

A guide to sustainability- related disclosures under the EU's 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 by 2030 as well as a minimum target of 27% for the share of renewable energy consumed in the EU.

To achieve this, a High Level Expert Group on Sustainable Finance (**HLEG**) was appointed by the EU and in January 2018 published a report offering a sustainable finance strategy for the EU. HLEG's 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, and 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**). The EU has since adopted the European Climate Law in June 2021 which made the goal of reaching climate neutrality by 2050 binding. It also set a new goal of reducing emissions by at least 55% below 1990 levels by 2030 and published a Renewed Sustainable Finance Strategy (**RSFS**) in July.

The RSFS sets out how the Commission intends to continue improving the financing of sustainable economic activities. In the RSFS, the Commission proposes initiatives in four different areas: climate transition finance, inclusiveness, resilience, and contribution of the financial system to sustainability goals and the international perspective. The Commission intends to report on the strategy's implementation by the end of 2023. Please refer to our update on EU sustainability measures [here](#).



United Kingdom

While the UK did not comprehensively onshore SFDR as part of its Brexit planning, it is still relevant for UK firms. For example, where firms provide services in relation to EU products or where firms market products in the EU under Member States' National Private Placement Regimes. Additionally, the UK government has said it will draw on the EU approach as it introduces UK specific measures as part of the UK road map to sustainable investing.

It is also worth noting that 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 departure from the EU does not absolve it of the commitments it made previously under the Paris Agreement.

In fact, the UK Government indicated in its 25 year Green Environmental Plan that it wanted to be a global thought leader in the area of sustainable finance. Most recently, at COP26, Rishi Sunak stated the UK's ambition to become the first ever 'Net Zero Aligned Financial Centre'. Under the government's proposals there will be new requirements for UK financial institutions and listed companies to publish net zero transition plans that detail how they will adapt and decarbonise as the UK moves toward a net zero economy by 2050.

The UK is implementing its own mandatory disclosures in line with TCFD along with its own taxonomy. The FCA published a Discussion Paper (DP21/4) on Sustainability Disclosure Requirements and investment labels on 3 November 2021. We expect a Consultation Paper from the FCA in Q2 2022. Please refer to our update on UK sustainability measures for further information on the UK's proposals, [here](#)

Overview of the SFDR

What is the purpose behind 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.

How is the SFDR implemented?

- 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 (**SFDR RTS**) developed by the EBA, EIOPA and ESMA (the **ESAs**).
- As noted below, the SFDR RTS has now been bundled with certain Taxonomy RTS which amend the SFDR RTS dealing with disclosure requirements for taxonomy aligned products.

Overview of the SFDR (cont'd)

What is the interplay between the Taxonomy Regulation and SFDR?

- Regulation (EU) 2020/852 (the **Taxonomy Regulation**) establishes an EU-wide classification system – “taxonomy” – to identify which economic activities can be considered “environmentally sustainable”.
- The Taxonomy Regulation interacts with the SFDR by imposing additional disclosure regulations on certain SFDR Article 8 and Article 9 products if that product invests in an economic activity that contributes to one of the six environmental objectives defined in the Taxonomy Regulation (those being: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems).
 - Article 5 of Regulation (EU) 2020/852 (the **Taxonomy Regulation**) sets out additional disclosures required by Article 9 SFDR products making sustainable investments. This includes:
 - disclosing information on the environmental objective(s) listed in Article 9 of the Taxonomy Regulation to which the investment underlying the financial product contributes; and
 - a description of how and to what extent the investments underlying the financial products are invested in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation,in accordance with the pre-contractual disclosures and periodic reports required by Articles 6(3) and 11(2) of the SFDR.
 - Article 6 of the Taxonomy Regulation effectively applies Article 5 to Article 8 SFDR products.

When does the SFDR take effect?

- The SFDR RTS was supposed to be in effect for the implementation of SFDR, however, the first draft RTS was controversial – in particular as regards the detailed disclosures concerning principal adverse impacts. In October 2020, the EC confirmed in a letter to the Chairs of the ESAs that the implementation of the SFDR RTS will be delayed 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 SFDR RTS was published in February 2021, then in March 2021 the ESAs issued a consultation paper on the content, methodologies and presentation of taxonomy-related sustainability disclosures, including draft regulatory standards (**Taxonomy RTS**). The Taxonomy RTS amended the SFDR RTS with the intention that they are to be read together.
- Aiming to avoid duplication and to minimise complexity, the Commission confirmed it intended to bundle the SFDR RTS with certain Taxonomy RTS (which amend the SFDR RTS that deal with disclosure requirements for taxonomy aligned products). In October 2021, a consolidated draft RTS was published and set out in section 5 of the [joint final report](#) from the ESAs (the **Draft RTS**).
- Due to the length and detail of the 13 bundled RTSs and to ensure a smooth implementation of their rules, the Commission has most recently confirmed that their application will be delayed until 1 January 2023 (see the Commission’s [letter](#) dated November 2021). Of course, this leaves firms in an unsatisfactory position of being bound by level one disclosure obligations under SFDR and the Taxonomy Regulation but without the formal implementation of the level two obligations that set out the content, methodologies and presentation of the information to be disclosed. However, earlier this year the Commission indicated that firms should take into account the draft regulatory technical standards when complying with their level one obligations and so it might be prudent for firms to consider following the Draft RTS despite its delayed implementation.

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 applies 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 (including, as recently clarified, sub-threshold AIFMs and non-EU AIFMs that market AIFs under national private placement regimes);
- 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.
- SFDR 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



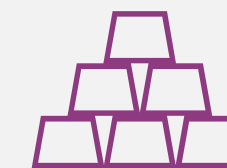
Alternative
investment funds



UCITS



Insurance-based
investment
products



Pension schemes
and pan-European
Personal Pension
Products

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: The Taxonomy Regulation establishes the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purpose 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 Article 9 products (including those that are taxonomy-aligned sustainable investments), the DNSH principle is mandatory. These products must DNSH to other environmental or social objectives.
- Per Article 21 of the Draft RTS, as well as disclosing how an FMP has taken into account indicators for adverse impacts in Table 1 of Annex I, DNSH reporting must also show whether sustainable 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.

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

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 of SFDR will be on a firm's website and the Draft RTS (Articles 4 to 10) mandate the content and form of those disclosures.
- Further, Articles 11 and 12 of the Draft RTS provide 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.

** [Guidance](#) issued by the Commission in July 2021 (**SFDR Guidance**) confirms that the calculation of the 500-employee threshold should take into account the number of employees of a parent undertaking and subsidiaries, regardless of whether they are established inside or outside of the EU.

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.

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 Table 1, Annex I.

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.

Firms should refer to Section 2 of the Draft RTS (Articles 20 to 27) for further clarity on the proposed content and form of disclosures relating to Article 9 products.

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.

Firms should refer to Section 1 of the Draft RTS (Articles 13 to 19) for further clarity on the proposed content and form of disclosures relating to Article 8 products.

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.

Firms should refer to Chapter IV (Articles 31 to 57) of the Draft RTS for further clarity on the proposed content of product website disclosures.

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.

Firms should refer to Chapter V (Articles 58 to 73) of the Draft RTS for further clarity on the proposed content of product disclosures in periodic reports.

Additional points to note

- While most of the level one obligations set out in the SFDR came into force on 10 March 2021, there were a number of clarifications that remained outstanding. In July 2021, the European Commission published guidance, as updated in November 2021, addressing some of these (including, for example, the application of SFDR to non-EEA AIFMs and subthreshold AIFMs and the application of the 500-employee criterion to non-EEA entities). *Please refer to our article on recent EU updates [available here], which summarises the EU's guidance.*
- 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 analysts 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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