BLUE MARK Morgan Lewis

Making Sense of Sustainable Investing

What Asset Managers Should Know About Compliance with Financial Regulations and Alignment with Industry Standards

DECEMBER 2021

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About the Authors

This report was jointly co-authored by **MORGAN, LEWIS & BOCKIUS LLP**, an international law firm, and **BLUEMARK,** a provider of impact verification services

About Morgan Lewis

Drawing upon the talents of our multidisciplinary lawyers in strategic global hubs, Morgan Lewis provides elite legal services and carefully calibrated strategies to bring our clients' ambitious ESG and sustainability goals to life. Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide legal services across industry sectors to clients around the world ranging from multinational corporations to startups. For more information about us, please visit www.morganlewis.com.

About BlueMark

BlueMark is a leading provider of impact verification services for investors and companies. Founded in January 2020 with a mission to "strengthen trust in impact investing," BlueMark's verification services are structured around the two key pillars of accountability for impact: Impact Management Practice (the extent to which an investor or company has the systems, processes, and capabilities to contribute to achieving the intended impact) and Impact Performance (the extent to which an investor or company has achieved the intended impact results). BlueMark draws on a range of industry standards, frameworks, and regulations for its verification methodology, including GRI, IMP, Impact Principles, PRI, SDG Impact Standards, and SFDR. Learn more at www.bluemarktideline.com.

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Glossary

ESG SCREENING

Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values, or ethics.

ESG INTEGRATION

The explicit and systematic inclusion of ESG issues in investment analyses and investment decisions to better manage risks and improve returns.

IMPACT INVESTMENTS

Investments made with the intention to generate positive, measurable, social and environmental impact alongside a financial return.

INVESTING FOR SUSTAINABILITY IMPACT

An investment approach where investors intentionally seek to influence what investee enterprises and other third parties do in assessable ways that help to address sustainability challenges.

THEMATIC INVESTMENTS

Investments that address specific sustainability themes or advance impact targets. Approaches range from overweighting a portfolio to exclusive thematic focus (e.g., positive screens), in some cases referred to as solutions oriented investments.

SUSTAINABLE INVESTMENT

An investment strategy that seeks to generate both financial and sustainability value, variously referred to as socially responsible investing, ethical investing, double- or triple-bottom-line investing, ESG investing, and/or Investing for Sustainability Impact.

Introduction

The investment world is changing. Investors are recognizing the value of sustainable investing and are seeking to invest in sustainable investment approaches. In response to this increased demand, regulators and private organizations are promulgating a wide variety of new regulatory requirements and industry standards applicable to sustainable investing. Each new development requires investment managers to reevaluate whether they are meeting client expectations and industry regulation. The chart on page 6 shows a sampling of recent developments.

These milestones reflect the rapid growth in regulations and voluntary standards aimed at standardizing and harmonizing the sustainable investment market, particularly in Europe and North America. The common thread among these milestones is a recognition that the market lacks broadly accepted standards or even vocabulary to address questions such as how an investment product should be labeled, how to monitor that practices and processes are followed when executing a given strategy, and how to disclose and report results to stakeholders. Collectively, these industry efforts seek to provide investors and other stakeholders with greater transparency and visibility into all aspects of sustainable investing.

The need for greater transparency is something that industry standard-setters have appreciated for quite some time and that regulators are increasingly addressing. Whereas a few years ago there were only a few sustainability-focused standards and regulations that investment managers were expected to monitor, there is now a wide array of competing guidelines, frameworks, and rules. This isn't a step shift—it's a sea change. And this change is only accelerating, with more standards under development and regulatory rulemaking in progress around the world.

Many investment managers are understandably feeling overwhelmed by the pace and scale of change and wondering how they are going to be able to keep up with these evolving requirements. This is especially true for global asset managers with dozens of strategies operating in multiple jurisdictions, as well as for smaller managers with limited resources, to meet these evolving requirements.

Indeed, investors are increasingly becoming sensitive to ESG factors in their portfolios and are looking for investment managers who have the capability, depth, and expertise to provide investment products that deliver on ESG and sustainability goals, either from a risk management perspective or in order to achieve

FIGURE A

Recent milestones in the evolution of sustainable investing regulations and standards

DEC. 2020	Net Zero Asset Managers Initiative launches with 30 founding-investor signatories committed to working toward net-zero emissions by 2050
JAN, 2021	Members of Net-Zero Asset Owner Alliance commit to report on 2025 targets to support 2050 net-zero emissions
MARCH 2021	SFDR requirements (Level 1) go into effect in the European Union; SFDR Regulatory Technical Standards (Level 2) to go into effect January 2023
MARCH 2021	SEC announces creation of a Climate and ESG Task Force
MARCH 2021	SEC issues request for public comments on potential climate-change disclosure rules, with proposed rules expected in early 2022
APRIL 2021	Financial institutions come together to form the Global Financial Alliance for Net Zero (GFANZ); by November 2021, more than 450 financial institutions representing $130 trillion in private capital are committed to net zero targets
APRIL 2021	SEC's Division of Examinations publishes a "Risk Alert" on ESG investing
JUNE 2021	International Organization of Securities Commissions (IOSCO) opens consultation on proposed recommendations about sustainability-related regulatory and supervisory expectations in asset management; consultation closed August 2021
JUNE 2021	G7 backs mandatory TCFD disclosures and the launch of TNFD
JULY 2021	EU Sustainable Finance Taxonomy goes into effect
JULY 2021	United Kingdom creates Impact Taskforce under its G7 presidency to advance work on Impact Transparency, Integrity & Reporting, and Instruments & Policies to Scale Impact Investment; first series of reports published in December 2021
JULY 2021	UK FCA publishes letter to authorized fund manager chairs outlining guiding principles on ESG disclosures
SEP. 2021	Leading investment consultants form the Net Zero Investment Consultants Initiative to push for net zero
NOV. 2021	CFA Institute introduces Global ESG Disclosure Standards for Investment Products; complementary Assurance Procedures to enable independent assurance of ESG disclosure statements are due to be issued on or before 1 May 2022
NOV. 2021	IFRS Foundation establishes the International Sustainability Standards Board (ISSB) in an effort to harmonize sustainability reporting; ISSB announces intention to consolidate with the Value Reporting Foundation (VRF) and Climate Disclosure Standards Board (CDSB) by June 2022; ISSB publishes prototype climate and general disclosure requirements
NOV. 2021	Institutional Limited Partners Association (ILPA) releases updated Due Diligence Questionnaire (DDQ) and Diversity Metrics Template; ESG section of the ILPA DDQ aligns with the PRI's updated responsible investment DDQ for private equity LPs
NOV. 2021	Launch of the Impact Management Platform by a group of leading industry standard-setters to coordinate efforts and mainstream the practice of impact management
NOV. 2021	UK FCA publishes sustainability disclosure requirements discussion paper seeking input on sustainability disclosure requirements and the UK FCA ESG strategy and priorities.

specific impact objectives. These investors are becoming more discerning in their evaluation of managers' ESG capabilities and are increasingly expecting managers to be able to substantiate their ESG and sustainability approaches.

What can investment managers do to keep up with new regulations and growing market expectations?

While the challenge of aligning with market standards and complying with industry regulations may feel insurmountable at times, there is a path to getting ahead of the curve. The key is not to treat each standard and regulation as independent, but rather as a part of a whole. By understanding the interconnected and holistic picture and the overarching goals of each of these standards and regulations, investment managers will be better able to take proactive steps to ensure that they are prepared for where the market and regulators are moving.

Investment managers—regardless of whether they practice ESG or norms-based screening, ESG integration, thematic investing, impact investing, all of the above, or even none of the above—should all be able to answer questions about how and whether ESG factors are a part of their investment processes, and, if not, why not. The reality is that even managers who don't utilize ESG or other sustainability factors in their investment processes are increasingly expected to be able to answer questions about their approach to sustainable investing, whether those questions come from clients, regulators, or other stakeholders. As noted above, an increasing number of investors are becoming aware that risks and opportunities can be identified through the appropriate application of ESG factors, and managers need to be prepared to respond to detailed inquiries about how they incorporate ESG into their investment management approach. The combination of these pressure points signals that the global financial community is moving in the direction of more transparency, and ultimately toward increased requirements for disclosures and reporting on a range of sustainability issues.

To clarify the components and connections within the landscape for investment managers, we have divided this report into two main sections.

Section 1 provides an overview of several key existing sustainability and impact frameworks relevant to investors. These frameworks include both regulatory frameworks (i.e., those that are mandated by a regulatory body) and market-based frameworks (i.e., those that are voluntary in nature). While these frameworks have significant differences, there are also many areas of overlap. By understanding how these regulations and voluntary standards complement each other, investment managers will be better equipped to design and implement a unified approach that responds to the needs of multiple stakeholders.

Section 2 provides a four-part roadmap to guide investment managers through key steps to achieving compliance with financial regulations and alignment with industry standards. These steps are adaptable and are designed to build on one another so that investment managers can effectively incorporate the regulations and standards that are most relevant for a particular type of fund or strategy.

The four steps include :

1. Clarify the specific label or classification used for the sustainable investment strategy (e.g., ESG vs. impact);
2. Identify the practices necessary to substantiate the execution of the strategy;
3. Identify applicable financial regulations and validate that existing practices and disclosures meet the relevant requirements; and
4. Verify that practices and disclosures align with prevailing standards.

An investment manager following these four steps will be better prepared to tackle the next round of regulations and standards in this ever-evolving space. Proactive compliance is the most effective form of compliance, and becoming an industry leader is the best way to stay an industry leader.

Section 1:

KEY FRAMEWORKS SHAPING THE SUSTAINABLE INVESTING MARKET

Key Frameworks Shaping the Sustainable Investing Market

There is a dizzying array of frameworks that investment managers are increasingly expected to integrate into their processes to remain competitive in the sustainable investing market. These frameworks can generally be broken into two categories: regulatory frameworks and market-based frameworks.

Regulatory frameworks

These are frameworks designed and overseen by local, national, or international regulators and legislators that require investment managers to disclose certain information about their approach to sustainable investing and/or their exposure to climate and other risks. Given that global financial markets are concentrated in the United States and the European Union, the most important regulatory-based frameworks applicable to investment managers are:

EU SUSTAINABLE FINANCE TAXONOMY

The Establishment of a Framework to Facilitate Sustainable Investment (or, the "Taxonomy Regulation") has been in effect in Europe since July 2020. The Taxonomy Regulation is a classification system that helps companies determine which activities qualify as "sustainable." The EU Taxonomy serves as a tool for investors to enable them to understand how environmentally sustainable an economic activity may be.[2]

SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)

Applicable to EU fund managers of private investment funds, as well as funds and accounts considered to be "financial products" under SFDR. Phase 1 of SFDR establishes three categories of investment funds, based on the significance of a fund's consideration or integration of environmental, social, and/or sustainable characteristics and includes high-level disclosure requirements. Phase 2 of SFDR is currently expected to go into effect January 1, 2023 and will provide detailed requirements around the presentation of fund disclosures related to ESG risks and other ESG claims.[3]

US SECURITIES AND EXCHANGE COMMISSION (SEC)

The SEC has not yet issued any proposed rules at the time of this paper's publication, but rule proposals are expected on issuer and investment product disclosure in the near term. In the meantime, the SEC has taken a number of actions in an effort to interpret and apply existing rules and regulatory frameworks to

2 See, e.g., EU taxonomy for sustainable activities, available at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

3 See, e.g., Sustainability-related disclosure in the financial services sector, available at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/sustainability-related-disclosure-financial-services-sector_e

companies' and funds' ESG activities. These actions have included examinations,[4] disclosure reviews,[5] ESG enforcement cases, the issuance of guidance,[6] the publication of an investor bulletin,[7] and a request for public input on climate change disclosure.[8]

UK FINANCIAL CONDUCT AUTHORITY (FCA)

Similar to the SEC, the UK FCA has not yet published formal regulations regarding ESG investing and is applying a network of existing rules to ESG and sustainable investing. The FCA has made it known that ESG is high on their regulatory agenda and has provided authorized fund managers some guidance as to their expectations in this area.[9] In a letter to chairs of authorized fund managers, the FCA set forth several guiding principles for funds pursuing sustainable or ESG strategies, such as consistency among marketing materials, fund names, fund disclosures, strategy descriptions and, ultimately fund holdings.[10]

Market-based frameworks

These are voluntary frameworks developed and overseen by independent standard-setters and industry groups that offer guidelines, principles, or recommended practices for investment managers with different kinds of sustainable investment strategies. We specifically focused on frameworks used by investors to guide their investment decision-making, as opposed to frameworks used by companies to disclose information to investors and other stakeholders.[11] Managers that adopt one or more of these frameworks are typically expected to report certain information about their approach, either to the standard-setters, investors, and/or the general public. A few of the most prominent market-based frameworks include:

IMPACT MANAGEMENT PROJECT (IMP)

The IMP was created as a time-bound forum for building global consensus on approaches to measuring, assessing, and reporting on impact. In particular, the IMP has developed a set of impact classes and accompanying guidance for categorizing investments based on their

4 See, e.g., the Division of Examinations 2021 Exam Priorities, available at https://www.sec.gov/files/2021-exam-priorities.pdf.

5 See, e.g., Fund Names Request for Comment (March 2020) available at https://www.sec.gov/rules/other/2020/ic-33809.pdf

6 See, e.g., The Division of Examinations' Review of ESG Investing Risk Alert (April 2021), available at https://www.sec.gov/files/esg-risk-alert.pdf

7 ESG Investor Bulletin (February 2021), available at https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-1.

8 Public Input Welcomed on Climate Change Disclosures (March 2021), available at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

9 See, e.g., A strategy for positive change: our ESG priorities (November 2021), available at https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities

10 Guiding principles on design, delivery and disclosure of ESG and sustainable investment funds (July 2021), available at https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf.

11 Examples of standards and frameworks used by companies to report on their ESG or sustainability performance include CDP, CDSB, GRI, IIRC, SASB, TCFD, TNFD, and the 'Stakeholder Capitalism Metrics' introduced by the World Economic Forum's International Business Council (WEF IBC). In September 2020, several of these organizations announced their intention to "work together towards comprehensive corporate reporting." In November 2021, the IFRS Foundation announced the creation of the International Sustainability Standards Board (ISSB) to further harmonize these frameworks.

impact characteristics, namely whether they are focused on A (avoiding harm), B (benefiting stakeholders), and/or C (contributing to solutions). The IMP has also established consensus as to the five key dimensions for measuring impact—Who, What, How Much, Contribution, and Risk. These Impact Classes and Impact Dimensions are relevant for investors who want to manage ESG risks, as well as those who also want to contribute positively to global goals.[12]

OPERATING PRINCIPLES FOR IMPACT MANAGEMENT (IMPACT PRINCIPLES)

The Impact Principles provide a framework and guidance for designing and implementing an impact management system that integrates impact considerations throughout the investment life cycle. The Impact Principles are relevant to all types of impact investors and sizes of investment portfolios, asset types, sectors, and geographies. The Impact Principles may be adopted at the corporate, line of business, fund, or investment-vehicle level. Signatories to the Principles are required to publicly disclose and independently verify their alignment with the Impact Principles.[13]

PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

The PRI works to understand the investment implications of ESG factors, and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. PRI members are expected to follow a set of investment principles for incorporating ESG issues into their investment practices, and to regularly report on their alignment to these principles according to PRI's disclosure framework.[14]

NET ZERO ASSET MANAGERS INITIATIVE (NZAMI)

The Net Zero Asset Managers Initiative is an international group of asset managers committed to supporting the goal of net-zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius and to support investing aligned with net-zero emissions by 2050 or sooner.[15]

NET ZERO ASSET OWNER ALLIANCE (NZAOA)

The members of the UN-convened Net Zero Asset Owner Alliance have committed to i) transitioning their investment portfolios to net-zero GHG emissions by 2050, consistent with a

12 More information about the Impact Management Project (IMP) is available at https://impactmanagementproject.com/
13 More information about the Operating Principles for Impact Management (Impact Principles) is available at https://www.impactprinciples.org/
14 More information about the Principles for Responsible Investment is available at https://www.unpri.org/
15 More information about the Net Zero Asset Managers Initiative is available at https://www.netzeroassetmanagers.org/

maximum temperature rise of 1.5°C above pre-industrial levels; ii) establishing intermediate targets every five years, and iii) regularly reporting on progress.[16]

SDG IMPACT STANDARDS

SDG Impact is an initiative of the United Nations Development Programme (UNDP) focused on catalyzing investment to achieve the Sustainable Development Goals (SDGs) by 2030. To date, SDG Impact has proposed Standards for Private Equity Funds, Bond Issuers, and Enterprises, as well as an assurance framework and SDG Impact Seal. SDG Impact has also collaborated with the Organization for Economic Cooperation and Development on developing the Impact Standards for Financing Sustainable Development, which are designed to support donors in the deployment of public resources through development finance institutions and private asset managers in a way that maximizes the positive contribution toward the SDGs.[17]

The above is not an exhaustive list of relevant frameworks, but rather a curation of the frameworks that are currently playing a significant role in shaping the sustainable investing market.[18] We highlighted these frameworks both for their broad applicability and for their potential for widespread adoption (see Figure B). The rapid multiplication of these regulatory and market frameworks is in part a response to the rapid evolution of the sustainable investment universe, with an ever-growing number of funds, strategies, and products that all purport to be committed to sustainability in some fashion. While plenty of investment organizations may be serious about that commitment, there is also growing concern about greenwashing in the market. A 2020 Global Impact Investing Network (GIIN) survey of nearly 300 impact investors found that impact washing topped their list of concerns (66%), far outpacing other market concerns like "inability to demonstrate impact results" (35%) and "inability to compare impact results with peers" (34%).[19] This is consistent with other studies of the sustainable investment landscape, which shows that the market is still evolving as best practices emerge, standards proliferate, and regulations go into effect. These frameworks each seek to, among other things, address those concerns.

All of the frameworks employ different strategies to achieve their various objectives, but there are key overlapping themes that can make assessment of and compliance with their requirements easier. The two main areas of overlap among these standards relate to *classification* (i.e., how investors define

16 More information about the Net Zero Asset Owners Alliance is available at https://www.unepfi.org/net-zero-alliance/

17 More information about the SDG Impact Standards is available at https://sdgimpact.undp.org/

18 Additional market-based standards and frameworks used by investors that may warrant consideration include the CFA Institute's Global ESG Disclosure Standards for Investment Products, the GIIN's IRIS+ platform, and the Joint Impact Indicators (JII) managed by HIPSO and the GIIN.

19 GIIN 2020 survey - https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf

FIGURE B

Market adoption of major frameworks

FRAMEWORK	APPLICABILITY	INTRODUCED	ADOPTERS[20]	ASSETS[21]
Regulatory				
EU TAXONOMY	EU managers and companies	2020	Mandatory for all investors and companies above a certain size	N/A
SFDR	EU managers	2021	Mandatory for all registered funds	N/A
SEC	US managers	TBD (expected late 2021 or early 2022[22])	Mandatory for all registered funds	N/A
FCA	UK managers	TBD (expected 2022)	Mandatory for all registered funds	N/A
Market-based				
IMP	Open to all investors	2016[23]	N/A	N/A
NZAMI	Open to all asset managers	2020	220 signatories	$57T+
NZAOA	Open to all asset owners	2019	56 members	$9T+
IMPACT PRINCIPLES	Open to all investors	2019	148 signatories	$422B+ in impact AUM
PRI	Open to all investors and investor organizations	2006	4,375 signatories	$121T+
SDG IMPACT STANDARDS	Open to all private investors and companies	2020	TBD	TBD

their approach to sustainable investing) and *practices* (i.e., how investors operationalize their sustainability approach with systems and processes). Classification is, in sum, the grouping of investment strategies based on similar approaches to ESG integration or impact achievement (e.g., Article 6, 8, and 9 strategies under SFDR or strategies that contribute to

20 As of September 30, 2021.

21 Investment organizations can align with multiple market-based frameworks, so these asset figures are not mutually exclusive.

22 In his October 5 testimony before the US House Committee on Financial Services, SEC Chair Gary Gensler said the commission would move forward with a public comment period for proposed rules on corporate climate risk disclosures in "the next handful of months."

23 IMP concluded its work as planned in late 2021 after being launched in 2016 as a time-bound forum for building global consensus on how to measure, assess and report impacts on people and the natural environment.

a firm's net-zero commitment). Practices are those activities at the firm that are employed to implement and substantiate integration of relevant ESG factors and impact considerations.

The growing focus on classification and practices is intended, in part, to provide investors with tools and disclosures to help them differentiate among strategies in an opaque and fragmented market. Both regulators and standard-setters are engaged in attempting to bring more coherence and clarity to the market, with regulators often borrowing from standard-setters in establishing their guidance. The standard-setters, meanwhile, are helping to fill in gaps left by regulators and setting an increasingly high bar for investment managers to meet. Recognizing that engaging in the practice of sustainable investing can be a journey and that not all managers will be able to meet this bar—at least not right away—the standard-setters are focused on pushing the entire market forward.

On the following page, Figure C provides an overview of the linkages between key investment and compliance activities and the relevant industry frameworks. Additional information about each framework is available in the Appendix.

FIGURE C

Mapping analysis of relevant industry standards

Investor Activity	SEC/FCA (questions to expect from examiners)	SFDR (relevant classification)	RELEVANT INDUSTRY STANDARDS OR GUIDANCE
Baseline disclosure or policy (applicable to all investors)	What is your approach to sustainable investing? How do you describe your sustainable process to clients?	Article 6/8/9	· PRI (re: ESG policy) · CFA Institute (Global ESG Disclosure Standards for Investment Products) · Net zero guidelines and targets · Impact Principles (P1) · SDG Impact Standards (S1)
Incorporation of ESG factors (applicable to investors with an ESG fund or strategy)	What are your policies for integrating ESG into your investment processes? How do ESG considerations interact with financial considerations when you are making investment decisions?	Articles 6/8	· PRI (1, 2, 3) · Impact Principles (P5) · IMP (A, B) · SDG Impact Standards (S2.1)
Contributing to positive solutions (applicable to investors with an impact fund or strategy)	What are your policies/ procedures for considering impact beyond ESG?	Articles 8/9	· IMP (C) · IMP (five dimensions of impact) · GIIN's Impact Classification System (ICS) · Impact Principles (P2, P3, P4, P6, P7, P8) · SDG Impact Standards (S1, 2)
Reporting (applicable to all investors)	How are you reporting your ESG/impact performance/ results to stakeholders?	Articles 6/8/9	· EU sustainable finance taxonomy · PRI (6) · PRI reporting framework (in development) · SDG Impact Standards (S3)
Verification (best-in-class investors)	How are you assuring your ESG/impact performance and results?	N/A	· Impact Principles (P9) · PRI reporting framework (in development) · SDG Impact Standards (S4) · CFA Institute (Assurance Procedures)

Section 2:

FOUR-STEP ROADMAP TO INTEGRITY IN SUSTAINABLE INVESTING

Four-Step Roadmap to Integrity in Sustainable Investing

In Section 1 we discussed how regulatory-based frameworks and market-based frameworks are coming together to shape the future of the sustainable investing market. In this section, we provide a roadmap to help investment managers understand the key steps they can take to prepare for this future.

While digesting all of the competing regulatory and market frameworks can be intimidating, investors are increasingly looking for managers who can demonstrate commitment to these standards (and certainly who can comply with the applicable regulatory requirements). Thus, there is a premium for managers to be able to

FIGURE D

The Investor Roadmap to Integrity in Sustainable Investing assess and incorporate these frameworks into their businesses, products, and strategies. We believe that managers can use the below four-step roadmap to align themselves with current frameworks and position themselves to be able to evolve their practices as these frameworks change over time. The first two steps focus on activities and procedures related to integrity in *classification* and *practices*, while the last two steps focus on controls and disclosures related to *compliance* and *verification*.

4

VERIFICATION

Verify that practices and disclosures align with prevailing standards

Impact Principles • **PRI** (reporting framework)
SDG Impact Standards (SDG Impact Seal)
CFA Institute (Assurance Procedures)

3

COMPLIANCE

Identify applicable financial regulations and validate that existing practices and disclosures meet the relevant requirements

EU Taxonomy • **SFDR** • **SEC** • **FCA**

Step 1 *Clarify the specific label or classification used for the sustainable investment strategy*

SUMMARY:

- The variety of approaches to sustainable investing has led to market confusion and raised concerns about greenwashing
- Accurate labeling (e.g., ESG vs. impact vs. other) is critical to mitigating this confusion as new products are brought to market
- The IMP's ABC framework (Act to avoid harm, Benefit stakeholders, Contribute to solutions) is a voluntary-based classification framework that has been adopted by a number of investors
- SFDR is the first regulatory-based classification system and is complementary to market-based frameworks like the IMP

As the sustainable investment landscape has evolved, so too have the terms and definitions used to describe the range of sustainable investment approaches and products. What "ESG" or "impact" means to one market participant or observer may mean something very different to someone else, depending on that person's experience, geography, and personal biases. While efforts are underway to harmonize the alphabet soup of terms, the lack of universal definitions, rules, and regulations has contributed to market confusion and skepticism.

The goal behind self-classification should be to offer a realistic assessment of what the fund or strategy is designed to do. Over-promising and then under-delivering is a recipe for unwanted scrutiny, either from investors who may take their capital elsewhere or regulators who may open an investigation that could result in a fine or other enforcement action. On the other side of the coin, where investment strategies adopt sustainable or ESG objectives, managers should also be wary of under-promising and over-delivering prior to communicating those changes to clients.

As an initial step, firms should look to adopt an agreed-upon internal taxonomy of terms or vocabulary related to their sustainability efforts. For example, what does the firm mean when it uses terms like "sustainable," "ESG," "impact," or "ESG integration"? Armed with the appropriate terms, firms will then be able to ensure that their strategies can be accurately classified and, more importantly, the strategies can be accurately described to investors and regulators.

Using this internal taxonomy, investment managers may then self-classify their products. Self-classification allows fund managers to signal to the market where they believe their products fit into the broader sustainable investment universe, and, more importantly, ensure that the firm and the clients have a shared understanding of the nature of their products. While extremely beneficial, self-classification can be a challenge. Fortunately, market and regulatory frameworks can serve as a guide for self-classification.

Market-based frameworks

Among market-based frameworks, the one with the most widespread adoption is the IMP's ABC framework, which classifies funds according to whether they Act to avoid harm, Benefit stakeholders, and/or Contribute to solutions. The framework is intentionally designed to be broadly applicable across a range of strategies, recognizing that different strategies may have certain advantages and limitations. For example, a credit fund may have policies and processes designed to minimize negative externalities, but the manager may have difficulty compiling evidence to show how they are benefiting stakeholders or contributing to solutions. Likewise, a fund that is focused on solar power may not be designed with the intention to avoid negative or adverse impacts such as the sourcing of key minerals like lithium and cobalt from corrupt companies and governments that mistreat workers.

In July 2021, the GIIN announced that it would manage the IMP+ACT Classification System (ICS), a self-assessment and reporting tool for investment practitioners wanting to disclose how and to what degree their financial products meet sustainability goals. ICS also borrows heavily from the IMP framework and directly links the different "impact classes" to the SDGs.[24]

In August 2021, Tideline published a "Guide to Using the Impact Investment Label," which builds on the firm's earlier work developing the concept of "impact classes" to bring greater clarity to the impact investment field.[25] The new guide introduced Tideline's Framework for Impact Labeling, which is designed to help investors communicate their approach to sustainable investing based on the degree to which they integrate Intentionality, Contribution, and Measurement into their investment process.[26] The framework specifically differentiates between impact investing, thematic investing, ESG integration, and negative or norms-based screening—collectively, four of the most common sustainable investment strategies.

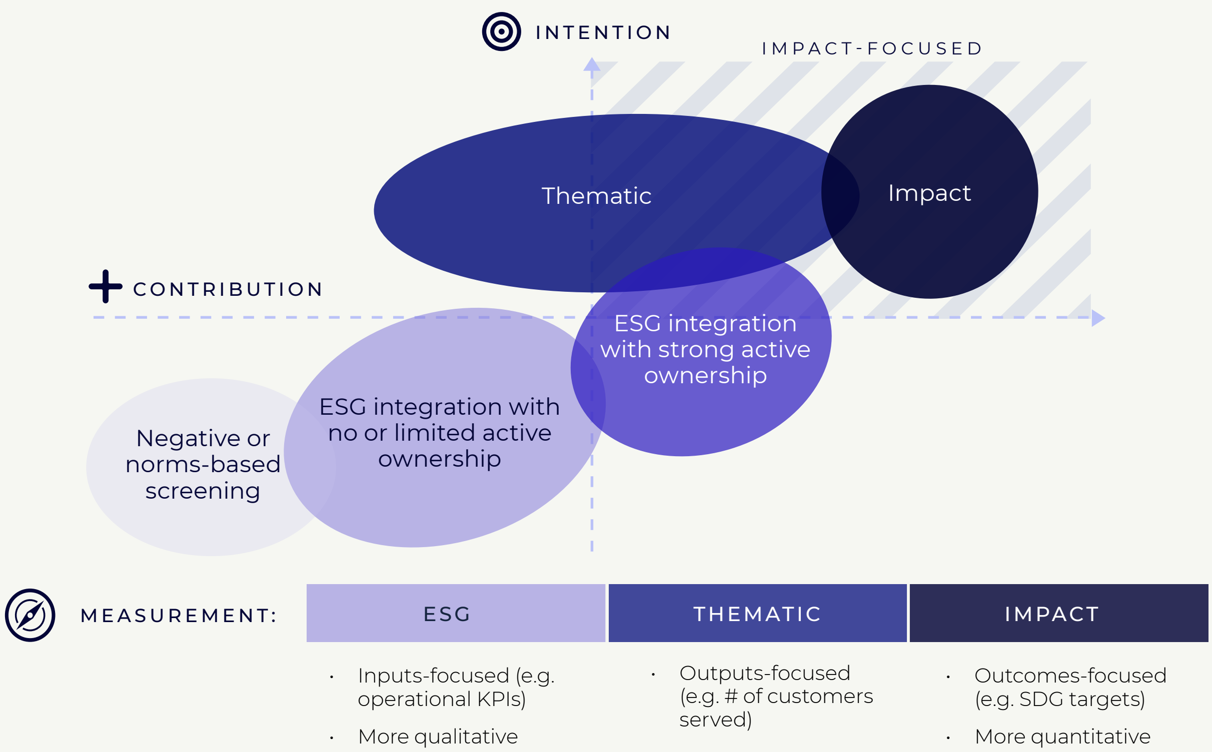
24 IMP+ACT Alliance Selects the Global Impact Investing Network (GIIN) to Manage the Impact Classification System (ICS) (July 2021), available at https://static1.squarespace.com/static/5e42575cbaddd700b0a14617/t/60f92d8fbfcf5919e95ca4d8/1626942868776/Press+Release+-+IMP%2BACTGIIN+7.22.21FINAL+%28002%29.pdf

25 Navigating Impact Investing: The Opportunity in Impact Classes (July 2016), available at https://tideline.com/navigating-impact-investing-the-opportunity-in-impact-classes/

26 Truth in Impact: A Tideline Guide to Using the Impact Investment Label (August 2021), available at https://tideline.com/truth-in-impact-a-tideline-guide-to-using-the-impact-investment-label/

FIGURE E

Tideline's Framework for Impact Labeling



Fund managers seeking to clearly communicate and differentiate their approach to sustainable investing can look to tools like the IMP's ABC Framework, the GIIN's ICS, and Tideline's Framework for Impact Labeling.

Another label that is beginning to enter the investment lexicon is "net zero," meaning an investment portfolio that is aligned with net-zero emissions. One framework helping to advance this concept is the Net Zero Asset Managers Initiative, which requires investment managers to report on the percentage of their overall assets under management that are managed to a net-zero carbon emissions goal by 2050. In order to comply with these requirements, managers must identify which of their products employ strategies that are consistent with this goal, and which can be a challenge given the lengthy time horizon to achieve net-zero emissions for a given portfolio. However, the metrics utilized to make this classification may also be informative for other classifications such as SFDR, which is discussed below.

Regulatory-based frameworks

SFDR generally requires funds to be classified in three categories, designated by the SFDR Article describing the classification. Article 9 funds have a "sustainable investment" as an objective, and Article 8 funds are promoted on the basis of their "environmental or social" characteristics. Article 6 applies to all other funds and generally requires the funds to make certain disclosures about how they address sustainability risks in their investment processes. Compliance with SFDR, therefore, requires investment managers to classify their investment strategies based on their level of incorporation of sustainability factors.

Neither the SEC nor the FCA have a correspon-ding classification requirement; however, both regulators require funds to disclose their investment strategies and risks and expect those strategies and risks to accurately reflect the implementation of any ESG considerations. In order to comply with these general disclosure obligations, investment managers should affect a substantially similar exercise as required under SFDR. Strategies with investment objectives related to sustainability or where environmental or social characteristics play a key role should include disclosure describing these objectives or processes.

Step 2 *Identify the practices necessary to substantiate the execution of the strategy*

SUMMARY:

- The sustainability-focused practices and processes that an investment manager could put in place will depend on the product's strategy/classification (e.g., product integrity reviews, impact measurement, impact reporting)
- For those that self-classified using the ESG label, the most relevant standards are likely PRI (using a lower bar for entry focused on disclosure of risks)
- For those that self-classified using the impact label, the most relevant standards are likely IMP and Impact Principles (using higher bar focused on reporting of impacts)
- Regulators tend to look for many of the same practices and processes as standard-setters to ensure compliance with existing regulations (e.g., SEC's "Risk Alert" on ESG investing)

With the regulatory and client attention focused on greenwashing and related concerns, investment managers may be called to substantiate that their sustainability strategies were being executed in accordance with their disclosed investment processes. To that end, managers should ensure that they have adopted the necessary policies, practices, and processes to execute on a particular sustainable investment strategy. If classification answers the question of "What?" then the practices behind a strategy answer the question of "How?"

- How are sustainability considerations incorporated into the investment process?
- How does the manager use third-party sustainability data?
- How does the manager ensure that a sustainable investment strategy, as implemented, appropriately incorporates relevant sustainability considerations?
- How are sustainability risks monitored?
- How are negative or adverse impacts managed?

The answers to these questions will vary depending on the outcome of Step 1.

Those managers that self-classify strategies as "sustainable" or "ESG" (or something similar) will need to implement practices focused on the identification, monitoring, and disclosure of sustainability risks associated with the strategy and its investments. Risk management is already an integral part of investment management practices, but adding ESG or sustainability issues to the existing risk framework may require developing new research capabilities in-house or acquiring new third-party data or outside expertise. In addition, integrating sustainable or ESG factors into the investment process beyond risk management requires new data about issuers and their sustainability and ESG footprints. Many issuers are voluntarily complying with some market standards, such as GRI, SASB, or TCFD. As a result, ESG and sustainability information is available publicly, but often this information is not consistently disclosed, yielding apples-to-oranges comparisons without significant data-processing work.

In contrast, those managers that self-classify using the "impact" label (or something similar) will likely be more focused on monitoring and managing positive and negative impacts. Tracking, engaging with and reporting on this information may require additional or different practices compared to those needed solely to manage sustainability risks. For example, impact investors may need to engage directly with different stakeholders (e.g., employees, communities) to determine if the desired impact outcomes were actually achieved. The market-based standards that can provide the most guidance for these practices include IMP, Impact Principles, and SDG Impact Standards. For example, Principle 6 of the Impact Principles specifically calls on signatories to "monitor the progress of each investment in achieving impact expectations and respond appropriately." The mechanics of how this is done are ultimately up to each investor, but those who want to meet a higher bar can consult existing industry standards for detailed guidelines and recommendations.

However self-classified, managers of funds or strategies that advertise their sustainable or ESG features should be prepared to substantiate how those features are integrated into the strategy. The failure to meet sustainable or ESG claims can be considered "greenwashing," and this is something regulators are very focused on in examinations and other inquiries. We should expect regulatory scrutiny to continue in the future. Such scrutiny may arise from any number of activities, including portfolio management practices, advertising and marketing, or even compliance oversight and supervision. In addition, the SEC and the FCA have been focused on fund disclosures and naming conventions in connection with its concern with greenwashing.

The good news for managers is that these obligations are not new. The SEC's focus on ESG considerations, while currently intense, is similar in kind to its focus on clear and accurate disclosure of any investment strategy. The same is true for the FCA, where the regulators are focusing on improving trust in the market and increasing transparency for consumers. Firms should already have processes in place to ensure that disclosures (both in offering documents and advertising materials) align with investment practices (and vice versa). Thus, a manager should be able to demonstrate how and to what extent ESG or sustainability considerations, as disclosed and advertised, factor into investment decisions and portfolio construction. What's different about ESG is the attention from clients and regulators who are seeking more substantiation of manager

ESG claims. Individual firms should assess exactly how they want to be able to provide this demonstration. For example, for some firms and strategies it may be sufficient to show an applied and documented investment philosophy and process. For other strategies, the application of an ESG or sustainability screen may be sufficient. For more complicated or "hybrid" strategies with quantitative sustainable targets, this demonstration may require analysis of each investment.

This same concern is present with advertising and marketing of sustainable and ESG products. With high investor demand for these products, the regulators are concerned that managers will aggressively describe the sustainable and/or ESG features of their products, leading to overstated or potentially misleading ESG claims in marketing materials. Indeed, the SEC staff has observed that some firms have had weak controls with respect to ensuring that information in marketing materials is consistent with ESG practices. The FCA has made similar observations, noting specific instances where fund holdings did not match ESG disclosures or where an ESG-named fund tracked an index that was not ESG-focused.

From a compliance-program perspective, the SEC has been focused on policies and procedures that provide an adequate level of compliance review and oversight for the level of ESG commitment a fund or strategy has established. The SEC has also focused on compliance personnel being sufficiently knowledgeable in ESG practices to be able to provide the correct level of compliance oversight.

Step 3 *Identify applicable financial regulations and validate that existing practices and disclosures meet the relevant requirements*

SUMMARY:

- Regulators in Europe, the United Kingdom and the United States are beginning to take a hard look at sustainable investing as more capital flows into funds and products using a "sustainable" label
- While Europe favors a more prescriptive approach, the United States and the United Kingdom are currently taking a more principles-based approach that seeks to build on the existing regulatory framework
- The regulatory environment is constantly evolving, with more regulations likely on the way
- Staying ahead of these regulations requires a sophisticated compliance program

As the sustainable investment industry continues to grow, fund managers should be prepared for additional regulations aimed at bringing more transparency and clarity to the market. While each jurisdiction will have a different regulatory philosophy, the countries and regions that hold the most sway in the investment management industry are the United States, United Kingdom, and European Union. We discuss key regulations in each region below, along with recommendations for ensuring compliance with regulatory requirements.

Europe and the United Kingdom are leading the way with respect to the regulation of sustainable and ESG funds. As noted above, the EU SFDR has established a high-level, principles-based disclosure regime for most fund management companies. On the horizon are the SFDR Level 2 requirements (the SFDR Regulatory Technical Standards, or SFDR RTS), which will include more detailed disclosure and reporting requirements to be made in mandatory templates. These requirements were intended to go into effect on January 1, 2022 but are currently delayed to January 1, 2023. In addition, certain Taxonomy Regulations will come into effect on January 1, 2022 and will have additional specific disclosure requirements for SFDR Article 6, 8, and 9 products.

Also on the horizon are any regulatory responses coming from the Final Report issued by IOSCO in November 2021 concerning recommendations on sustainability-related practices, policies, procedures, and disclosure in asset management. While IOSCO is not a regulator itself, it is a collection of global regulators, so its formal recommendations could impact the direction of global regulation to come. At a high level, the IOSCO Report sets forth policy recommendations regarding policies and procedures, disclosure, enforcement practices, and terminology.

At the time of this paper, neither the SEC nor the UK FCA have established any ESG-specific rules. Instead, their oversight and regulation of ESG funds is founded in existing regulations and rules governing registered funds. The key regulatory areas for investors interested in sustainable investing include disclosure, fund names, and compliance programs.

DISCLOSURE

Funds are required to disclose, among other information, details about their investment objectives, investment strategies, and risks. In the United States, the SEC staff in particular, when reviewing these disclosures for ESG funds, frequently request clarifying and/or additional information viewed as helpful to investors to understand the ESG components of the funds' strategies. Investment advisers may also include information about ESG investing practices in other areas and regulatory filings, such as for U.S. investment advisors, Form ADVs filed with the SEC. These disclosures are an important resource for investors to understand an adviser's approach to ESG and should be consistent with other disclosures (e.g., in relevant prospectus disclosure, website content). Another important location of ESG information is in fund and adviser marketing materials. All disclosures regarding investment strategies and risks should be consistent across regulatory documents and marketing materials, inclusive of information related to ESG investment practices.

FUND NAMES

Another area where regulators are focused on ESG and the potential risks to investors presented by ESG funds is fund names. In the United States, Rule 35d-1 under the Investment Company Act of 1940 (the "1940 Act"), or the "Names Rule," establishes requirements pertaining to the use of certain words in a fund's name. Recently, the SEC disclosure staff has focused on the use of terms like "ESG" and "sustainable" in fund names and, citing the Names Rule, has requested funds to include policies requiring a fund with such names to invest at least 80% of its assets in securities meeting a definition of "ESG" or "sustainable." Fund managers should ensure they are able to comply with such a quantitative investment policy before adopting it as part of the fund's disclosure. In addition, SEC personnel have also recently alluded to potential changes to the Names Rule in order to establish formal guidelines for naming ESG funds. The FCA is also focusing on fund names, noting in their guiding principles that a fund's ESG focus should be consistently reflected in its name, objectives, strategy and holdings.

COMPLIANCE PROGRAMS

The SEC and the FCA require funds and their advisers to have in place compliance programs that are reasonably designed to prevent violation of federal securities laws and are adequate to ensure the firm's compliance. Compliance programs generally should be designed with adequate compliance controls to prevent harm to investors. ESG investment strategies vary widely, and regulators expect that fund and/or adviser compliance programs will include policies and procedures that are appropriate for the types of strategies contemplated by the fund and/or adviser.

There are a number of steps that firms can consider taking in anticipation of further regulatory scrutiny of ESG practices, regardless of the timing of any additional ESG requirements.

These steps include:

1. UNDERSTAND THE ESG LANDSCAPE, INCLUDING VARIOUS ESG GLOBAL STANDARDS AND FRAMEWORKS

The global ESG landscape lacks precision and standardization in both practices and terminology. Understanding the ESG frameworks that are most relevant and applicable to a manager and/or fund is a key starting point to ensuring compliance with existing regulatory requirements, as well as building an ESG investment and compliance program that is sufficiently flexible to adapt to future ESG rules and requirements.

2. CROSS-FIRM COORDINATION

Regardless of jurisdiction or regulatory requirements, ESG considerations span many investment and operational functions within an investment firm. Investment management, investment risk, product development, compliance, legal, marketing, board relations, and firm leadership all need to be in sync to ensure ESG practices, reporting, and messaging are consistent. Cooperation among these functions is critical to managing potential risk areas related to ESG investing.

3. CONSIDERATIONS FOR ESG COMPLIANCE

Compliance policies and procedures should address the specific characteristics raised by a firm's approach to ESG, as they should with any product offered by the firm. The following should be considered and addressed in policies as applicable:

PRODUCT DEVELOPMENT

Determine relevant stakeholders to consult when developing new investment products, including claims of compliance with any ESG standards or frameworks, and ensure that a communication infrastructure is in place.

DISCLOSURE

Ensure that disclosures regarding ESG strategies, compliance with any ESG standards and frameworks, and ESG risks are disclosed accurately and consistently across fund registration statements, offering documents, regulatory filings, websites, and marketing materials.

COMPLIANCE MONITORING AND OVERSIGHT

Determine compliance controls necessary to implement specific ESG strategies, and guidelines and controls necessary to ensure adherence to any applicable ESG standards and frameworks. Consider whether an ESG-specific compliance policy is warranted.

INVESTMENT MANAGEMENT

Ensure that ESG investment decisions are documented sufficiently—particularly when such decisions include subjective or qualitative assessments of ESG data.

SPOTLIGHT ON MORGAN LEWIS

ESG at Morgan Lewis

Morgan Lewis lawyers have extensive background advising investment management clients with respect to the implementation of ESG into their businesses and their investment products. We established a cross-disciplinary ESG and Sustainability task force to leverage our global strengths and create carefully calibrated strategies to bring our clients' ESG and sustainability goals to life. Using our deep understanding of regulations and markets, we stay on top of rapidly evolving ESG regulatory initiatives to ensure that our clients can implement their own strategic visions.

We employ our expansive industry, corporate governance, and financial market experience to help our clients evaluate the practical and legal implications of ESG and sustainability strategies on a global basis. We advise on ESG and sustainable fund formations, investments, transactions, regulatory issues, and compliance matters, among many more matters. We act as trusted advisers to public and private companies on ESG-related policy, risk management, disclosure, due diligence, and contract provision questions, as well as alternative entity formations. We are recognized as a market innovator on ESG and impact investment lending, and we devise strategies for our lending clients to ensure that their investors can track social impact in loan covenants, and we develop ESG transaction structures—from early "angel"-round investing, to established syndicated loans, to ESG-specialized financing.

We counsel clients on the US Department of Labor's ("DOL's") efforts to regulate ERISA plan fiduciaries' use of ESG factors in plan investment decision-making, helping them navigate evolving regulatory guidance to balance their fiduciary duties with marketplace demands, shareholder and retirement plan participant interest, and DOL enforcement efforts.

We help companies, fund investors and sponsors, private foundations, public charities, community development financial institutions, family offices, and impact-oriented businesses to optimize tax advantages in transactions achieving ESG, sustainable investing, and impact investing goals. We advise on impact-oriented structures—including opportunity zone funds, mission-related investing, economic development, developing country investments, and funds eligible for program-related private foundation investment. We also support corporations and family offices in their philanthropic activities, including funding donation and endowment programs through charities, donor-advised funds, and private foundations.

With all of this experience and an ingrained culture of collaboration across our practices and global footprint, Morgan Lewis lawyers are well equipped to counsel any client on how it can respond to these changing regulations, capture new opportunities, and position its firm for success.

Step 4 *Verify that practices and disclosures align with prevailing standards*

SUMMARY:

- Independent verification is essential to market transparency, comparability, and integrity
- The verification process can help a manager identify areas of strength and uncover areas for improvement
- Voluntary standards are increasingly encouraging or requiring verification to comply with their frameworks—and there is an expectation that verification requirements will become more commonplace as the sustainable investing market evolves

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Fund managers that complete steps 1-3 may also want to seek external verification or assurance of their sustainability-related practices and/or disclosures as a mechanism to reinforce the legitimacy of their strategy and claims. While current regulations do not explicitly call for external verification, several industry standard-setters require signatories and members to obtain a third-party seal of approval to remain in good standing.

The Operating Principles for Impact Management, launched in April 2019, are currently the most widely adopted market standard to require independent verification. However, there is an expectation that verification will soon be seen as a prevailing practice in the industry and eventually a baseline expectation for any investment manager seeking to attract institutional capital. Other industry associations and standard-setters—including PRI, SDG Impact, and the CFA Institute—have signaled that they plan to introduce verification requirements in the near future.

Independent verification can provide several benefits to investors, regardless of whether they are looking to align to one of these standards.

These benefits may include:

- Increasing investor trust and confidence in a manager's sustainability approach
- Differentiating a manager's product(s) in the market
- Identifying key strengths and potential areas for improvement
- Providing a basis for consistent and objective evaluation of claims
- Benchmarking against peers

Many leaders across the sustainable investment market see independent verification as essential to ensuring greater accountability and a more efficient marketplace, in much the same way that financial audits are widely viewed as essential to the functioning of capital markets. There are different types of verification services available to investment managers, depending on their strategy and the frameworks or standards they want to adopt. The verification process for the Impact Principles will be different than the one for the SDG Impact Standards, just as the verification process for a private equity strategy will be different than the one for a green bond or social bond.

In general, these verifications tend to focus on either investor practices (the systems and processes used by an investor to manage its sustainable investments) or investor performance (an investor's sustainability results relative to its stated intentions). Investors may pursue one or both kinds of verifications, typically with an expert third party that has experience in that specific investment sector.

There is already a range of verification providers in the market, each with a different methodology and area of expertise. It is largely up to each individual manager to decide how it wants to go about selecting a provider and undergoing a formal verification.

But the goal of any verification exercise should be about more than just "checking the box"—it should be treated by investors as an opportunity to learn and improve their approach to sustainable investing. Given the rapid evolution of the sustainable finance space, a commitment to continuous learning and improvement is critical to staying ahead of the competition and meeting the ever-higher bar of market expectations.

SPOTLIGHT ON BLUEMARK

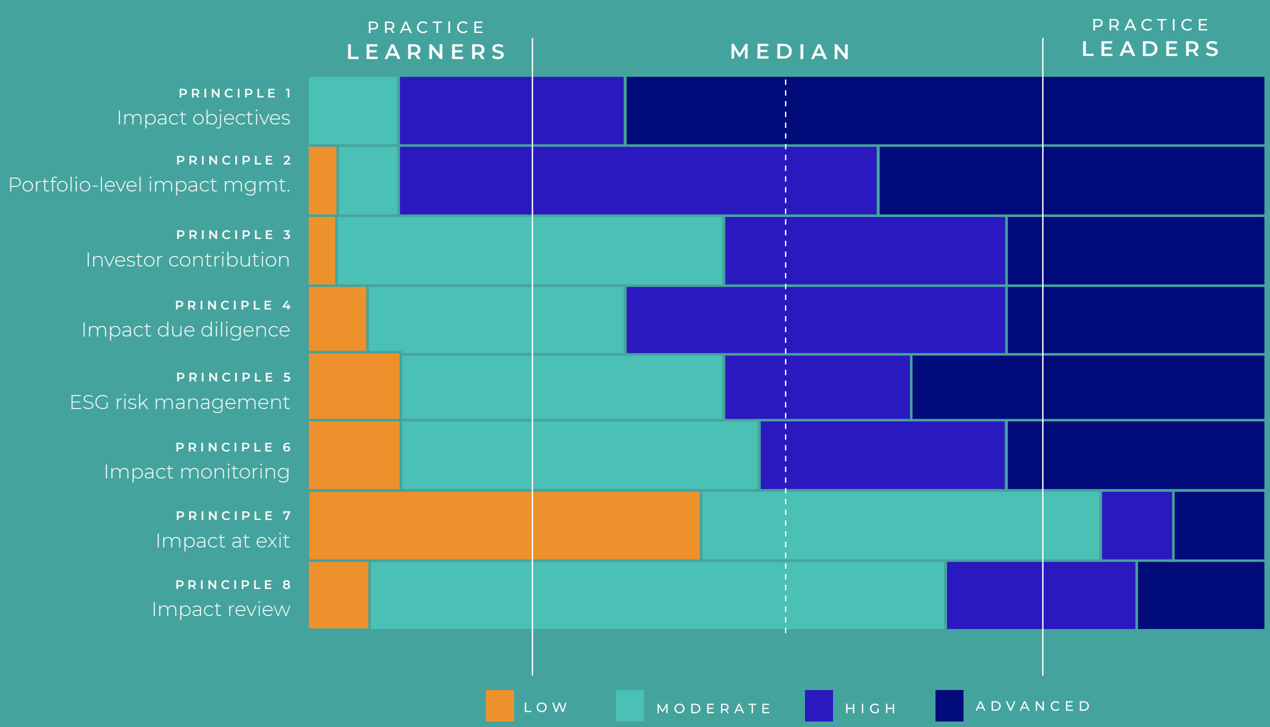
“Making the Mark” and the BlueMark Practice Benchmark

BlueMark publishes an annual report, “Making the Mark,” that uses the aggregated results from client verifications to generate data and insights on shared challenges and potential areas of improvement across the impact investing industry. In the 2021 report, BlueMark used its verification data to create the BlueMark Practice Benchmark, which was designed as a tool that impact investors can use to see how they stack up against their peers. The Benchmark specifically differentiates between Practice Leaders (those in the top quartile) and Practice Learners (those in the bottom quartile) across a range of industry best practices.

For instance, BlueMark found that while 93% of the investors in the research sample align their investments with the SDGs, just 48% go a step further to align their impact objectives with the 169 targets underlying the SDGs. Similarly, 43% of all investors verified by BlueMark align their staff incentive systems with impact performance, but only 32% monitor and review any unexpected positive or negative impacts from their investments. This data shows a clear segmentation between Leaders and Learners in the impact investing field—a distinction that will become clearer as additional verifications are completed.

FIGURE F

The Benchmark for Impact Investing Practice



Conclusion

There is little doubt that the sustainable investing market will continue to grow, both in terms of the number of funds and managers and the total amount of capital. But how the market grows and develops is still very much up for debate.

Private organizations like IMP and PRI have historically led this debate and contributed countless tools, frameworks, principles, and innovations. But with regulators now also joining the debate, the sustainable investing market is poised to enter a new chapter that is defined less by confusion and skepticism and more by harmony and trust.

Indeed, both standard-setters and regulators are pushing in the direction of greater transparency and accountability, with several more major milestones expected in the months ahead. A preview of some of these developments is included below.

FIGURE G

Upcoming milestones in the evolution of sustainable investing regulations and standards

DEC. 2021	G7 Impact Taskforce delivers report to G7 with recommendations for harmonizing the sustainable investing market and accelerating the flow of capital to sustainable investments and companies
Q1 2022	SEC proposed rules on climate-change disclosures and human capital management disclosures
APRIL 2022	Mandatory TCFD disclosures for UK-registered companies and financial institutions go into effect
MID-2022	ISSB publishes standards for climate reporting
MID-2022	SDG Impact launches framework for assurance
2022	CFA Institute publishes Assurance Procedures to enable independent assurance of ESG disclosure statements
2022	DOL finalizes rules for ERISA plans clarifying that ERISA fiduciaries should consider financially material ESG factors in their investment decisions
2022	UK FCA sustainability disclosure comment period closes
2022	EFRAG and GRI co-construct new biodiversity standards to align global and European sustainability reporting
JAN. 2023	SFDR Regulatory Technical Standards (Level 2) go into effect

Nobody can predict what this market will look like in six months, let alone five or 10 years from now. But the signs are there for those who know where to look.

We believe that managers can position themselves for this uncertain future while complying with emerging and evolving standards and regulations by taking the four steps described in this paper: classifying their products, assessing their practices, identifying applicable regulation, and, as appropriate, engaging an independent verifier.

This is an ever-changing field. For more information, please contact a member of the BlueMark or Morgan Lewis teams listed below.

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Appendix

EU SUSTAINABLE FINANCE TAXONOMY

- In effect in Europe since July 2020, Taxonomy Regulation is a classification system that helps companies determine which activities qualify as sustainable and enables investors to understand the environmental sustainability of their activities.
- Taxonomy Regulation establishes six environmental objectives:
  - *Climate change mitigation*
  - *Climate change adaptation*
  - *Sustainable use and protection of water and marine resources*
  - *Transition to a circular economy*
  - *Pollution prevention and control*
  - *Protection and restoration of biodiversity and ecosystems*
- Qualifying activities must:
  - *Contribute substantially to one or more objectives*
  - *Do no significant harm to any environmental objectives*
  - *Be carried out in compliance with minimum social safeguards*
  - *Comply with technical screening criteria*

SUSTAINABLE FINANCE DISCLOSURE REGULATION

(SFDR)

- Applicable to EU fund managers of private investment funds and other funds or accounts considered "financial products."
- Phase 1 (effective March 2021) established three categories of investment funds, based on the significance of a fund's consideration or integration of environmental, social, and/or sustainable characteristics:
  - *Financial products promoting environmental or social characteristics*
  - *Financial products with a targeted sustainability objective*
  - *Other products not covered by the first two categories*
- Phase 2 (effective January 2023) will provide detailed requirements around the presentation of fund disclosures related to ESG risks and other ESG claims.

  Three steps for companies to take to align with regulatory requirements and anticipate the disclosure requirements:
  - *Assess sustainability risks that may impact their own activities with quantitative and qualitative data and produce internal reports;*
  - *Evaluate principal adverse impacts stemming from their own activities; and*
  - *Define strategic sustainability targets either as promoting environmental and/or social characteristics or contributing to an environmental or social objective.*

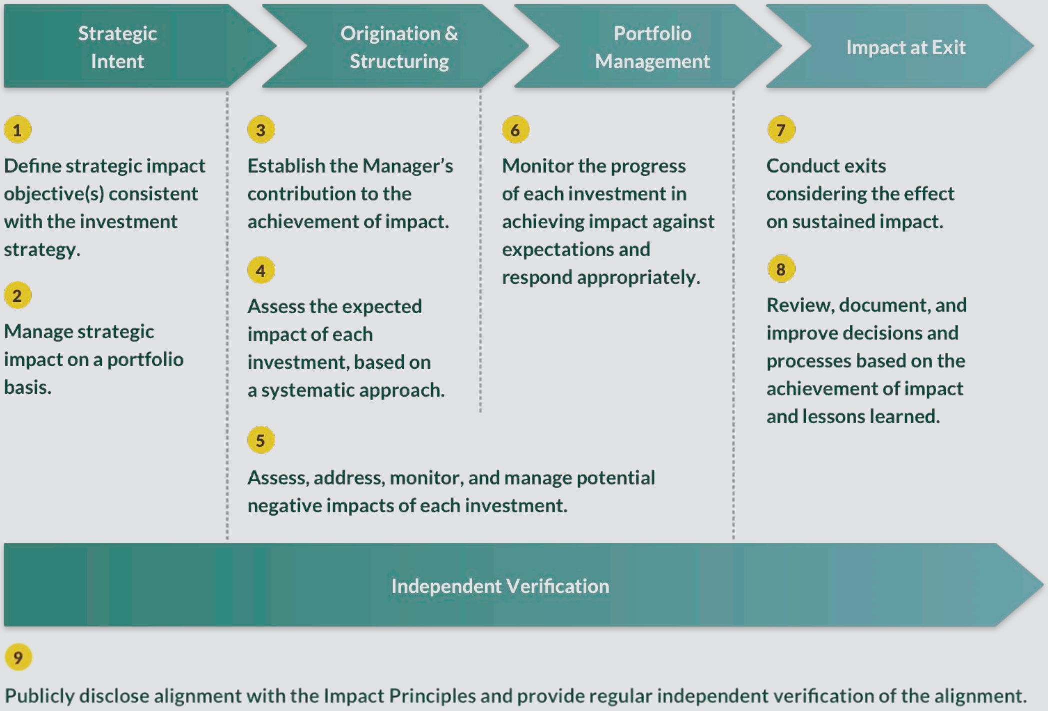
OPERATING PRINCIPLES FOR IMPACT MANAGEMENT (IMPACT PRINCIPLES)

Operating Principles for Impact Management

The Impact Principles are a framework for investors for the design and implementation of their impact management systems, ensuring that impact considerations are integrated throughout the investment lifecycle. They may be implemented through different types of systems, each of which can be designed to fit the needs of an individual organization. They do not prescribe specific tools and approaches, or specific impact measurement frameworks. The expectation is that industry participants will continue to learn from each other as they implement the Impact Principles.

The Impact Principles are scalable and relevant to all types of impact investors and sizes of investment portfolios, asset types, sectors, and geographies. The Impact Principles may be adopted at the corporate, line of business, fund, or investment vehicle level. Asset managers with a diverse set of investment products may decide to adopt the Impact Principles for only specific funds or vehicles that they consider impact investments and need not adopt the Impact Principles for the entirety of their assets. As well, asset owners that invest in bonds, funds, and other investment vehicles may apply the Impact Principles to their own investment processes. The Impact Principles do not have to be followed by the investee company, fund, or asset.

The way in which the Impact Principles are applied will vary by type of investor. Asset owners and their advisors may use them to screen impact investment opportunities. Asset managers may use the Impact Principles to assure investors that impact funds are managed in a robust fashion.



INFORMATION SOURCED FROM THE IMPACT PRINCIPLES WEBSITE AT
HTTPS://WWW.IMPACTPRINCIPLES.ORG/

SDG IMPACT STANDARDS

SDG Impact

The Standards are decision-making standards, not performance or reporting standards. They are designed to help organizations integrate operating responsibly and sustainably and contributing positively to sustainable development and the SDGs into organizational systems, investment frameworks and decision-making practices, using a common language and shared approach to do so.

The foundation of the Standards is operating sustainably and contributing positively to sustainable development and the SDGs. This cannot be achieved without demonstrating respect for human rights in line with the United Nations Guiding Principles for Business and Human Rights (UNGPs), planetary boundaries in line with science-based targets, and other responsible business practices in line with the UNGC's Ten Principles and UN Women's Empowerment Principles and is realized through effective impact management and decision making. The Standards are organized around four interconnected themes – strategy, management approach, transparency, and governance (see Figure 1) – each of which plays an important role in fully integrating sustainability and contributing positively to the SDGs into organizational systems and decision making.

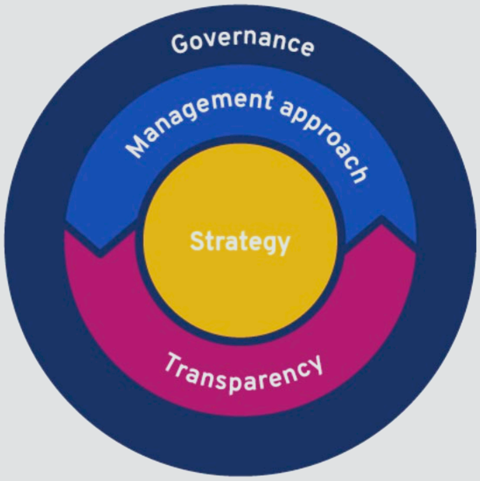
- Strategy Embedding sustainability and contributing positively to the SDGs in purpose and strategy is important because it drives attention, focus and resources to what matters most and where the organization can have the most significant impact on important outcomes – including by reducing negative ones. It recognizes that organizations' prospects for future prosperity increasingly depend on the health of the planet and the wellbeing of humanity. Operating responsibly and sustainably and contributing to the SDGs is not an add on to what business gets done – it's how all business gets done.

- Management approach Integrating responsible business practices and impact management into organizational systems and decision making is about setting the right conditions to maximize chances of achieving the organizational goals of contributing positively to the SDGs and increasing the probability of success over time. It helps organizations generate options and make more informed choices between those options to optimize their contribution towards sustainable development and the SDGs.

- Transparency Being transparent is an important element of being accountable to Stakeholders – all interested parties including those affected or potentially affected in future by the organization's decisions and activities. It also helps Stakeholders make more informed decisions, for instance about whether they want to work with or for the organization, invest in or lend to the organization, or buy or use the organization's products and services. To be effective, transparency needs to be useful and accessible to all Stakeholders.

- Governance Governance is an essential element of embedding responsible business and impact management practices into organizational decision-making. The organization's informal and formal governance mechanisms define expectations of behavior, how decisions are made and how the organization holds itself and others accountable for their decisions and actions in accordance with its values, principles, and policies.

Figure 1: The SDG Impact Standards



INFORMATION SOURCED FROM A REPORT INTRODUCING THE SDG IMPACT STANDARDS AVAILABLE AT HTTPS://SDGIMPACT.UNDP.ORG/ASSETS/ABOUT-THE-SDG-IMPACT-STANDARDS.PDF

IMPACT MANAGEMENT PROJECT (IMP)

Some investors are motivated to manage impact because the creation of positive change for people and planet is why they exist. Some are driven by a concern about regulatory and reputational risk. Some see it as a way to unlock commercial value — for example, backing enterprises that are cost-cutting through energy savings or increasing customer loyalty. And some just believe that use of the capital should align with their personal values.

Depending on their motivation, investors' intentions therefore range from broad commitments, such as "to mitigate risk", "to achieve sustainable long-term financial performance", or "to leave a positive mark on the world", to more detailed objectives such as "to support a specific group of people, place, outcome" or "to address a specific social or environmental challenge". Each of these intentions relates to one of three types of impact: A, B or C.

- A. At a minimum, investors can choose enterprises that act to avoid harm to their stakeholders, for example decreasing their carbon footprint or paying an appropriate wage; such 'responsible' enterprises can also mitigate reputational or operational risk (often referred to as ESG risk management), as well as respect the personal values of their asset owners.

- B. In addition to acting to avoid harm, investors can also favour enterprises that actively benefit stakeholders, for example proactively upskilling their employees, or selling products that support good health or educational outcomes; an increasing range of these 'sustainable' enterprises are doing so in pursuit of financial outperformance over the long term (often referred to as pursuing ESG opportunities).

- C. Many investors can go further: they can also invest in enterprises that are using their full capabilities to contribute to solutions to pressing social or environmental problems, such as enabling an otherwise underserved population to achieve good health or educational outcomes or hiring and upskilling individuals who were formerly long-term unemployed.

By being clear about their impact goals, investors can review their portfolio to assess whether the enterprises/assets they are invested are – or are not – achieving those goals.

Enterprises' intentions relate to three types of impact: A, B or C

Illustrative example

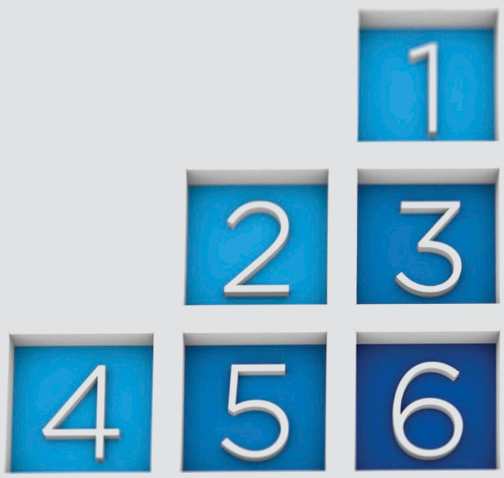
INFORMATION SOURCED FROM THE IMP WEBSITE AVAILABLE AT
HTTPS://IMPACTMANAGEMENTPROJECT.COM/IMPACT-MANAGEMENT/HOW-INVESTORS-MANAGE-IMPACT/

PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

The six Principles for Responsible Investment offer a menu of possible actions for incorporating ESG issues into investment practice.

The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. They have attracted a global signatory base representing a majority of the world's professionally managed investments.

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



INFORMATION SOURCED FROM THE PRI WEBSITE AVAILABLE AT
HTTPS://WWW.UNPRI.ORG/PRI/WHAT-ARE-THE-PRINCIPLES-FOR-RESPONSIBLE-INVESTMENT