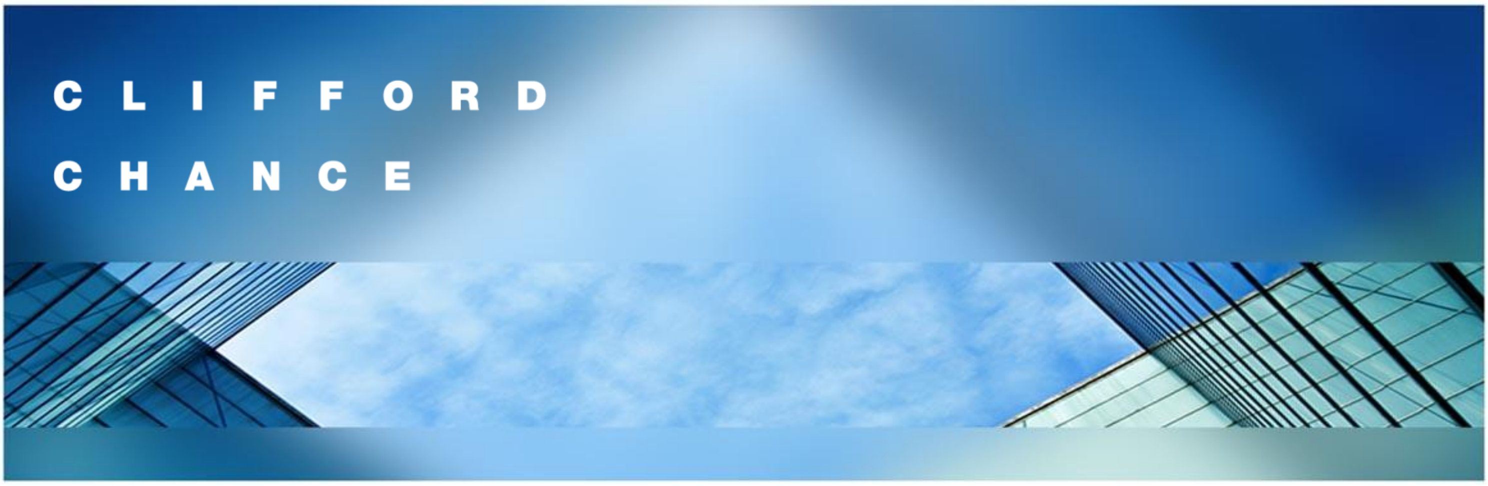

THE FSRA PUBLISHES GUIDANCE ON ESG FUNDS AND MODEL PORTFOLIOS

The Financial Services Regulatory Authority ("**FSRA**") has issued guidance on 14 November 2024 concerning funds domiciled in or marketed into or from the ADGM which claim ESG characteristics (the "**ESG Guidance**"). The ESG Guidance aims to clarify FSRA expectations for the management and marketing of such vehicles, mitigate the risk of greenwashing, and encourage transparent disclosure of ESG-related information in line with global best practices.

In this briefing, we cover the main points from the ESG Guidance with respect to the FSRA's expectations of funds holding themselves out as having ESG characteristics and the implications for fund managers.

Key issues

- ESG funds are expected to provide sufficient information for investors to understand the investment strategy and any underlying indicators.
- Broad descriptors such as "sustainable" do not provide sufficient clarity to investors given the plethora of potential meanings.
- Fund managers are encouraged to make use of recognized frameworks, taxonomies, indices and attestation services to assure stakeholders that funds are being managed in accordance with their stated methodologies.

SCOPE AND AIMS

The ESG Guidance applies to "**ESG Investment Vehicles**", meaning:

(a) **Domestic Funds**, being funds established or domiciled in the ADGM;

(b) **Model Portfolios**, being portfolios of segregated holdings managed on a discretionary basis where each client has a separate agreement with the manager but all clients in a particular profile receive the same portfolios and these are traded and adjusted at the same time and in the same way; and

(c) **Foreign Funds**, being funds that are not established or domiciled in the ADGM where such fund is marketed into or from the ADGM or where any "Regulated Activity" under the Financial Services and Markets Regulations 2015 is carried out within the ADGM with respect to such fund,

which choose to hold themselves out as having environmental, social and/or governance characteristics.

The ESG Guidance will also impact "other ADGM Authorised Persons that provide financial services or raise investor funds while purporting to have ESG characteristics".

The ESG Guidance affirms the FSRA's position that electing to promote an ESG Investment Vehicle as having an "ESG focus" is at the discretion of the vehicle and its manager.

The ESG Guidance is distinct from an ESG-labelling framework such as the FSRA's existing framework for the designation of ADGM "Green and Climate Transition" funds and portfolios. Instead, the ESG Guidance explains how the FSRA's expectation is that communications to investors in relation to ESG sustainability standards remain clear, fair and not misleading.

INVESTMENT STRATEGIES AND MARKETING

ESG has taken on many meanings since the UN Compact coined the term. ESG is now used as shorthand for a broad set of impact investing and management strategies. However, the term was originally intended to encourage investors to consider the financial impacts of ESG factors as part of their broader analyses.

The ESG Guidance sets out the FSRA's understanding of the main strategies of ESG investing as falling into four categories:

- **ESG Integration**, meaning ongoing consideration of ESG factors within an investment analysis and decision-making process with the aim to improve risk-adjusted returns;
- **Screening**, meaning applying rules based on defined criteria that determine whether an investment is permissible;
- **Impact Investing**, meaning investing with the intention to generate positive, measurable social and/or environmental impact alongside a financial return; and
- **Thematic Investing**, meaning selecting assets to access specified trends.

The ESG Guidance makes clear that the FSRA does not expect funds to conform to any particular investment category or strategy. Rather, the regulatory intention is to ensure that investment products should not mislead investors as to their focus and objectives.

The use of broad terms like "sustainable" or "responsible" must be accompanied by clarifying disclosures to ensure that investors understand the specific ESG objectives of the product. Where a vehicle allows itself a level of discretion to make investments which do not conform with its headline ESG objectives/criteria, it must disclose the relevant thresholds, for example by reference to proportions of its holdings.

If an ESG Investment Vehicle employs multiple investment strategies, it must clearly communicate these strategies and their interplay to avoid category errors. Furthermore, ESG Investment Vehicles which aim to achieve measurable ESG impact are expected to provide detailed information about the metrics and indicators they use to measure such impact, as well as any limitations or uncertainties in their reporting. Regular monitoring and evaluation of performance against these metrics is also required.

EXTERNAL FRAMEWORKS AND ATTESTATION

The FSRA advocates for the use of independent, third-party, published and credible taxonomies for asset selection in ESG Investment Vehicles. The ESG Guidance considers that such taxonomies help clarify the practical meaning of "ESG" in the context of a particular product or service.

The ESG Guidance encourages ESG Investment Vehicles to select taxonomies that cover all three components (i.e. environmental, social and governance) of ESG and to document the processes and justifications for their selection. Additionally, once a taxonomy is chosen, the ESG Investment Vehicle is required to disclose this choice to investors in relevant documentation and marketing materials. Specifically, the ESG Guidance references the EU's taxonomy for sustainable activities and the UN Sustainable Development Goals as examples of internationally recognized ESG taxonomies.

The ESG Guidance also highlights the role of third-party attestation as an existing requirement for Green Funds under the ADGM Fund Rules. Similarly, the ESG Guidance affirms the FSRA's support for ESG Investment Vehicles making use of third-party attestation to provide reassurance to investors that funds are being managed in accordance with their objectives.

As an exception, attestation should not be necessary for ESG Investment Vehicles whose asset selection methodology relies on an ESG benchmark or index. Nevertheless, where an ESG benchmark is used in investment selection, the relevant fund should provide investors with information on such benchmark's methodology and the underlying data.

This reflects the unease many investors otherwise experience when relying on benchmarks due to "issues relating to data quality, the inability of regulators or investors to verify or audit the underlying data, reliance on hard-to-clarify concepts, and potential conflicts of interest".

CONCLUSION

The ESG Guidance provides useful clarity on the FSRA's approach to regulating communications from ESG funds and preventing greenwashing in the asset management space. By understanding the FSRA's outlook on the ESG fund market, and by having regard to the regulator's suggestions as to how its expectations may be satisfied, fund managers are better equipped to ensure compliance and provide comfort to their stakeholders.

As well as the particular approaches suggested in respect of attestation and benchmarking, the FSRA's overriding emphasis remains on the importance of accuracy, clarity and simple language in avoiding risks of greenwashing and/or misleading investors as to the methodology or impact of a fund.

Whereas the FSRA's existing framework on Green and Climate Transition funds provides an avenue for standardisation, the ESG Guidance seeks to clarify the variety of approaches taken in formulating and marketing ESG funds across the broader market. In any case, the goal is to ensure investors are appropriately informed.

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