

Does ESG do what it says? The new SFDR requirements

A guide to sustainable
investing



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Marketing communication



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Does ESG¹ do what it says? The new SFDR requirements

A guide to sustainable investing

How to ensure that an investment product described as 'Sustainable' does indeed deliver "What's written on the tin", to paraphrase the British expression?

And when the content does measure up to the description, how can we avoid confusion for investors faced with the plethora of designations applied to sustainable products?

Having begun the tricky challenge of defining a sustainable activity (see our article on the European Taxonomy), the European Commission has turned to the equally challenging topic of requirements for labelling sustainable investment products. The result is this month's "Sustainable Finance Disclosure Regulation", or SFDR².

As the name implies, SFDR is about disclosure, in terms of both communication and transparency. In contrast to the approach taken in the European Taxonomy regulation, SFDR does not prescribe what features sustainable financial products should include. The likely benefit of SFDR is that even mere disclosures can create incentives for financial products to evolve in a certain direction, if companies are required to communicate certain elements. We expect SFDR will provide an incentive to boost sustainability-related credentials.

Who is impacted by SFDR?

The scope of SFDR is very broad. SFDR applies to financial advisers as well as to "financial market participants" which are meant to encompass asset managers, investment firms and credit institutions providing portfolio management, as well as some asset owners. This brings pension funds, insurance companies, and others within the scope of the regulation.

It is worth noting that SFDR applies not only to those financial market participants or financial advisers offering sustainable investment products, but to all of them, even those which do not have an express ESG-focus or sustainability-focus. SFDR is not "just" a regulation for sustainable investment products, but a regulation aimed at making every firm disclose its strategic business and policy decisions, comprising specific sustainability-related information as the case may be, on its website. Financial market participants manufacturing sustainable investment products fall under additional disclosure obligations specific to their sustainable products.



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1 - Environment, Social and Governance
2 - Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector



What notable disclosure requirements apply to the entities covered by SFDR?

SFDR distinguishes disclosure requirements at the entity level, from those at the level of each financial product.

Implementation is expected in two phases. Level 1 requirements mostly enter into force on 10 March 2021, while implementation of Level 2 disclosure has been postponed to 2022. The Regulatory Technical Standards (RTS) published on 4 February 2021 by the European Securities Market Authority (ESMA) provide the information on these Level 2 disclosure requirements, in particular regarding the communication of the Principal Adverse Impact (PAI) indicators discussed below, as well as website disclosures.

I. Entity level Disclosures

These new disclosures apply to *all* entities within the scope of the regulation, as mentioned.

- **Sustainability risks** – Financial market participants and financial advisers must explain how they take into account the potential negative financial impact of sustainability-related factors on their investment decisions or investment advices. One way to disclose this could be through a set of sustainability risk policies and practices. For instance, should the financial market participant invest in the oil & gas sector, such policy would cover the possibility that some oil & gas assets become 'stranded' or suddenly impaired, with negative financial impact.

- **Principal Adverse Impacts of investment decisions on sustainability factors** – Through their capital allocation decisions, financial market participants do cause, or at least enable negative impacts of their decisions to occur on the environment, social and/or employee matters (the so called ‘sustainability factors’). For instance, an asset manager financing a new coal mine will indirectly cause a large amount of carbon dioxide to be emitted. SFDR requires such asset manager to disclose how such carbon dioxide emission impacts the environment and/or on social aspects and how this is measured.

Together, Sustainability Risks and Principal Adverse Impacts represent the two faces of the ‘Double Materiality’ concept of sustainability considerations in investing.

- **Do No Significant Harm (DNSH)** – In addition to Sustainability Risks and Principal Adverse Impacts, SFDR requires financial market participants to uphold minimum social and environmental standards by referring to a series of treaties and international conventions. That is, the regulation emphasizes that financial market participants may not violate these treaties, placing addition emphasis by making adherence to the treaties a part of the financial regulatory framework for financial market participants. The specifics of DNSH when applied within SFDR therefore differ from those in the Taxonomy. In the European Taxonomy, DNSH means that asset managers shall not jeopardize any of the six environmental objectives defined in the that regulation.

- **Remuneration Policy** – Financial market participants and financial advisers are required to explain how their remuneration policy integrates sustainability-related considerations.

II. Financial Product Disclosures

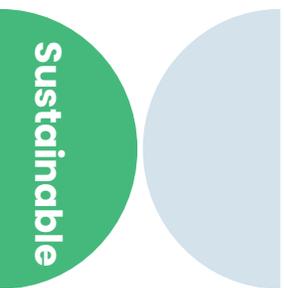
SFDR distinguishes two types of financial products. Any product that does not fall within one of these two categories cannot be presented as ‘sustainable’, even if the entities disclose how they integrate Sustainability Risks and PAI in investment management decisions.

- **Products promoting Sustainability Characteristics (Article 8)** – These products explicitly integrate environmental and/or social considerations into their management, beyond mere integration of sustainability risks, but without a sustainable investment objective. Article 8 requires promoters of these products to explain in detail, through both pre-contractual documentation and regular reports, how they concretely integrate these sustainability characteristics.

- **Products with a Sustainable Investment Objective (Article 9)** – Results of the methods. Whilst Article 8 products could be construed as products integrating sustainability-related considerations as the *means*, Article 9 products differ through the definition of an explicit sustainable objective applicable to the product – that is, the *result*. The regulation provides some examples of sustainable investment objectives, such as preserving biodiversity, reducing inequalities, or addressing climate change. Financial products classified as Article 9 by their manufacturer or promoter must explain what their sustainable objective(s) is (are), and must also explain how they intend to achieve these results as well as how they measure those results through sustainability-related metrics.

Who determines whether a product falls under Article 8 or Article 9, or neither of them?

It is the responsibility of the entity manufacturing and/or advising the financial product to define its classification. Since SFDR is about disclosure, not about prescription, the intention is that financial market participants and financial advisers will compare the sustainable features of their various products with the categories defined in the regulation, and communicate their classification based on that mapping. Considering the vast number of financial products impacted by SFDR, national regulators in charge of market regulation do not have the capacity to review each and every pre-contractual document before 10 March to ascertain whether the new disclosure matches the category (Article 8, Article 9, or neither) selected by the promoter of the investment product.



How will SFDR impact sustainable investing in Europe?

The number of financial products featuring sustainability characteristics is likely to skyrocket in Europe. Already in 2020, more than 250 funds were transformed into sustainable products, according to the Financial Times³. The forthcoming revision of the MiFID directive could accelerate that trend by introducing a so-called "sustainability preference", requiring advisors to specifically ask their clients whether they wish to take sustainability into account. A client expressing a preference for sustainable products could then only be offered Article 8 or Article 9 products.

It will probably take a while for the dust to settle and for all concerned to get a good sense of which type of financial products is classified as Article 8, and which unique features distinguish an Article 9 product from an Article 8 product. If the company promoting the product determines it is neither Article 8 nor Article 9, then it cannot promote any ESG characteristics and no 'claims' of sustainability can therefore be made. Adding to the complexity of the situation, the supervisory authorities of the EU member states may be adding additional specifics to the EU sustainable finance framework regulations. The implementation of the Taxonomy regulation requiring further disclosures by market participants will also contribute to improving transparency on specific environmental characteristics.

SFDR might provide useful for sophisticated investors who are able to parse the jargon accompanying the litany of newly created disclosures. It remains to be seen whether retail investors will ultimately become more savvy thanks to these disclosures, or conversely be bogged under by cryptic SFDR-related jargon-laden 'fine print'.

3 - <https://www.ft.com/content/e0237f69-a8c8-4bfc-9ccc-c466fb1f401>

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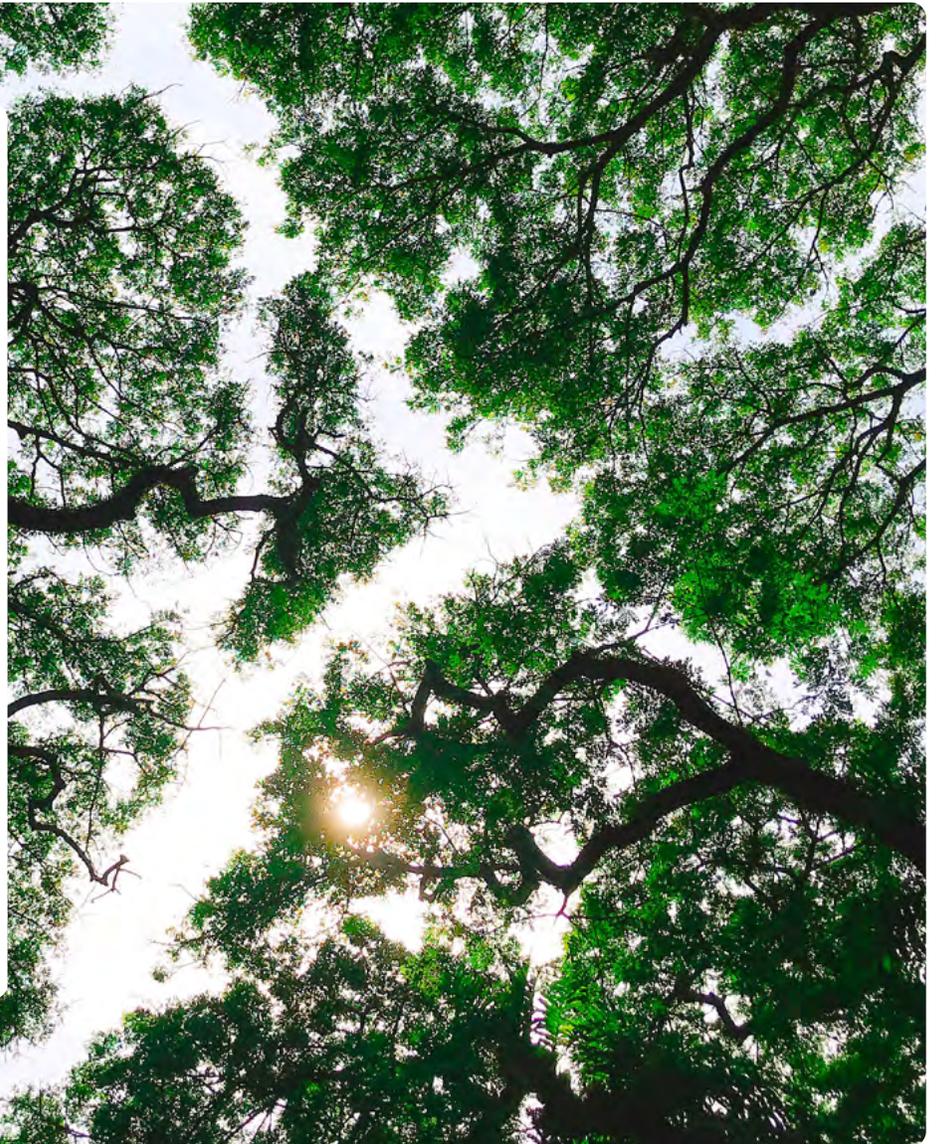
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\$171 B*

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