Sustainable Finance Disclosures Regulation

Spotlight on the Regulatory Technical Standards

While many firms are racing to the 10 March finish line to prepare the disclosures required under the Sustainable Finance Disclosures Regulation (SFDR), these initial disclosures represent just a first wave while the industry awaits the more detailed implementing rules that will underpin core elements of the new disclosure framework.

Under SFDR, the Joint Committee of the European Supervisory Authorities (ESAs) of ESMA, EIOPA, and EBA were tasked with developing detailed rules, known as Regulatory Technical Standards (RTS), in relation to two key areas of the framework: Entity-level disclosures on principal adverse impact and product-level disclosures for ESG products (often known as Article 8 and Article 9 products).

The final advice from the ESAs was published on 4 February, with a suggested implementation date of 1 January 2022. This gives the industry precious little time to understand the key elements of these new requirements and put the necessary processes in place to be ready to comply by the deadline. In a supervisory statement released on 25 February 2021, the ESAs "recommend[ed] national competent authorities to encourage financial market participants and financial advisers to use the interim period from 10 March 2021 until 1 January 2022 to prepare for the application of the RTS."

A final piece of the jigsaw puzzle, the product-level disclosures required under the Taxonomy, also due to be implemented by 1 January 2022, is still to be developed, meaning firms are likely to be further squeezed when it comes to their implementation timelines.

In this briefing note, we will seek to highlight some of the key elements of the regulatory technical standards, including changes from the drafts consulted on last year.

Timeline for adoption

4 February 2021	ESAs publish final Regulatory Technical Standards.
25 February 2021	ESAs publish Supervisory Statement on SFDR.
March 2021 (tbc)	ESMA due to commence consultation on Taxonomy disclosures for Article 8 and Article 9 products.
April 2021 (tbc)	European Commission expected to adopt SFDR RTS, together with package of Level 2 measures under UCITS, AIFMD, Solvency 2, IDD and MiFID. From the date of adoption, the co-legislators, the European Parliament and the Council, have three months to object or request an extension to the scrutiny period.
August 2021 (tbc)	Assuming no objections from the co-legislators, the RTS will be final and will be published in the Official Journal.
1 January 2022	Deadline to implement the RTS and Taxonomy disclosures.

1. Principal adverse impacts disclosures

Under SFDR, firms will be required to provide a statement on whether they consider "principal adverse impacts" in their investment decision-making or a clear explanation of why they do not do so. Financial advisers must also provide a statement setting out whether they consider principal adverse impact in their investment advice. Firms with more than 500 employees must provide the required disclosures by 30 June 2021; however, this can be on a high level and principles-based given the absence of the regulatory technical standards.

The final regulatory technical standards remain consistent with the spirit of the drafts consulted on in the summer of 2020, but some changes have been introduced in response to industry feedback. The requirements contained within the RTS are detailed, but we would highlight three key areas of focus: Disclosure of mandatory indicators, a framework to prioritise other principal adverse impacts, and the link to engagement policies.

a) Mandatory indicators

As signalled in the drafts consulted on in 2020, the ESAs consider that there is a need to define a template and a core set of indicators that firms must report against in order to ensure comparability of disclosures, which was subject to strong opposition by the industry. However, firms will be relieved to see that the list of indicators has been reduced to 14 indicators for investee companies, while separate indicators have been developed for sovereigns and real estate.

While the reduction in the number of indicators is to be welcomed, many of the indicators are likely to continue to represent challenges for firms to source the requisite data in the right format. While some indicators require very precise quantitative metrics, others are more qualitative. Sourcing and aggregating this data is therefore likely to be a significant task for firms to complete.

While the ESAs recognise current data limitations, the RTS calls for firms to undertake best efforts to acquire the information, including employing external market research providers, internal financial analysts and specialists in the area of sustainable investments, undertake specifically commissioned studies, use publicly available information or shared information from peer networks or collaborative initiatives, as well as engaging directly with companies. We would also highlight an additional challenge pertaining to the need to look through certain holdings, such as investments in holding companies or funds in order to assess the principal adverse impacts of the underlying investments.

Corporate issuers

+ Total greenhouse gas (GHG) emissions, plus GHG emissions split by Scope 1, Scope 2, and Scope 3
+ Carbon footprint
+ GHG intensity of investee companies
+ Share of investments in companies active in the fossil fuel sector
+ Share of non-renewable energy consumption and non-renewable energy production of investee companies from non-renewable energy sources compared to renewable energy sources, expressed as a percentage
+ Energy consumption in GWh per million EUR of revenue of investee companies, per high impact climate sector
+ Share of investments in investee companies with sites/operations located in or near to biodiversity-sensitive areas where activities of those investee companies negatively affect those areas
+ Tonnes of emissions to water generated by investee companies per million EUR invested, expressed as a weighted average
+ Tonnes of hazardous waste generated by investee companies per million EUR invested, expressed as a weighted average
+ Share of investments in investee companies that have been involved in violations of the UNGC principles or OECD Guidelines for Multinational Enterprises
+ Share of investments in investee companies without policies to monitor compliance with the UNGC principles or OECD Guidelines for Multinational Enterprises or grievance/complaints handling mechanisms to address violations of the UNGC principles or OECD Guidelines for Multinational Enterprises
+ Average unadjusted gender pay gap of investee companies
+ Average ratio of female to male board members in investee companies
+ Share of investments in investee companies involved in the manufacture or selling of controversial weapons

Sovereign issuers

+ GHG intensity of investee countries
+ Number of investee countries subject to social violations (absolute number and relative number divided by all investee countries), as referred to in international treaties and conventions, United Nations principles and, where applicable, national law

Real estate

+ Share of investments in real estate assets involved in the extraction, storage, transport, or manufacture of fossil fuels
+ Share of investments in energy-inefficient real estate assets

b) Framework for assessing materiality of other principal adverse impacts

In addition to the mandatory indicators, firms will be required to report on at least one additional environmental indicator and at least one additional social indicator selected from a longer list of indicators. While the ESAs set out that firms should be encouraged to report on as many principal adverse impacts as possible, firms will need to have in place a framework to assess and select additional indicators that are most material to their investments.

In defining such a framework, the ESAs have set out the following considerations that would need to be taken into account:

"The **scope, severity, probability of occurrence and potentially irremediable character on sustainability factors.** For this purpose, the scope should concern the reach of the effects of the impact, for example, the number of individuals that could be affected, [...], or the extent of environmental damage, [...]. The probability of occurrence and the potentially irremediable character of the principal adverse impacts on sustainability factors should concern the likelihood of adverse impacts materialising and whether these materialised impacts could lead to irreparable environmental or social harm."

c) Engagement and proxy voting

An evolution of the framework from earlier drafts includes a greater emphasis on the link between the due diligence on principal adverse impacts and a firm's engagement and proxy voting, in particular as a means to demonstrate that actions have been taken to mitigate principal adverse impacts. A summary of such actions has now been integrated into the reporting template, to be shown alongside the PAIs.

We would highlight, however, that the ESAs have set out particularly high expectations for such engagements, including "setting up documented and time-bound engagement in actions or shareholder dialogue with specific sustainability objectives and planning escalation measures in case those objectives are not achieved, including reductions of investments or exclusion decisions." The RTS also specifically calls for the firm's engagement policies to set out "how those policies adapt where there is no reduction of the principal adverse impacts over **more than one reference period."**

Timeline

By 10 March 2021	Firms with less than 500 employees to include statement on websites as to whether they consider principal adverse impacts, based on high-level principles-based approach set out in SFDR Regulation.
By 30 June 2021	Firms with more than 500 employees to publish PAI statement on websites based on high-level principles-based approach set out in SFDR Regulation.
By 1 January 2022	Publication of due diligence policies, including information on engagement policies and standards adhered to, including RTS requirements.
1 January 2022-31 December 2022	First reporting period, with calculation of PAIs conducted on four touchpoints on 31 March, 30 June, 30 September, and 31 December.
30 June 2023	First annual reporting of PAIs.

2. Product disclosures for Article 8 and Article 9 products

Under the SFDR Regulation, ESG products are segmented into two broad categories: Article 8 products that promote an environmental or social characteristic and Article 9 products that have sustainable investments as their objective. Products falling under these categories are required to provide enhanced disclosure in their pre-contractual documents, on websites and in periodic reporting.

A major criticism of the proposals consulted on last year was that the proposed templates applied a "one-size-fits-all" approach to disclosure that was unlikely to be suitable for the wide range of products to be covered. In the commentary accompanying the final RTS, the ESAs have highlighted the challenge of developing a common set of reporting templates that are relevant to a broad array of products and strategies that will be covered by Article 8 and Article 9. In particular, the ESAs recognised that the level of granularity required by these disclosures is likely to be far too detailed for the average retail investor, as attested by consumer testing undertaken by the Dutch regulator, but not comprehensive enough to satisfy the needs of professional investors. The resulting templates are therefore a compromise, requiring firms to provide detailed and granular disclosures but with some additional flexibility to tailor the disclosures to the strategy in certain areas.

We would highlight a number of areas that deserve to be called out, including debates regarding the scope of products that should be classified under Article 8 and Article 9, the new modular approach to disclosures, the link to principal adverse impact in product disclosures, and the disclosure regime applicable to passive investment strategies.

a) Scope of Article 8 and Article 9

A key question in relation to the implementation of SFDR concerns the scope of products that fall under Article 8 and Article 9, given that the SFDR regulation does not set out clear criteria in this regard. The question of scope is one that the ESAs have raised with the European Commission in a letter in January 2021, and a response to this letter from the European Commission clarifying this question of scope is expected in the coming weeks. Notwithstanding any clarification from the European Commission, the final RTS includes some hints as to how the ESAs view this question.

With regards to the scope of Article 8, the ESAs set out in the recitals view that the scope of Article 8 is intended to be broad, including exclusion and best-in-class approaches. However, the ESAs also make reference to products that have "minimum environmental and social safeguards" as not being within the scope of any "environmental and social characteristics."

In relation to Article 9, the ESAs again have included commentary that they consider that only products that almost exclusively invest in sustainable investments should fall under Article 9 and that any other investments should not undermine the sustainable investment objective of the fund, which would seem to place a very high bar for funds to be considered as Article 9.

ESAs letter to European Commission clarifying Level 1

Scope of Article 8

+ Can the name of a product like "sustainable" or "ESG" be considered as promoting an E/S characteristic?
+ Does the consideration of ESG factor or risks constitute promotion? If so, how can firms comply with Article 6 without triggering Article 8 disclosures?
+ Would an intrinsic characteristic, such as a tobacco exclusion, or complying with national laws, e.g., cluster munition, even without any explicit promotion, be within scope of Article 8?
+ Do Article 8 products need to invest a minumum share of investments in sustainable investments to qualify as Article 8?

Scope of Article 9

- + Must Article 9 products only invest in sustainable investments, or should a minumum proportion of investments be in sustainable investments?
- + Where an EU Climate Transition Benchmark or Paris Aligned Benchmark exists, is it necessary for a passive fund to track such a benchmark for Article 9(3) to apply?
- + If the questions above are affirmative and the EU CTB/PAB does not require index components to track sustainable investments, can the product fall within Article 9(3)?

b) Modular approach to Article 8 and Article 9

A major criticism of the draft RTS consulted on last year and the proposed templates was that the disclosures were not flexible enough to cater to the wide range of strategies that are likely to fall under Article 8. The final RTS attempts to address this issue by taking a more modular approach to disclosures, focusing on the following core elements:

- + Whether the product invests partially in sustainable investments (for Article 8 only).
- + Whether the product considers principal adverse impacts.
- + Whether the product is a passively managed strategy using a reference benchmark to attain its environmental or social characteristics or its sustainable investment objective.
- + Whether the product has carbon reduction as its objective (for Article 9 only).

The answers to these questions will determine whether additional sections of the template are required to be completed, in addition to the core disclosures that are required, covering:

- + **The environmental and/or social characteristics or sustainable investment objective of the product:** This should include a list of sustainability indicators used to measure the attainment of the environmental and/or social characteristics or sustainable investment objective of the fund.
- + **The investment strategy pursued:** This section is limited to those elements of the investment strategy that are binding and a description of the good governance policies applied, the definition of which has now been aligned across Article 8 and Article 9 funds. For Article 8 products, the information disclosed in this section should also include any commitment to a minimum reduction in the investment universe.
- + **The planned asset allocation:** This information should include the minimum allocation to investments that meet the environmental and/or social characteristics of the sustainable investment objective of the fund and the purpose of any "other" investments, including the use of derivatives. For Article 8 products, this section should also this should include whether any sustainable investments are made.

The website disclosures and periodic reporting largely follow the same pattern as the pre-contractual disclosures, with some additional information to be included.

For the website disclosures, there is a clear focus on methodologies for calculating the sustainability indicators, data and its limitations, due diligence and internal controls, as well as engagement policies followed by the product, including measures taken in relation to sustainability controversies.

For periodic reporting, additional disclosures include the top 15 investments and a breakdown of investments by sectors, including any fossil fuel investments, as well as any engagement or other actions taken in support of the environment or social characteristics or sustainable investment objective of the product.

c) Consideration of principal adverse impacts and the Do No Significant Harm principle

As mentioned above, product providers will need to clearly disclose whether the product considers principal adverse impacts from 1 January 2022, as the ESAs consider that the consideration of principal adverse impacts would be one way for a product to promote an environmental or social characteristic. This is in addition to any existing requirements under Article 7 of the SFDR, which requires firms that comply with entity-level disclosures in relation to

PAI to include information in pre-contractual and periodic disclosures on whether and, if so, how the product considers principal adverse impact.

A second key area where the principal adverse impact indicators are used is in relation to the "Do No Significant Harm" principle for sustainable investments. Article 9 products and any Article 8 products that commit to partially invest in sustainable investments will be required to disclose how the product takes into account the mandatory indicators that have been developed for entity-level reporting (see above), in addition to the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights to align with the Taxonomy definition of "minimum social safeguards."

d) Passive strategies and disclosure on reference benchmarks

Where a fund uses a reference benchmark to attain its environmental or social characteristics or sustainable investment objective, the ESAs consider that core methodological disclosures should be made at the index level for such financial products. Such products would therefore be required to supplement the core disclosures with the following:

+ An explanation of how the reference benchmark is continuously aligned with each of the environmental or social characteristics promoted by the financial product or the sustainable investment objective and with the investment strategy.
+ An explanation of how the designated index differs from a relevant broad market index.
+ An indication of where the methodology used for the calculation of the designated index can be found.

Such additional detail is also matched in the periodic reporting requirements, where passive strategies would be required to include a comparison of the performance of the financial product with regard to the indicators measuring the sustainability factors of the index and a comparison of the performance during the reference period of the financial product with regard to a relevant broad market index.

Timeline

By 10 March 2021	Article 8 and Article 9 product disclosures to be produced, in accordance with high-level and principles-based approach, set out in the SFDR Regulation.
By 1 January 2022	Pre-contractual disclosures annexes to be completed using the RTS template.
From 1 January 2022	First periodic reporting using templates to be developed in 2022, covering the previous reference period, unless the RTS are adopted after July 2021, in which case the ESAs recommend that periodic reports using the RTS templates should commence for reference periods from 1 January 2022, with periodic reports published later in 2022 or 2023 depending on the reference period.
By 30 December 2022	Firms subject to entity-level reporting to include statement in pre-contractual disclosures whether, and if so, how the product considers principal adverse impact and that information on such impacts can be found in periodic reports.

Summary of SFDR and TR disclosure obligations on financial market participants, financial advisers, and financial products

Content (Article)	Entity or product level disclosure	Application of Level 1 obligation	Draft application date of RTS provisions
Sustainability risks policy (Article 3 SFDR)	Entity (financial market participants and financial advisers)	10 March 2021	N/A (Level 1 provisions are not complemented by RTS)
PAI of investment decisions on sustainability factors at entity level (Article 4(1)(a), 4(2), 4(3), 4(4), 4(5)(a) SFDR)	Entity (financial market participants and financial advisers)	10 March 2021 (30 June 2021 for financial market participants or parent undertakings of financial market participants with more than 500 employees)	1 January 2022. As set out in Article 4 RTS, the first statement to contain non reference period information. Second statement to contain information relating to reference periods by 30 June each year with a reference period of the previous calendar year. The first possible reference period under the RTS is 1 January 2022 – 31 December 2022, and the statement covering that reference period must be published no later than 30 June 2023. The reporting of GHG Scope 3 emissions applies to reference periods starting from 1 January 2023.
No consideration of PAI at entity level (Article 4(1)(b), 4(5)(b) SFDR)	Entity (financial market participants and financial advisers)	10 March 2021	1 January 2022
Consistency of remuneration policies with the integration of sustainability risks (Article 5 SFDR)	Entity (financial market participants and financial advisers)	10 March 2021	N/A (Level 1 provisions are not complemented by RTS)
Integration of sustainability risks into investment decisions and investment advice (Article 6 SFDR)	Financial product and financial advice	10 March 2021	N/A (Level 1 provisions are not complemented by RTS)
Consideration of PAI at product level (Article 7(1) SFDR)	Financial product	30 December 2022	N/A (Level 1 provisions are not complemented by RTS)
No consideration of PAI at product level (Article 7(2) SFDR)	Financial product	10 March 2021	N/A (Level 1 provisions are not complemented by RTS)

Content (Article)	Entity or product level disclosure	Application of Level 1 obligation	Draft application date of RTS provisions
Pre-contractual disclosures for products promoting environmental or social characteristics (Article 8 SFDR and Article 6 TR)	Financial product	(1) 10 March 2021 (Article 8(1) and (2) SFDR) (2) 1 January 2022 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (Article 8(2a) SFDR (3) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR)	(1) 1 January 2022 (2) 1 January 2022 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (3) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR
Pre-contractual disclosures for products with sustainable investment objective (Article 9 SFDR and Article 5 TR)	Financial product	(1) 10 March 2021 (Article 9(1), (2) and (3) SFDR) (2) 1 January 2022 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (Article 9(4a) SFDR) (3) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR (Article 9(4a) SFDR)	(1) 1 January 2022 (2) 1 January 2022 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (3) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR
Website disclosures for Article 8 and 9 SFDR products (Article 10 SFDR)	Financial product	10 March 2021	1 January 2022

Content (Article)	Entity or product level disclosure	Application of Level 1 obligation	Draft application date of RTS provisions
Periodic reporting disclosures for Article 8 and 9 SFDR products and Article 5 and 6 TR products (Article 11 SFDR, Article 5-6 TR)	Financial product	(1) Periodic reports issued from 1 January 2022, including the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (Article 11(1) SFDR) (2) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR (Article 11(1)(c) and (d) SFDR)	(1) Periodic reports issued from 1 January 2022, including the taxonomy-related disclosures for environmental objectives referred to in Article 9(a)-(b) TR (Article 11(1) SFDR) (2) 1 January 2023 for the taxonomy-related disclosures for environmental objectives referred to in Article 9(c)-(f) TR (Article 11(1)(c) and (d) SFDR)
Review of disclosures (Article 12 SFDR)	Entity (financial market participants and financial advisers) and financial product	10 March 2021	N/A (Level 1 provisions are not complemented by RTS)
Marketing communications not contradicting disclosures in SFDR (Article 13 SFDR)	Entity (financial market participants and financial advisers) and financial product	10 March 2021	Option to develop ITS on standardised presentation of marketing communication has not been exercised by the ESAs to date

Notes:
+ SFDR: Sustainability-related disclosures in the financial services sector
+ TR: Taxonomy regulation
+ PAI: Principal adverse impacts
+ RTS: Regulatory technical standards

Sources: European Securities and Markets Authority, European Banking Authority, European Insurance and Occupational Pensions Authority, Joint Committee of the European Supervisory Authorities, Joint ESA Supervisory Statement on the application of the Sustainable Finance Disclosure Regulation, 25 February 2021

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