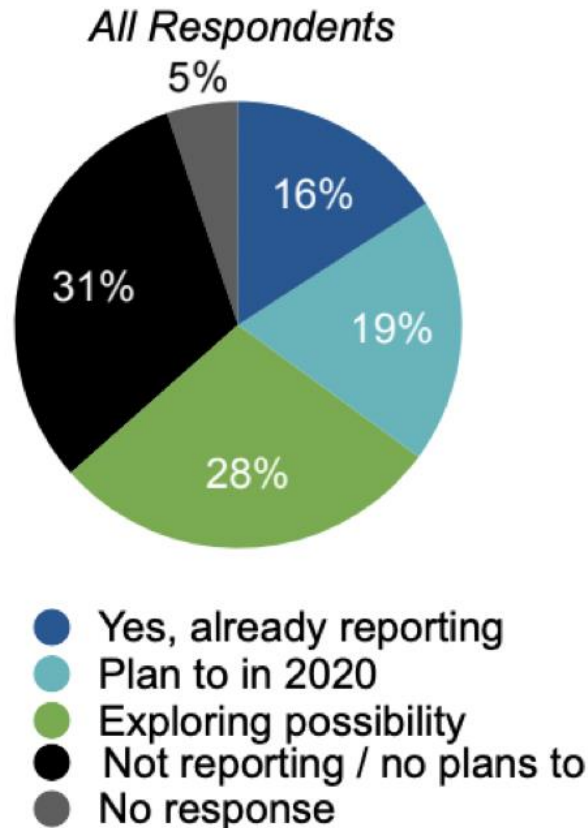
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- The incorporation of ESG principles must occur to ensure the following outcomes:
  - Elect investment options based solely on pecuniary factors which refers to a decision having a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan’s articulated funding policy and the investment objectives.
  - Not put others’ interests ahead of plan participants’ economic interest.
  - Consider ESG (and other similar non-pecuniary) factors only where investment returns will not suffer and where the Plan will not take on additional risks or higher fees.
  - Determine that ESG (and other similar non-pecuniary) factors present appropriate pecuniary risks and rewards under general investment theories

# What does ESG compliance involve?

- Fully Incorporating ESG into asset management involves a number of processes including:
  - Conducting thorough due diligence on ESG issues/factors when reviewing an investment opportunity.
  - Screening investment opportunities to rule out those that may not be aligned with investor preferences, values or ethics.
  - Explicitly and systematically integrating analysis of ESG issues/factors in the investment decision (i.e. buy/sell).
  - Active ownership or stewardship for investors to encourage investee companies to improve their business practices via an ESG overlay and which is often expressed through engagement or proxy voting.
  - Regular reporting to investors on ESG issues/factors in the asset manager's portfolio.
- Impact/SRI go beyond ESG and involve deliberately investing capital to create measurable social, environmental or other specific benefits.

# How hard is ESG compliance?

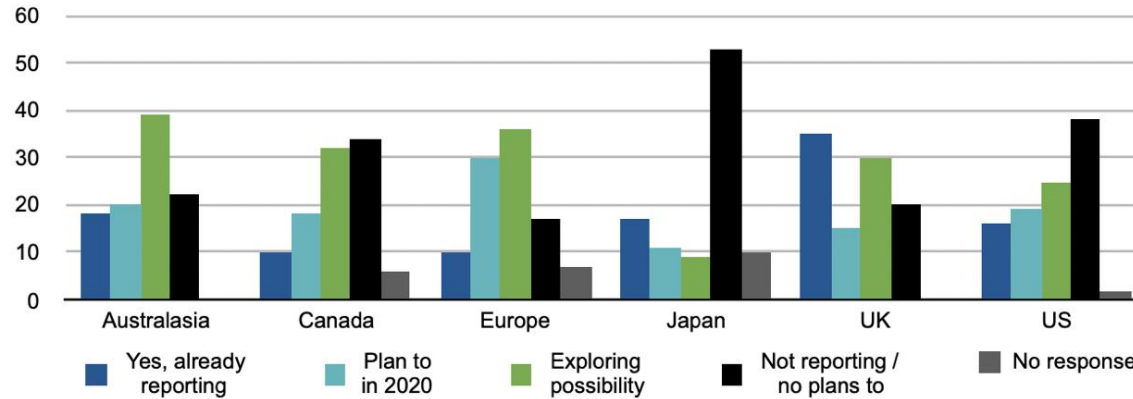


*Chart sums to <100% due to rounding.*

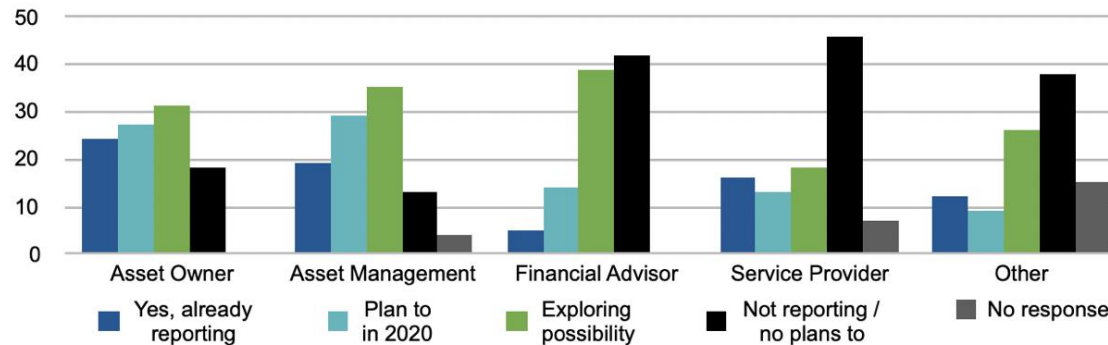
- From a 2019 TFCDD Poll conducted by the Global Sustainable Investment Alliance conducted a TFCDD Poll via the various country or regional alliances of which included responses from 84 international asset management firms.

# How hard is ESG compliance?

Percentage by Region



Percentage by Organization Type







# Covid-19 Compliance Issues

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- Large increase in failed trades during WFH.
  - ESMA noted was not linked to liquidity bi

# Post Covid-19 Testing

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- Ensure all records come back from home premises and double check all trades were recorded
- Increase testing of investment restriction and risks parameter
  - Consider full check on high risk strategies or funds
  - Review substantial shareholding limits for breaches
  - Review short position reporting
- Increase sample testing of best execution
- Review failed trades, errors and settlement breaks
- Back test for potential insider dealing
  - Market announcements vs trades
  - New positions initiated
  - Sample check IMS and recorded phones for broker contact
  - Sample check expert network meetings

# Post Covid-19 Testing

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- Review PA dealing
  - Firms reporting increases in personal share dealing trading levels
  - Cross check against fund positions
  - Cross check against other staff requests
  - Sample check recorded lines
- Refresh fit and proper certifications
- Refresh declarations of adherence to the Compliance Manual
- Review compliance training is up to date – see online logs



# Post Covid-19 Risk and Compliance

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- Employee integrity
  - What do you know about their WFH set-up?
  - What do you know about other household members and their jobs?
- Employee monitoring
  - System improvements to monitor WFH activities
- Systems improvement for compliance and risk teams
  - Need to be integrated into WFH technology solutions
  - Part of “hoot and holler” team
  - Communications networks to include a desk compliance officer
- Automation of more compliance functions
  - Weakness in highly manual compliance functions exposed when WFH and not on the desk next door

An aerial view of a city at dusk or dawn, with a network of white lines and glowing nodes overlaid on the buildings, suggesting a global or digital network. The text 'Thank You' is prominently displayed in the upper left quadrant.

# Thank You



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