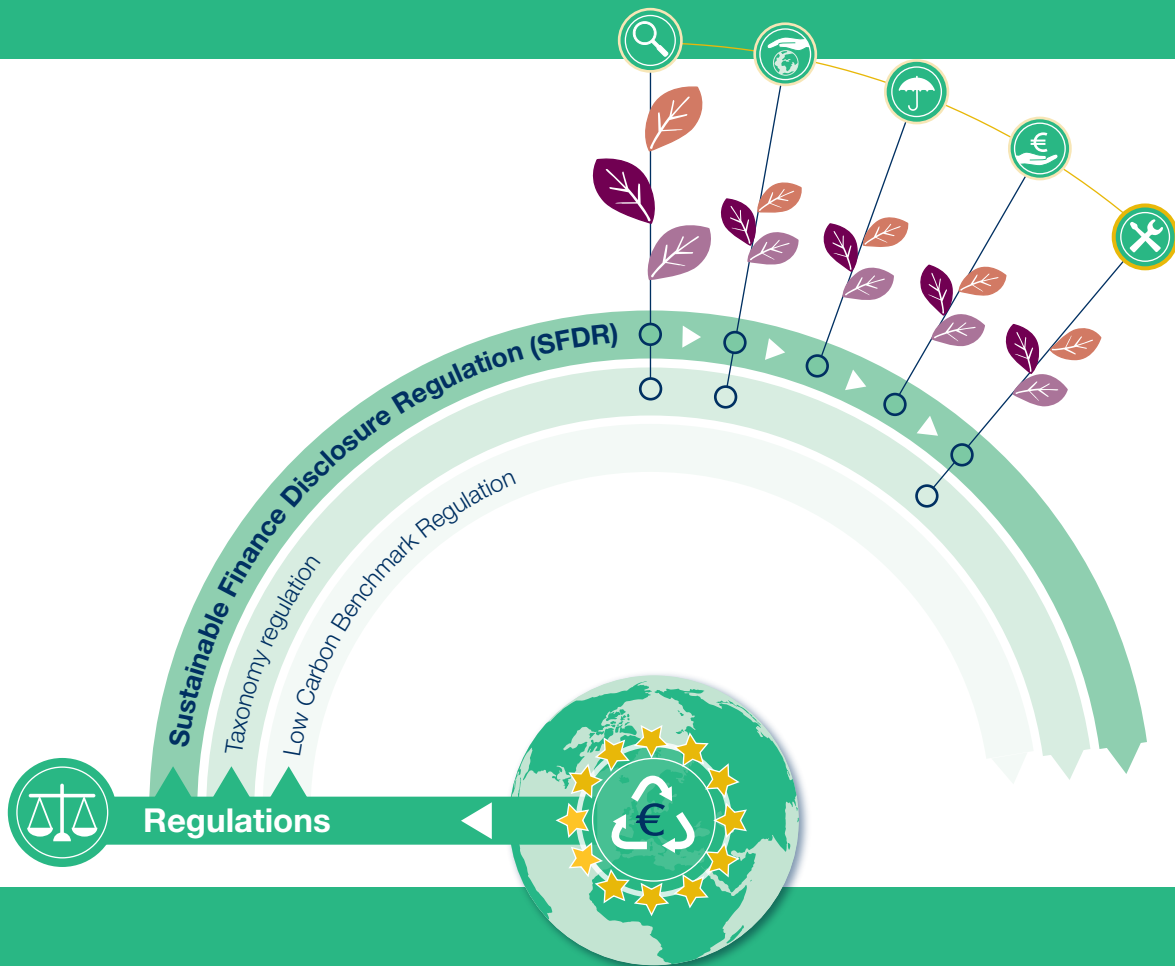


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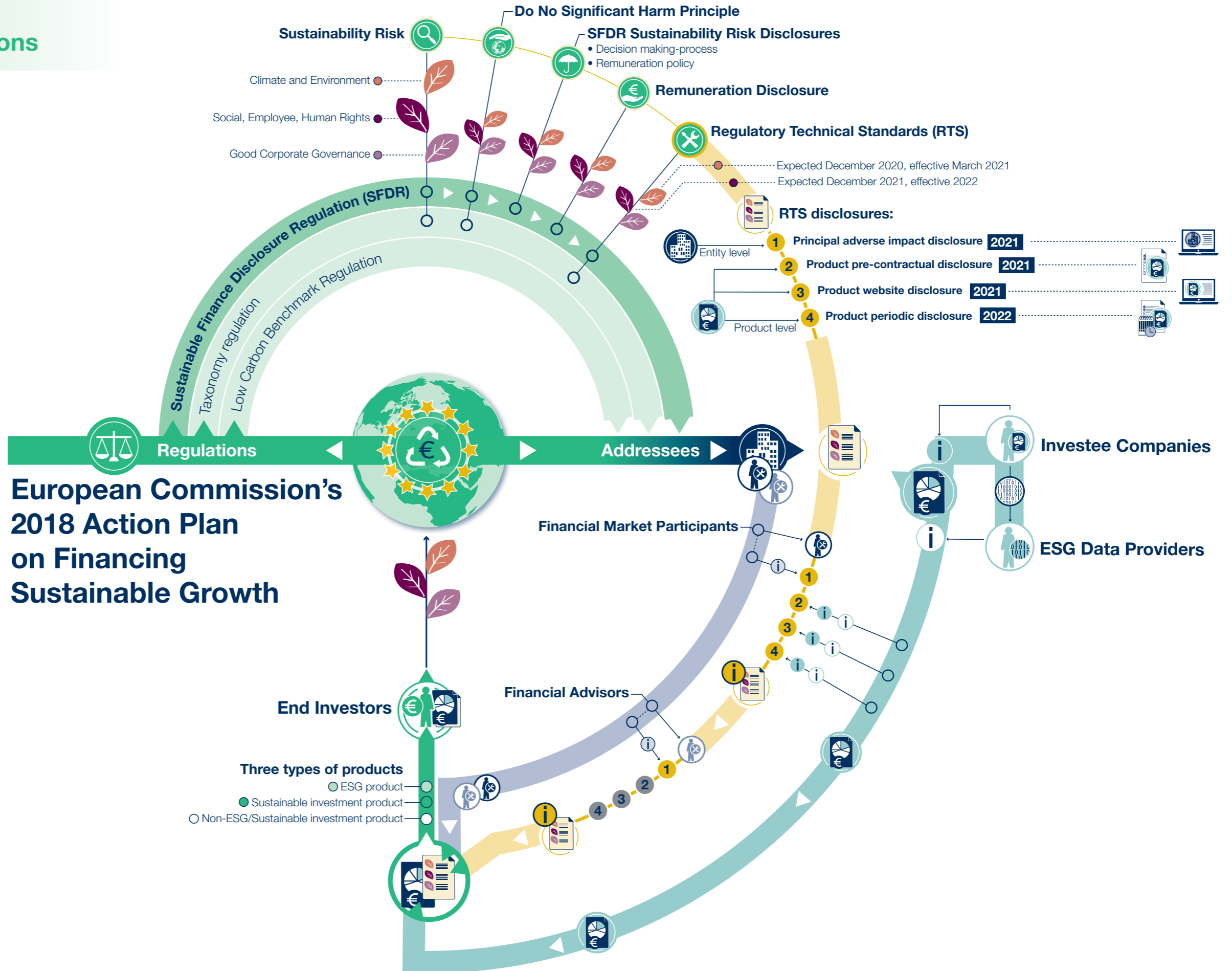
ESG

PRACTICAL IMPLICATIONS OF ESG DISCLOSURE REGULATIONS

JUNE 2020

Overview of ESG Disclosure Regulations

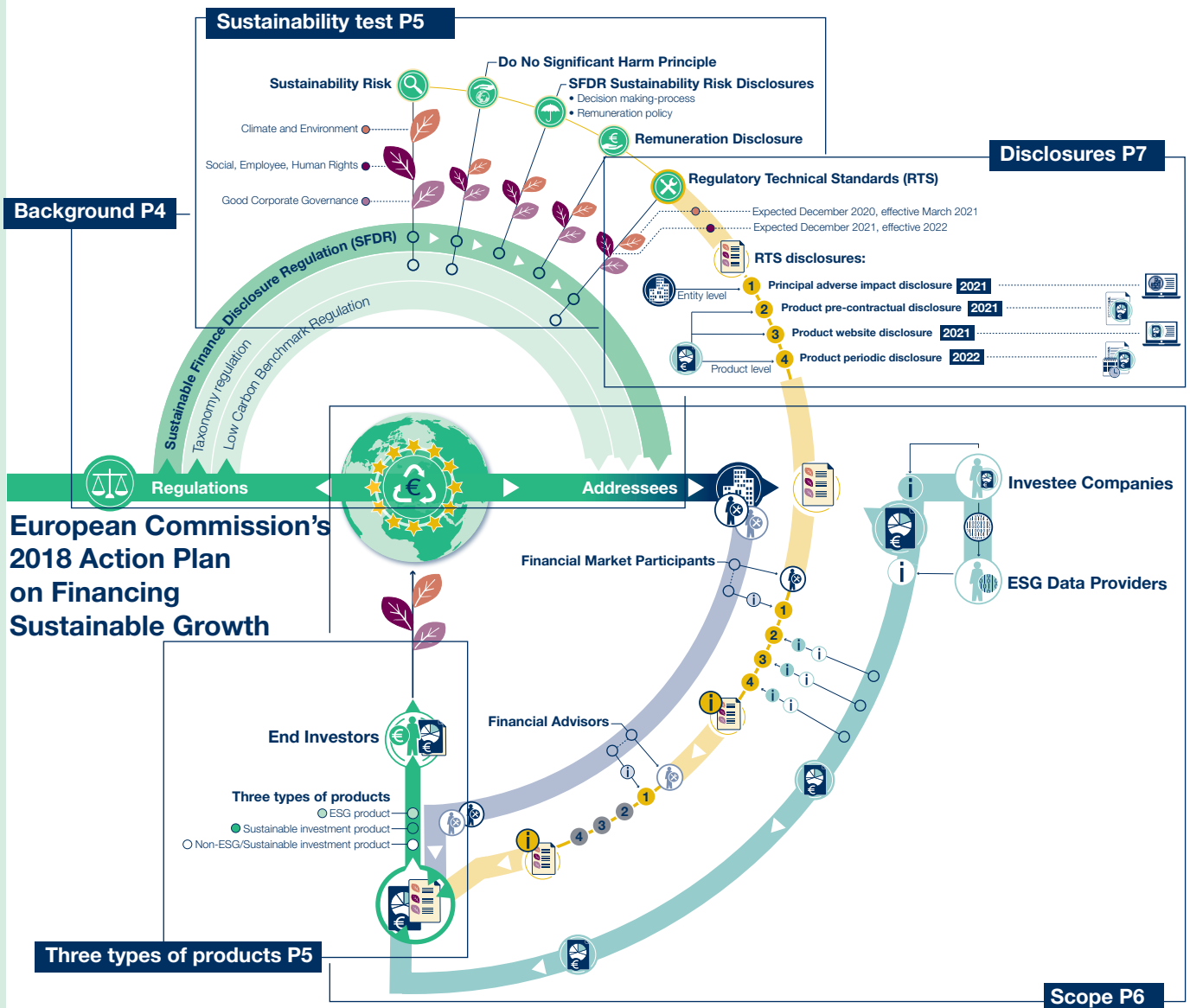
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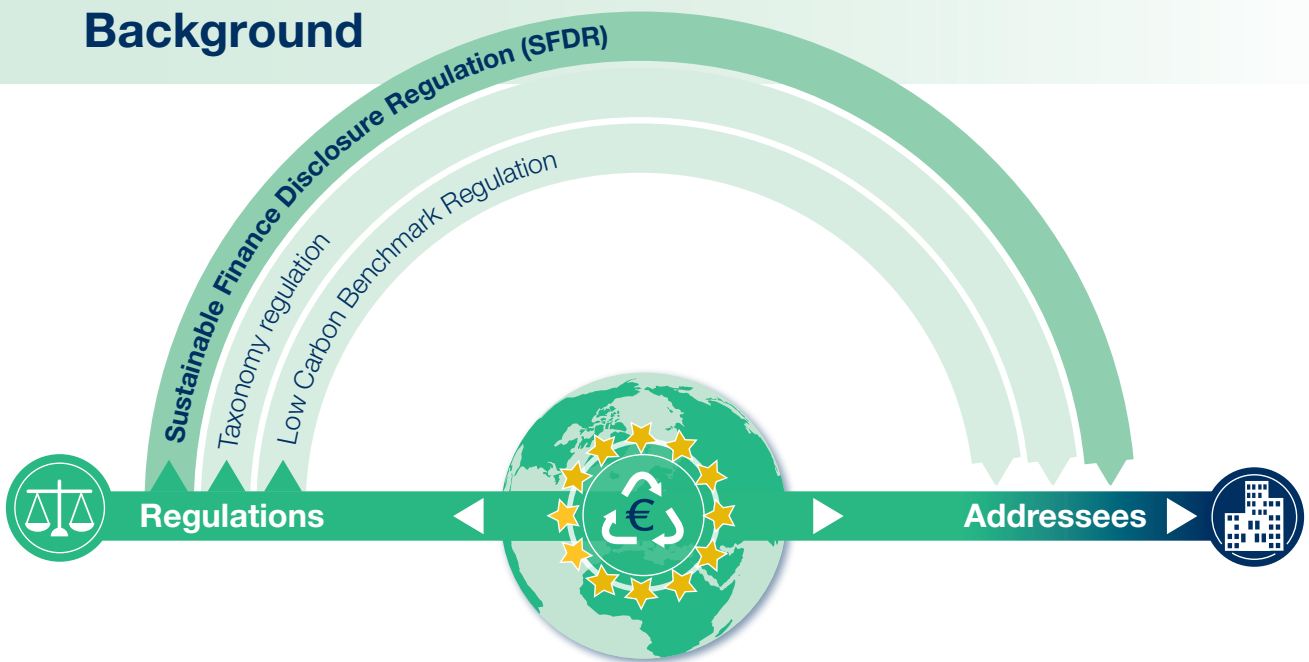
Introduction

As of 10 March 2021, many financial market participants and financial advisers will be subject to new disclosure obligations following the entry into force of the EU Sustainable Finance Disclosure Regulation (SFDR) on 29 December 2019. The SFDR sets rules on transparency with a view to promoting both the integration of sustainability risks into investment processes and disclosures to investors. On 23 April 2020, the European Supervisory Authorities EBA, EIOPA and ESMA (collectively the ESAs) published **a joint consultation paper** seeking feedback on the proposed regulatory technical standards (RTS) which specify how to address the obligations created by the SFDR. The disclosure requirements will have a significant impact on current disclosure practices. In view of the challenging timelines, financial institutions need to prepare now.

This e-book discusses the practical implications and challenges facing financial market participants and financial advisers during the implementation of the SFDR and the RTS. The illustration below shows the relationship between the different themes of the SFDR.



Background



The SFDR is one of the regulations presented as part of the European Commission's 2018 Action Plan on Financing Sustainable Growth to reach its climate change mitigation targets with the aim to:

- reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- assess and manage relevant financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity.

The European Commission considers the new disclosure rules necessary because the current investor disclosure rules enabling end investors to make informed investment decisions before purchasing financial products are insufficiently developed and not based on harmonized requirements.

In essence, the SFDR aims to harmonise ESG disclosure standards for different types of products and different types of end-consumers

In essence, the SFDR aims to harmonise ESG disclosure standards for different types of products and different types of end investors. This is achieved by setting similar standards for a wide range of information documents, ranging from detailed fund prospectuses to concise "key information documents" for pan-European pension products (PEPPs). This is in itself a challenging task, and unsurprisingly has resulted in implementation difficulties for the financial institutions in scope.

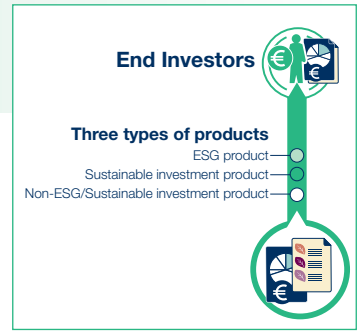
Framework

Three types of products

The SFDR is closely related to the **Taxonomy Regulation** on the establishment of a framework to facilitate sustainable investment. The taxonomy regulation sets out an EU-wide classification system, intending to provide businesses and investors with a common language to identify the economic activities that are considered environmentally sustainable.

Together with the Taxonomy Regulation, the SFDR will require financial market participants and financial advisers to disclose the degree of environmental, social and governance sustainability of funds and pension products that are (i) promoted as environmentally or socially friendly or (ii) have a sustainable investment objective, and to include disclaimers where they are not. In practice, this results in a system that channels the full range of investment products into three product types:

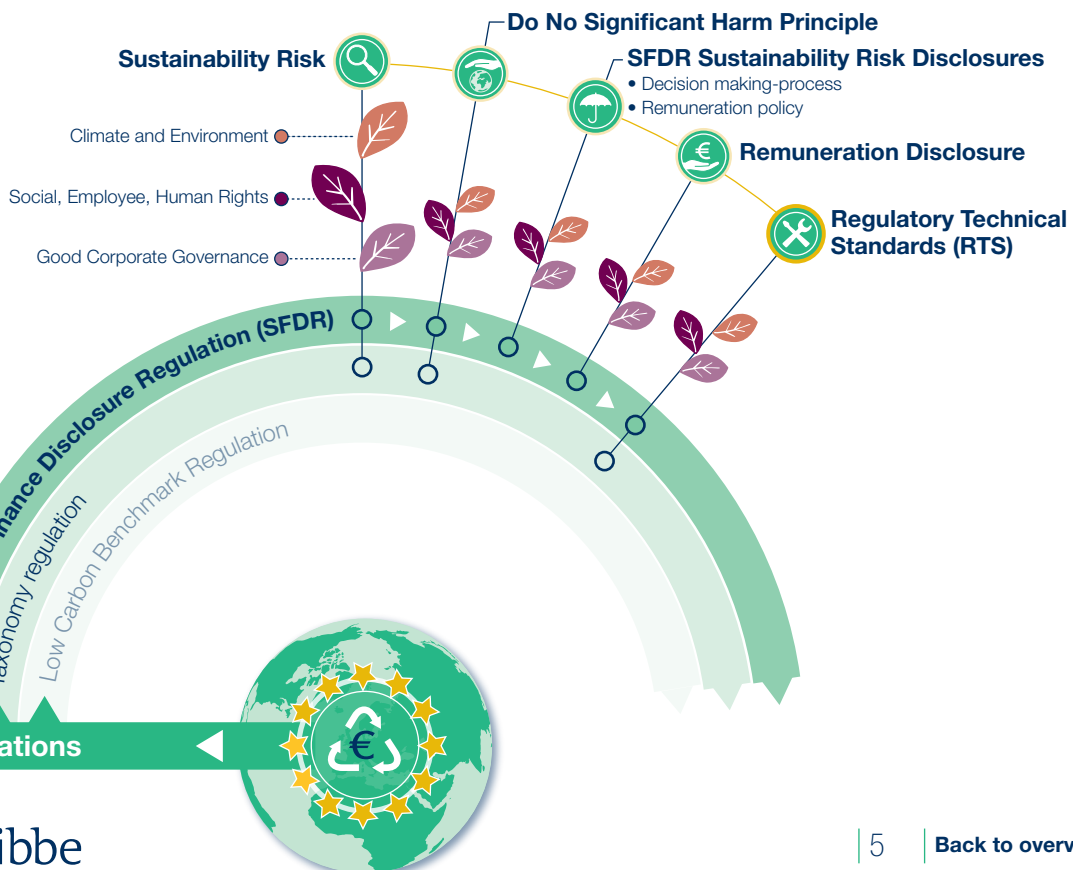
- the ESG product;
- the Sustainable investment product; or
- the Non-ESG/Sustainable investment product.



Sustainability test

The SFDR and the consultation paper suggest that, going forward, there will no longer be the option to label an investment product as sustainable or green without meeting the sustainability test and without disclosing in detail why it fits within either the ESG or Sustainable Investment category.

The consultation paper covers detailed rules on the content, methodology and presentation of ESG disclosures, differentiating between entity-level disclosures, product-level disclosures and information relating to the 'Do Not Significantly Harm principle' (DNSH principle). The DNSH principle is a core



principle of both the Taxonomy Regulation and the SFDR. The objective is to inform end investors as to how their investment does not significantly harm environmental and social objectives.

In short, a product will pass the sustainability test under these regulations if it (i) substantively contribute to the EU's six economic activities that qualify as environmentally sustainable, (ii) do no significant harm to these activities, and (iii) meet minimum safeguards in view of good governance, social employee matters, respect for human rights and anti-corruption and anti-bribery matters. The RTS under consultation are binding standards supplementing the SFDR.

Scope

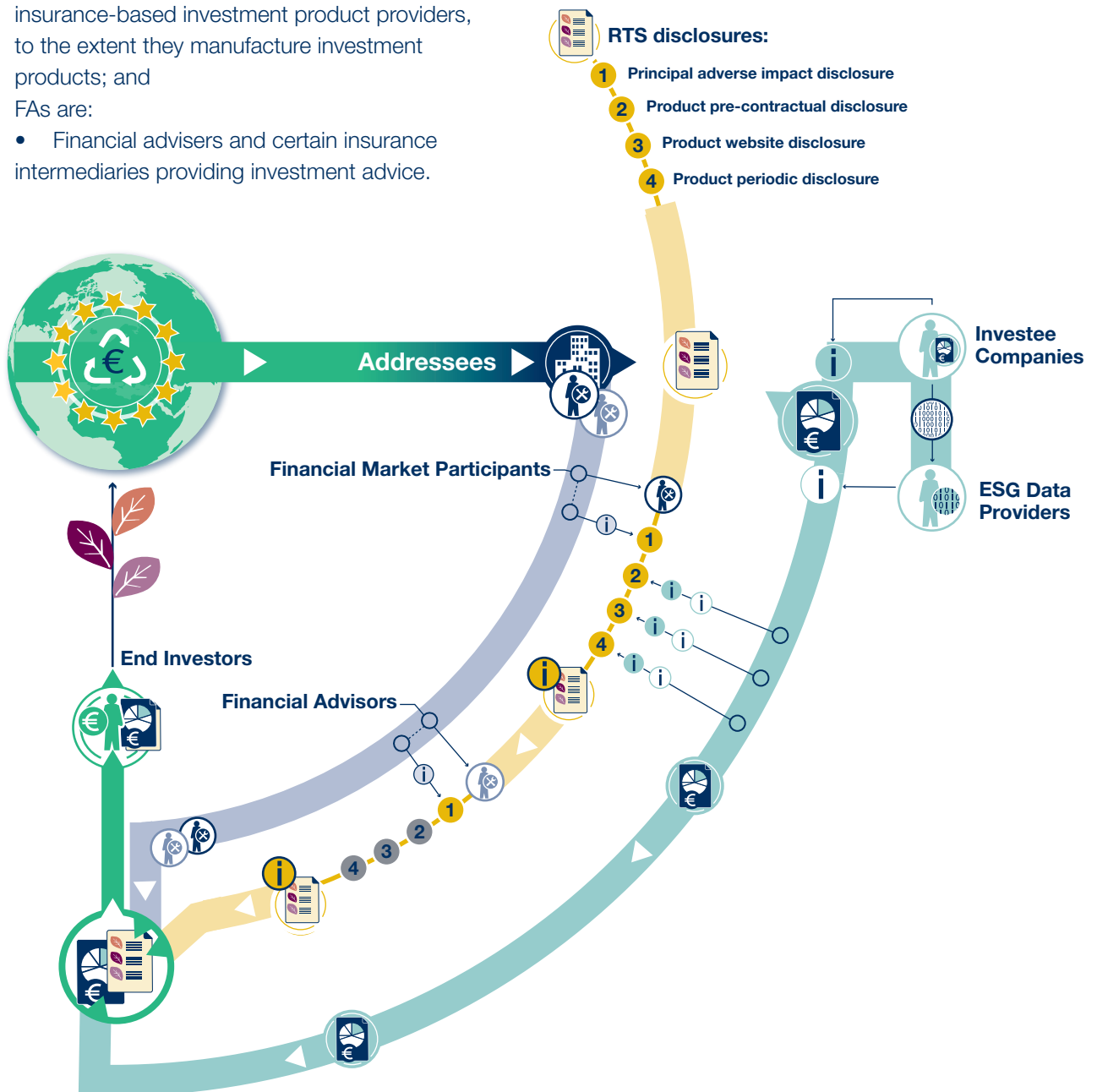
The scope of the SFDR is broad, covering a wide range of financial products and market participants. The SFDR and RTS apply to 'financial markets participants' (FMPs) and 'financial advisors' (FAs).

FMPs are, among others:

- fund managers, credit institutions, MiFID investment firms, pension providers and insurance-based investment product providers, to the extent they manufacture investment products; and

FAs are:

- Financial advisers and certain insurance intermediaries providing investment advice.



Although not in scope of the disclosure regulations, investee companies and external data providers, analysts or consultants, and end consumers also play a significant role in the information chain regulated by these rules. The purpose of the disclosure rules is to ensure that end investors have access to reliable data, which they can then use to make an informed decision to invest in an ESG product, a Sustainable

Investment product or in a product without ESG or sustainable investment features. The FMPs and FAs will therefore have to rely on external data providers and the information provided by investee companies through their disclosures.

The SFDR contains only a limited exemption for FAs with less than three employees.

FMPs with more than 500 employees on their own balance sheet or, where they are parent undertakings, on their group balance sheet, will be required to make disclosures in line with the SFDR

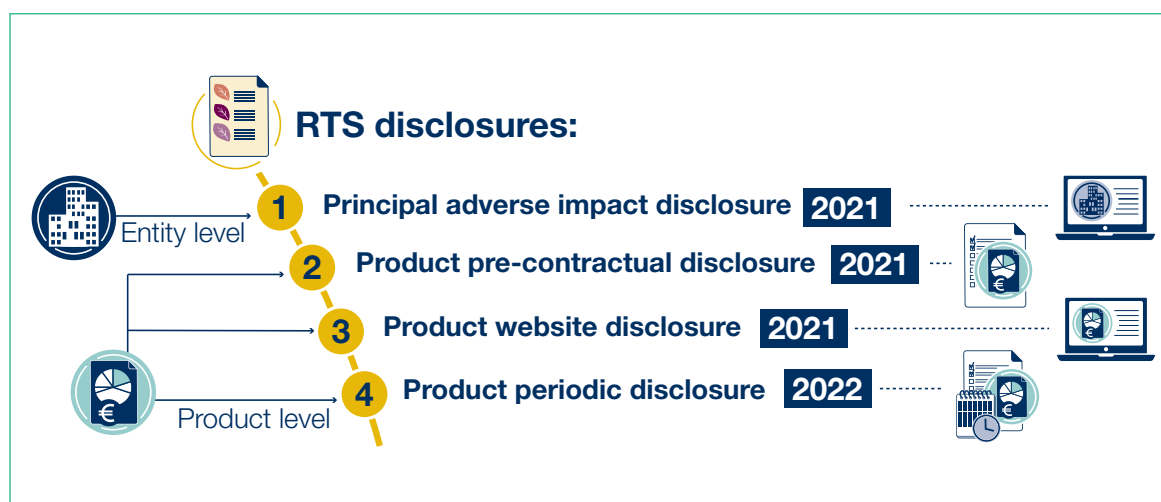
Disclosures

The SFRD essentially comes down to two types of disclosures -disclosures to be made at entity level, and those to be made at product level. A summary of the disclosure requirements is reflected below.

Entity Level Disclosures

1 Principal adverse impact disclosure (**art. 4 SFDR, art. 4 and 12 RTS**): requiring FMPs and FAs to publish an adverse sustainability impact statement on the entity's website, including the completion of a mandatory template using a predetermined set of indicators, in accordance with the DNSH principle. If no adverse impacts are identified, clear reasons for this must also be disclosed. This requirement is based on the 'comply or explain' nature of the SFDR. However, 36 months after entry into force all companies with 500 or more employees will no longer have the option of explaining why they do not take adverse impact into account in their investment decisions.


The purpose of this provision is to ensure that investors can rely on these adverse impact disclosures, which explain how FMPs and FAs take principal adverse impacts (i.e. the impacts of investment decisions and advice that result in negative effects on sustainability factors) into account, and what actions will be undertaken to address them. This provision also requires FMPs to publish relevant information regarding the due diligence procedures carried out on the underlying assets.



2 Sustainability risk integration disclosure (**art. 3 SFDR**): requiring FMPs to disclose information on their website about their policies concerning the integration of sustainability risks in their investment decision-making process. FAs must also disclose information on their website about their policies on

the integration of sustainability risks in their investment advice or insurance advice. If no sustainability risks are considered, clear reasons for not doing so must be disclosed.

3 Remuneration policy disclosure (**art. 5 SFDR**): requiring FMPs and FAs to include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks and to disclose these policies.



Pre-contractual disclosure requires FMPs to include ESG-related information in their precontractual information

4 Pre-contractual disclosures (**art. 6 SFDR**): requiring FMPs and FAs to include in their pre-contractual information packages descriptions on how sustainability risks are integrated into their investment decisions, and how the sustainability risks impact the returns of the financial product. This requirement will be integrated into existing sectoral disclosure formats.



Product level disclosures

5 ESG Product pre-contractual disclosure (**art. 8 SFDR and art. 14 RTS**): requiring FMPs to include in their pre-contractual information packages certain information, including:


- how a product claiming environmental or social characteristics does in fact meet those characteristics;
- where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics; and
- information as to where that index can be found.

6 Sustainable Investment product pre-contractual disclosure (**art. 9 SFDR and art. 23 RTS**): requiring FMPs to include in their pre-contractual information packages certain information, including:

- how the designated index is aligned with the investment objective; or
- if no index is used, how the sustainable investment objective is to be attained.

7 Product website disclosure (**art. 10 SFDR and art. 33-35 RTS**): requiring FMPs to publish on their websites certain information, including:

- the characteristics or objective of the product;
- the investment strategy;
- the due diligence carried out on the underlying assets of the financial product; and
- the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including relevant data sources.



Periodic disclosure requires FMPs to periodically report and involving a mandatory reporting template, with focus on how the product complies with the DNSH principle

8 Periodic disclosure (art. 11 SFDR and art. 36-52 RTS): requiring FMPs to periodically report (under sector-specific legislation) and involving a mandatory reporting template, a granular list of items to be included, with the focus on the product's level of success in meeting its sustainable characteristics and objectives alongside how the product complies with the DNSH principle.

Impact

The great variety of new disclosures that FMPs and FAs must make will have practical consequences, such as the need to introduce new systems and processes to implement and monitor the information that needs to be disclosed. A fair balance must be found to avoid over-informing end investors with sustainability-related information, as opposed to the more basic product information that must be disclosed (such as return projections and risk factors). The RTS also contain record-keeping requirements that differ from the existing ones, which (for example) may lead to extra data storage. It should also not be forgotten (and only briefly covered in the impact analysis of the consultation paper) that FMPs and FAs need to obtain the data, information or analysis forming the basis of the information that must be disclosed; this information must be obtained from third parties such as sustainability consultants or rating agencies. These third parties are not subject to supervision or harmonized legislation, which inevitably leads to differences in analyzing sustainability factors.

Key takeaways



- Compliance with SFDR ESG disclosure rules requires financial market participants and financial advisers to divide their product range into three categories: ESG products, Sustainable Investment products, and products that do not meet these qualifications.
- Financial market participants and financial advisers will have to prepare different disclosures at entity and product level.
- The disclosure package will be substantial and requires diligent monitoring and alignment in view of the variety in presentation requirements for websites, product documentation, and annual disclosures.
- The SFDR ESG disclosure rules expose the vital significance of accessible and reliable information from investee companies on the climate, environmental and social specificities of their assets.

Further information and contact details

The consultation is open until 1 September 2020.

For further information please contact the members of our ESG Corporate and Financial Markets Team or visit [StibbeESG.com](https://www.stibbe.com/ESG).

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