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A guide to sustainability-related disclosures under SFDR

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Introduction

European Union

In October 2014, the European Commission (**EC**) set an ambitious economy-wide target of at least 40% greenhouse gas emission reduction for 2030energy efficiency targets of at least 27%. This target was agreed in 2015 through the Paris Climate Agreement.

To achieve this target, a High Level Expert Group on Sustainable Finance was appointed by the EU and in January 2018 published a report offering a sustainable finance strategy for the EU. Their recommendations formed the basis of an action plan on sustainable finance adopted by the EC and published in March 2018 (**Action Plan**).

The Action Plan aimed to foster transparency and long-termism in financial and economic activities, re-orient investments toward more sustainable technologies and businesses, and manage financial risks stemming from climate change, environmental degradation and social issues. Proposed legislative changes arose from the Action Plan, including the subject of this guide, Regulation 2019/2088 on sustainability-related disclosures in the financial sector (**SFDR**).

Since the implementation of the Action Plan, under increased global pressure to act on climate change, the EC presented a growth strategy in December 2019 aiming to make Europe the first climate neutral continent by 2050 (the **European Green Deal**). Following this, the EC has consulted on a renewed (as compared to the levels in 1990), as well as renewable energy and sustainable finance strategy which could lead to more legislative proposals in the future.

United Kingdom

The UK's pledge to reduce emissions was made as part of a joint pledge with members of the European Union set out in the Paris Climate Agreement. The UK's decision to depart from the EU does not absolve it of the commitments it has made to date.

In fact, the UK Government has indicated that it wants to be a global thought leader in the area of sustainable finance. In its 25 Year Green Environmental Plan, the government refers to a "Green Brexit" and states that it will "*set gold standards in protecting and growing natural capital – leading the world in using this approach as a tool in decision-making*". Indeed, in June 2019, ahead of the European Green Deal, the UK set itself the target to bring greenhouse gas emissions to net zero by 2050.

The UK did not comprehensively onshore SFDR, however, SFDR is still relevant for UK firms managing EU products or marketing products into Europe. Additionally, where a European manager has delegated investment management to a UK firm it will likely require that UK firm as its delegate to comply with SFDR.

As announced by the Chancellor in November 2020, the UK will implement its own green taxonomy and mandate climate risk disclosures for UK companies over a five-year period. These disclosures will be in line with the recommendations of the Task Force for Climate-related Financial Disclosures (**TCFD**) and we are expecting an FCA consultation paper in relation to the same this Summer.

Overview of the SFDR

In the recitals to the SFDR, it was observed that divergent disclosure standards and market-based practices could:

- make it difficult to compare different financial products;
- create an uneven playing field for financial products and for distribution channels; and
- create additional barriers within the internal market.

It was also observed that the lack of harmonised rules relating to transparency makes it difficult for investors to compare different financial products in different Member States with respect to their ESG risks and sustainable investment objectives.

The SFDR therefore aims to reduce information asymmetries with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment, by requiring financial market participants and financial advisers to make pre-contractual and ongoing disclosures to end investors.

The SFDR sets out the framework for disclosures, however, the content, methodologies and presentation of information required to be disclosed by the SFDR will be set out in Regulatory Technical Standards (**RTS**) developed by the EBA, EIOPA and ESMA (the **ESAs**).

The RTS was supposed to be in effect for the implementation of SFDR (i.e. by 10 March 2021), however, the first draft RTS was highly controversial – in particular as regards the level of detail required for disclosures concerning principal adverse impacts. In October 2020, the European Commission wrote a letter to the Chairs of EMSA, the EBA and EIOPA confirming that the implementation of the RTS will be delated to “a later stage”. This did not, however, impact the implementation of SFDR with financial market participants and financial advisers needing to comply with its high level and principle-based requirements from 10 March 2021 (or later as stated in the SFDR).

A revised RTS (**Draft RTS**) was published on 2 February 2021 with an anticipated application date of 1 January 2022. Per a Joint ESA Supervisory Statement of 25 February 2021, national competent authorities have been encouraged to refer financial market participants and financial advisers to the requirements set out in the Draft RTS as a reference for the purposes of applying the provisions of Articles 2a, 4, 8, 9 and 10.

Scope of the SFDR

The SFDR applies at both the firm and the product level, irrespective of whether a firm or product has an ESG focus. The firms that the SFDR apples to include:

Financial market participants (FMP)

Financial market participants (FMPs) include:

- an insurance undertaking which makes available an insurance-based investment product;
- an investment firm which provides portfolio management;
- an institution for occupational retirement provision;
- a manufacturer of a pension product;
- an alternative investment fund manager;
- a pan-European personal pension product provider;
- a manager of a qualifying venture capital fund;
- a manager of a qualifying social entrepreneurship fund;
- a UCITs management company;
- a credit institution which provides portfolio management.

Financial advisors with three or more employees

Financial advisers (Fas) include:

- an insurance intermediary which provides insurance advice with regard to insurance-based investment products;
- an insurance undertaking which provides insurance advice with regard to insurance-based investment products;
- a credit institution which provides investment advice;
- an investment firm which provides investment advice;
- an alternative investment fund manager which provides investment advice;
- a UCITS management company which provides investment advice.

Note that:

- Some firms may both be FAs and FMPs. Depending on the nature of its activities, a firm would comply with the rules on FMPs where they manufacture financial products, and the rules on FAs where they provide investment advice or insurance advice.
- The Regulation does not apply to insurance intermediaries which provide investment advice with regard to insurance-based investment products nor to investment firms providing investment advice provided they employ fewer than three persons.

Scope of the SFDR cont’d

The products that the SFDR applies to include:

- Portfolios managed under MiFID II
- Alternative investment funds
- UCITS
- Insurance-based investment products
- Pension schemes and pan-European Personal Pension Products

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Concepts in the SFDR

The SFDR introduces certain concepts that FMPs and FAs will need to consider:

1. Sustainable Investment:

- An investment in an economic activity that contributes to an environmental objective, as measured by indicators on the use of energy, renewable energy, raw materials, water and land, the production of waste, greenhouse gas emissions or its impact on biodiversity and the circular economy (the circular economy being a system which reduces waste i.e. reusing, sharing, recycling, refurbishing etc.).

- An investment in an economic activity that contributes to a social objective, in particular, tackling inequality or fostering social cohesion, social integration and labour relations.

- An investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular, with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

- *NB: Regulation (EU) 2020/852 (the* ***Taxonomy Regulation****) establishes the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable.*

2. Sustainability Risk:

- An environmental, social or governance event or condition that could cause an actual or potential material negative impact on the value of an investment.

3. Sustainability Factors:

- Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

4. Do no significant harm (DNSH) principle

- For products that are promoted with a sustainable objective, the DNSH principle is mandatory. These products must DNSH to other environmental or social objectives.

- The Draft RTS has brought the SFDR in line with the Taxonomy Regulation. In addition to disclosing how an FMP has taken into account indicators for adverse impacts in Annex I of the Draft RTS, DNSH reporting must also show whether investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights including the principles and rights set out in the eight fundamental conventions identified in the Declaration of International Labour Organisation on Fundamental Rights and the Rights at Work and the International Bill of Human Rights.

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Requirements under the SFDR

The next sections cover:

1. The requirements under the SFDR that apply to FMPs and FAs;
2. The requirements under the SFDR that apply to all “financial products”
3. The requirements under the SFDR that apply in relation to sustainable investments and the promotion of products with “E” or “S” characteristics

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Requirements at firm level

1. Sustainability Risk Policies (Article 3):

- An FMP will have to publish information about its policies on the integration of sustainability risks in its investment decision-making processes and an FA will have to publish information about its policies on the integration of sustainability risks in their investment/insurance advice.
- The disclosure will be on a firm's website.
- The Draft RTS does not prescribe how this disclosure should be made.

2. Principal Adverse Impacts (Article 4):

- Where an FMP considers principal adverse impacts of investment decisions on sustainability factors, it will need to publish and maintain a statement on due diligence policies with respect to those impacts, taking into account their size, nature and scale of their activities and the types of financial products that they make available. FMPs with more than 500 employees on their balance sheet or, where they are parent undertakings, more than 500 employees on their group balance sheet, must make this disclosure.
- Where an FMP does not consider principal adverse impacts of investment decisions on sustainability factors, it must publish and maintain clear reasons why they do not do so and whether they intend to in the future.
- Where an FA considers in its investment/insurance advice the principal adverse impacts on sustainability factors, it will need to publish and maintain on its website information in this regard (taking into account their size, the nature and scale of their activities and the types of financial products they advise on).
- Where an FA does not consider adverse impacts of investment decisions on sustainability factors, it must publish and maintain reasons why they do not do this, and whether they intend to do so in the future.
- To ensure sufficient comparability of firms' principal adverse impact disclosures, the information should be disclosed annually and in the form laid down in Annex I of the Draft RTS. The statement would be updated annually so that a firm can show the progress it has made toward reducing the principal adverse impacts of investment decisions on environmental and social factors.
- The disclosures under Article 4 will be on a firm's website.
- The Draft RTS provides that for FMPs and FAs that do not consider the principal adverse impacts of investment decisions on sustainability factors, such FMPs and FAs must publish information in a separate section of the website titled "No consideration of sustainability adverse impacts" including a prominent statement that the FMP/FA does not consider adverse impacts of its investment decisions on sustainability factors and clear reasons why the FMP/FA does not do so and whether, and if so, when it intends to consider those adverse impacts by reference to at least the indicators in Table 1 of Annex I of the Draft RTS (Articles 11 and 12 of the Draft RTS).

3. Remuneration Policy (Article 5)

- FMPs and FAs are to include in their remuneration policies information on how those policies are consistent with the integration of "sustainability risks", and publish that information on their websites.
- The Draft RTS does not prescribe how this disclosure should be made.

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Requirements for all Financial Products

1. **Integration of sustainability risks (Article 6)**

- FMPs and FAs will need to include in their pre-contractual disclosures the manner in which "sustainability risks" are integrated into their investment decisions or investment/insurance advice and the results of the assessment of the likely impacts of "sustainability risks" on the returns of the financial products that they make available or advise on.
- If an FMP or an FA deems that "sustainability risks" are irrelevant, the disclosure should include a clear and concise explanation for that.
- Where the disclosure should be made will depend on the financial product. For UCITS management companies, the information would be included in the prospectus. For firms that provide portfolio management or investment advice under MiFID II, the disclosure would be made in accordance with Article 24(4) of MiFID II.
- The Draft RTS does not prescribe how this disclosure should be made.
- Article 7 of the Taxonomy Regulation provides that where a financial product is not subject to Article 8(1) or Articles 9(1) to (3) of SFDR, the information to be disclosed under Article 6(3) and Article 11(2) of SFDR shall be accompanied by a statement that says: "*The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities*."

2. Principal adverse impacts at product level (Article 7)

- If an FMP considers the principal adverse impacts of its investment decisions on sustainability factors, then by the 30th of December 2022, the pre-contractual disclosures referred to in Article 6 will include a clear and reasoned explanation on whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors and a statement that information on principal adverse impacts on sustainability factors is available in the financial product's periodic report.
- If an FMP does not consider principal adverse impacts of its investment decisions on sustainability factors, the pre-contractual disclosures referred to in Article 6 shall include a statement that the FMP does not consider the principal adverse impacts of investment decisions on sustainability-related factors, and the reasons for this.
- The Draft RTS does not prescribe how this disclosure should be made, however, where information in the periodic report includes quantifications of principal adverse impacts on sustainability factors, that information may rely on the factors provided in Annex I to the Draft RTS.

Requirements for sustainable investments & products promoting “E” & “S” characteristics

1. Sustainable Investments (Article 9)

Per Article 9 of the SFDR, where a financial product has sustainable investment as its investment objective, information to be disclosed under Article 6 (the pre-contractual disclosures) shall be accompanied with:

- information on how the objective is to be attained (where there is no benchmark aligned with that objective); or
- where there is a benchmark aligned with that objective, information on how the designated index is aligned with the objective and why and how the designated index differs from a broad market index. FMPs shall include in the pre-contractual information an indication of where the methodology used for the calculation of the indices and benchmarks are to be found.

2. Financial products promoting environmental or social characteristics (Article 8):

Where a financial product promotes “E” or “S” characteristics, along with other characteristics, provided that the companies in which investments are made follow good corporate governance practices, the information disclosed under Article 6 shall include:

- information on how those characteristics are met; and
- if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. FMPs shall include in the pre-contractual information an indication of where the methodology used for the calculation of the index is to be found.

3. Website disclosures (Article 10)

FMPs must publish on their websites (in a prominent easily accessible area):

- a description of the “E” or “S” characteristics or the sustainable investment objective;
- information on the methodologies used to assess, measure and monitor the “E” or “S” characteristics or the impact of the sustainable investments selected for the financial product, including data sources, screening criteria for the underlying assets and relevant sustainability indicators used to measure the overall sustainability impact of the financial product; and
- the information referred to in Article 9 and 11.

4. Periodic Reports (Article 11)

In the periodic report of a product promoting “E” or “S” characteristics, an FMP must include a description of the extent to which those characteristics are met.

In the periodic report of a sustainable investment product, an FMP must include a description of:

- the overall sustainability-related impact of the financial product by means of sustainability indicators; or
- where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.

As set out in the Draft RTS, FMPs should disclose a minimum set of standardised and comparable quantitative and qualitative indicators to show how their product meets its characteristics or objective. These indicators should be relevant to the design and investment strategy of the financial product as described in pre-contractual information and to ensure consistency between the pre-contractual disclosures and periodic disclosures, FMPs should report on the specific sustainability indicators mentioned as part of the pre-contractual information used to measure the attainment of environmental or social characteristics, or the delivery of the sustainable investment objective.

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Requirements for sustainable investments & products promoting "E" & "S" characteristics cont'd

- Assessing good governance practices is an integral part of financial products under Articles 8 and 9 and should be a prerequisite for promoting these. These products should include information on the FMP's policy to assess good governance practices of investee companies.
- FMPs are expected to monitor, throughout the product's lifecycle, how the product complies with the disclosed "E" or "S" characteristics or sustainable investment objective. Therefore, the Draft RTS says that FMPs should mention, as part of their website disclosures, the control mechanisms put in place to monitor such compliance on a continuing basis.
- FMPs that market financial products promoting environmental or social characteristics, or a combination of those characteristics, should make disclosures on those characteristics without misleading end-investors. The Draft RTS notes that disclosure of criteria for the selection of underlying assets should be limited to criteria that FMPs are actually bound by, and should not disclose selection criteria that may be disapplied or overridden at the FMP's discretion.
- The Draft RTS will require FMPs to be transparent as to the share of investments that will be carried out via direct holdings, and those carried out via alternative methods. In particular, FMPs should explain how the use of derivatives is compatible with the "E" or "S" characteristics being promoted, or with the sustainable investment objective pursued.
- The Taxonomy Regulation requires as regards Article 8 and 9 products that the information to be disclosed in accordance with Articles 6(3) and 11(2) of the SFDR shall include the information on the environmental objective or environmental objectives to which the investment underlying the financial product contributes and a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable. A consultation published in March 2021 (the **Consultation**) sets out additional draft revisions to the Draft RTS to factor in the Taxonomy Regulation product-related disclosure requirements.

Per the Draft RTS (as amended by the Consultation), the pre-contractual disclosures for Article 8 products will need to include an annex in accordance with the template set out in Annex II of the Draft RTS and a prominent-statement in the relevant document (i.e. the prospectus of a UCITS fund) that information related to environmental or social characteristics is available in that annex. FMPs will need to include a statement at the beginning of the annex to explain whether the financial product intends to make any sustainable investments, and that the financial product promotes environmental or social characteristics but does not have as its objective sustainable investment. Information in the annex shall be made up of sections titled:

- What environmental and / or social characteristics are promoted by this financial product?
- What investment strategy does this financial product follow?
- What is the asset allocation planned for this financial product?
- For a financial product which includes sustainable investments: to which objectives do the sustainable investments contribute to and how do they not cause significant harm?
- Does this financial product take into account principal adverse impacts on sustainability factors?
- Where an index is designated as a reference benchmark for the purpose of attaining the "E" or "S" characteristics promoted by the financial product: is a specific index designated as a reference benchmark to determine whether this financial product is aligned with the environmental and / or social characteristics it promotes?
- Can I find more product specific information online?

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Requirements for sustainable investments & products promoting “E” & “S” characteristics cont’d

Similarly, per the Draft RTS Article 9 products’ pre-contractual disclosures will need to include an annex in accordance with Annex III of the Draft RTS, and a prominent statement in the relevant document that information related to sustainable investment is available in the annex. The statement at the beginning of the annex will need to state that the financial product has a sustainable investment objective. Information in the annex shall be made up of sections titled:

1. What is the sustainable investment objective of this financial product?
2. What investment strategy does this financial product follow?
3. What is the asset allocation planned for this financial product?
4. To which objectives do the sustainable investments contribute to and how do they not cause significant harm?
5. Does this financial product take into account principal adverse impacts on sustainability factors?
6. For a financial product referred to in Article 9(1): is a specific index designated as a reference benchmark to meet the sustainable investment objective?
7. For a financial product referred to in Article 9(3): does the financial product have the objective of a reduction in carbon emissions?
8. Can I find more specific information online?

Additional points to note

- FMPs and FAs need to ensure that their marketing communications do not contradict the information disclosed pursuant to the SFDR.
- Website disclosures under Articles 3, 5 and 10 must be kept up to date and a clear explanation of any amendment needs to be published on the website.
- Disclosed information should be available for at least 10 years after its publication.
- Firms may find it difficult to identify principal adverse impacts on sustainability factors. In this regard, firms can engage directly with investee companies' management boards. Firms may want to consider employing internal financial analysist and specialists in the area of sustainable investments or appointing external market research providers. Firms can also use information in the public domain and information shared through collaborative initiatives.
- Firms can seek to reduce their principal adverse sustainability impacts through exercising their shareholder voting rights, liaising with the management of investee companies setting up documented and time bound engagement actions or shareholder dialogue with specific sustainability objectives, and planning escalation measures if objectives are not achieved i.e. reducing investments or exclusion decision.

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