REGULATION (EU) 2019/2088

On sustainability-related disclosures in the financial services sector

(SFDR)

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ESG industry developments give prominence to EU rules on Sustainable Finance, including SFDR:

According to the Financial Times:

- “More than one in five of the world’s largest companies have made some form of commitment to reaching net zero emissions.”
- “Investors with more than $100tn in assets, such as BlackRock, Vanguard and Amundi, have signed the Principles for Responsible Investment, to integrate ESG information into their investment decisions.
- “The total assets in specialist sustainable investing mutual funds hit a record of almost $1.7tn in 2020, up 50 per cent over the year.”
- “Propelled by the new EU rules on sustainable finance, PwC predicts that assets in sustainable investment products in Europe will jump more than threefold to reach €7.6tn by 2025. The number of ESG funds is expected to outnumber conventional funds.”

Source: FT “Sustainable investing boom and net zero pledges drive ESG talent war” 5-6-21, “Greenwashing in finance: Europe’s push to police ESG investing” 10-3-21.

ESG industry developments give prominence to EU rules on Sustainable Finance, including SFDR:

Specialists from the European industry of sustainable finance have stated to the FT:

- "Private equity has realised you can't IPO a business unless it's got a really strong sustainability or ESG story."
- "Private equity buyers recognise that assessing the ESG credentials of prospective and existing investments is now a requirement."
- "Many of the funds that use the ESG label are not as sustainable as they appear. Several popular ESG funds, for example, invest in the world's largest carbon emitters."

Source: FT "Sustainable investing boom and net zero pledges drive ESG talent war" 5-6-21, "Greenwashing in finance: Europe's push to police ESG investing" 10-3-21.

What is the purpose of SFDR?

To provide **harmonised rules** on:

- how financial market participants and financial advisers **integrate sustainability risks** in their **processes (articles 3,5,6),**
- how financial market participants and financial advisers **consider adverse sustainability impacts (article 4, 7),**
- which **financial products** have **sustainable investment** as their **objective (articles 8,9,10,11).**

These types of disclosures form the key components of SFDR.

They apply at the **legal entity level** (<u>financial market participants 'FMP' & financial advisers 'FA'</u>) and **product level.**

- **Entity level information** must be disclosed on the **website.**
- **Financial product information** must be disclosed on **pre-contractual documents** (e.g. information to clients Art. 24.4 MiFID II, UCITS prospectus), **periodic reports** and on the **website.**

What is the scope of SFDR?

- **'financial market participant'** means: (a) an **insurance undertaking** which makes available an insurance-based investment product (IBIP); (b) an **investment firm** which provides portfolio management; (c) an **institution for occupational retirement provision** (**IORP**); (d) a **manufacturer of a pension product**; (e) an alternative investment fund manager (**AIFM**); (f) a pan-European personal pension product (**PEPP**) provider; (g) **a manager of a qualifying venture capital fund** registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (**UCITS management company**); or (j) a **credit institution** which provides portfolio management.
- **'financial adviser'** means: (a) an insurance intermediary which provides insurance advice with regard to IBIPs; (b) an insurance undertaking which provides insurance advice with regard to IBIPs; (c) a credit institution which provides investment advice; (d) an investment firm which provides investment advice; (e) an AIFM which provides investment advice in accordance with point (b)(i) of Article 6(4) of Directive 2011/61/EU; or (f) a UCITS management company which provides investment advice in accordance with point (b)(i) of Article 6(3) of Directive 2009/65/EC.
- **'financial product'** means: (a) a **portfolio** managed in accordance with Directive 2014/65/EU; (b) an alternative investment fund (**AIF**); (c) an **IBIP**; (d) a **pension product**; (e) a **pension scheme**; (f) a **UCITS**; or (g) a **PEPP**.

What are the core concepts of SFDR?

The Principal Adverse Impacts concept

- 'PAI' (recital 20, 18): impacts of **investment decisions** and **advice** that result in **material** or likely to be **material negative effects** on sustainability factors.
- **'sustainability factors'** (article 2.24): environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

How are PAI assesed? By indicators.

The RTS Final Report provides a list of **common reference indicators** (18esg+ 22e+24sg) to asses PAI e.g.:

*The negative effects of a FMP's portfolios of investments as regards **green house gas emmissions***, is assessed by specific indicators such as:

- carbon footprint or
- GHG intensity of investee companies.

How are PAI prioritised and identifed? According to the RTS Final Report, by considering the scope/severity/probability of occurrence and potentially irremediable character on sustainability factors.

What are the disclosure requirements under the PAI concept?

- **Article 4** (Recitals:18,19,20): **Since 10.3.2021** entities who had decided to consider PAI, should have published on their website a **statement on due diligence policies OR should have explained why they do not do so.**

The due diligence statement for FMP includes at least:

(a) information about **the policies** on the identification and prioritisation of PAI and indicators (i.e. persons responsible for implementation, methodologies to assess probability/severity of PAI, data sources used),

(b) a description of the PAI (i.e. indicators) and of any **actions** in relation to PAI described **taken** (i.e. shareholder dialogue with specific sustainability objectives, meetings with the management of investee companies) or, where relevant, **planned**,

(c) brief summaries of **engagement policies** (Article 3g of Directive 2007/36/EC), where applicable,

(d) a reference to FMP's **adherence to responsible business conduct codes** and internationally recognised **standards** for due diligence and reporting (Recital 18: Principles for Responsible Investment (PRI) and OECD due diligence guidance for responsible business conduct).

From **30.6.2021**, **large FMP and FMP parents of large groups** should consider PAI and publish the due diligence statement.

- **FMP may refer to the RTS Final Report for further guidance on PAI description or other aspects of the due diligence statement.**
- **FA may refer to the RTS Final Report for guidance on the information to be included in their statement.**

- **Article 7** (all products):

- **Since 10.3.2021 FMP who do not to consider PAI at the entity level**, should have stated in the pre-contractual documents of their products, that they do not consider the adverse impacts of investment decisions.
- **By 30.12.2022 FMP who consider PAI at the entity level**, shall disclose in the pre-contractual documents of the financial products, whether they consider PAI at the product level.

The sustainability risk concept

- 'sustainability risk' **(article 2.22): an environmental**, **social** or **governance event** or **condition** that, if it occurs, could cause an actual or a potential **material** negative **impact** on the **value of the investment.**

Examples of environmental risks: **Climate-related physical risks** such as changes in annual precipitation and extreme weather conditions that **could pose a threat e.g. to the continuity of a business undertaking's operations**, or **other types of risks** such as climate related regulation and initiatives (carbon pricing) that **could increase costs and administrative burden to the business undertaking.**

Examples of social risks: a business undertaking's quality of the **relations with employees, customers and local communities**, that **could pose a threat e.g. to the reputation, legal compliance and quality of services of the business undertaking's operations.**

Example of governance risk: lack of sound management structures that could result in poor capital allocation **of the business undertaking.**

What are the disclosure requirements under the sustainability risk concept?

- **Article 3** (Recital 12, 13): **Since 10.3.2021** entities should have disclosed on their website how they **integrate sustainability risks** in their investment decision-making **process** or **advice**.

Recital 12:

- FMP & FA **should integrate in their processes**, including their due diligence processes **sustainability risks,**
- should **assess** on a **continuous basis** all relevant **sustainability risks** that might have a relevant **material negative impact on the financial return** of an **investment** or **advice**.

The **Commission recently adopted six amending Delegated Acts, on fiduciary duties,** which clarify the obligation to integrate sustainability risks and other sustainability matters, reinforcing SFDR.

- **Article 5 (**Recital 22**): Since 10.3.2021** entities should have disclosed on their website, **how** their **remuneration policies** are **consistent with the integration of sustainability risks** (i.e. remuneration does not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance).

- **Article 6** (all products): **Since 10.3.2021** entities should have disclosed in the pre-contractual documents of **financial products**:

  (a) the manner in which **sustainability risks are integrated** into their investment decisions or advice **AND**

  (b) the **results** of the **assessment** of the likely **impacts of sustainability risks** on the **returns** of the **financial products** (**in qualitative or quantitative terms).**

Entities that deem **sustainability risks not to be relevant**, should include **a clear and concise explanation** in their pre-contractual documents.

The sustainable investment concept

SFDR 'sustainable investment' (article 2.17) means an **investment** in an **economic activity** that:

- ✓ **contributes to an environmental objective**, (eg reduction/avoidance of greenhouse gas emissions, good status of water/marine water, should be verifiable: RTS Final Report= PAI indicators + minimum safeguards) **OR**
- ✓ **to a social objective**, (eg tackles inequality, fosters social cohesion, social integration and labour relations, should be verifiable RTS Final Report= PAI indicators + minimum safeguards)

PROVIDED THAT the economic activity:

- ✓ **does not significantly harm (DNSH)** neither the environmental nor the social objective (should be verifiable: RTS Final Report= PAI indicators + minimum safeguards) **AND**
- ✓ the **investee companies follow good governance practices** (sound management structures, employee relations, remuneration of staff and tax compliance).

SFDR "sustainable investments" include "environmentally sustainable investments" within the meaning of Taxonomy Regulation (recital 19 TR).

minimum safeguards: specific international minimum human and labour rights and standards

Taxonomy Regulation "environmentally sustainable investment" (article 3 TR) means an investment in an **economic activity that:**

- ✓ **contributes substantially** to one or more **environmental objectives:** (E1) climate change mitigation; (E2) climate change adaptation; (E3) the sustainable use and protection of water and marine resources; (E4) the transition to a circular economy; (E5) pollution prevention and control; (E6) the protection and restoration of biodiversity and ecosystems; **(contribution is assessed by technical screening criteria established in Delegated Acts)**

- ✓ **does not significantly harm any** of the environmental objectives **(DNSH principle is assessed by technical screening criteria established in Delegated Acts)**

- ✓ is **carried out** in compliance with **minimum safeguards** i.e. specific international minimum human and labour rights and standards

- ✓ complies with **technical screening criteria (**under what conditions the economic activity (i) makes a substantial contribution to a given environmental objective; and (ii) does not significantly harm the other objectives).

Technical Screening Criteria = 4.6.2021 **Adoption of first Delegated Act** on climate objectives, **the second Delegated Act** on the remaining objectives is **underway.**

Minimum Safeguards = procedures implemented by an undertaking to ensure the alignment with the OECD Guidelines for Multinational Enterprises, **UN Guiding Principles** on Business and Human Rights, the **Declaration** of the International Labour Organisation on Fundamental Principles and Rights at Work and the **International Bill of Human Rights**

What are the disclosure requirements under the sustainable investment concept?

- **Articles 8-9: Since 10.3.2021:** FMP should have disclosed in pre-contractual documents information on their financial products that fall under article 8 or 9 **(details of disclosures: RTS Final Report as guidance).**

For **taxonomy related products** FMP shall disclose the required information from **1.1.2022, or 1.1.2023, depending on the environmental objective of the f.p.**

- **Article 10: Since 10.3.2021:** FMP should have disclosed the information on their article 8 or 9 financial products on their website **(details of disclosure: RTS Final Report as guidance).**
- **Article 11: From 2022/2023:** FMP shall disclose on the efficiency of their article 8, 9 products in periodic reports **(details of disclosure: RTS Final Report as guidance).**

The classification of f.p. under articles 8 & 9 is not a straight forward exercise, as it is not based on particular investment strategies or approaches:

Article 9 products (dark green products) should **comply** with **ALL** the criteria set out in the **definition** of **SFDR** sustainable investment or **TR** environmentally sustainable investment.

Article 8 products (light green products) should **promote** environmental and/or social characteristics, **provided that** the investee companies follow good governance practices.

Article 8 products (RTS Final Report Recital):

- “**One of the ways** in which financial products can promote environmental or social characteristics is **to take into account principal adverse impacts** of investment decisions.”
- “Financial market participants that make available financial products that promote environmental or social characteristics should make disclosures on those characteristics without misleading end investors…Therefore, disclosure **criteria** for **the selection of underlying assets** should be limited to those that **are binding** on the investment decision-process.”
- “Financial products that promote environmental or social characteristics **can invest in a wide range of assets**, **some of which may not contribute to** the specific environmental or social **characteristics** promoted by the financial product”.
- “The financial product **may pursue** in **part sustainable investment**.”