

New European ESG Disclosure Standards for Funds: European Supervisory Authorities Publish Final Draft Rules

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The three European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs) published last week the long-awaited Final Report, including the draft Regulatory Technical Standards on the content, methodologies and presentation of disclosures under the EU Regulation on sustainability related disclosures in the financial services sector (the “SFDR”) (the “SFDR Level 2 Rules”). The rules provide the detailed disclosure and reporting required for products and regulated EU investment firms within scope of SFDR.

Whilst the SFDR largely applies as of 10 March 2021, the SFDR Level 2 Rules apply only in January 2022. This means that whilst firms must comply with the high-level disclosure requirements in the SFDR, the detailed disclosure need not be supplied until January 2022.

We summarise below the key points of the final draft rules.

Principal Adverse Impacts Reporting (Article 4 of the SFDR). “Principal adverse impacts” (“PAI”) reporting is the requirement under the SFDR for larger firms to consider and report on a range of sustainability factors (framed as “externalities” because they may not be related to the value of the investment) across all their portfolios. Reflecting industry objections as to the scope of disclosures required under the previous draft published in 2020, the final draft contains a reduced set of “universal mandatory indicators” (now 14 set out in Table 1, reduced from 32) and a set of additional “opt-in indicators” for environmental and social factors (set out in Tables 2 and 3), with separate indicators for investments in sovereign assets and real estate assets.

Firms making PAI disclosure must disclose the mandatory indicators (Table 1), at least one additional indicator relating to climate or other environmental impacts (Table 2) and at least one additional indicator relating to social, employee, human rights, anti-corruption or anti-bribery impacts (on the basis of a materiality assessment) (Table 3) and specify any other indicators they may use. The assessment must be based on an average of four calculations made in quarterly “snapshots” during the year, with

historical comparisons going back at least five years. Information is required in the disclosure on methodologies to assess the impacts and data sources.

A recital indicates that where the investee company is a holding company or fund, the firm should “look through to the individual underlying investments of those companies and consider the total adverse impacts arising from them”. This will make it difficult in practice for funds of funds to comply with the requirements.

For firms that opt out, the requirement to publish on the firm’s website a “statement of no consideration of adverse impacts on sustainability factors” remains as drafted before.

In more detail, in the PAI impacts tables (Tables 1, 2 and 3):

- The mandatory indicators for the general class of “investments in investee companies” comprise nine environmental indicators (including various greenhouse gas emissions indicators, including, from 1 January 2023, scope 3 GHG emissions) and five social and employee indicators. There are only two mandatory indicators for investments in sovereigns and supra-nationals and for real estate assets.
- The additional opt-in indicators comprise various climate and other environment related indicators and social and anti-corruption and anti-bribery indicators.
- There is now an “actions taken” disclosure forming part of the table of disclosure relating to PAI indicators, asking firms to disclose their engagement and other actions taken and planned in relation to each impact.

As well as firms being required to summarise the “engagement policies” they have in place with investee companies to address the principal adverse impacts, there is now an obligation to disclose how the firm changes its engagement policies where “there is no reduction of the principal adverse impacts over more than one reference period”.

The ESAs indicate some sympathy for the challenge for firms to obtain all the data required for PAI reporting. A recital states that firms should use “all reasonable means available” through the use of internally and externally available data and through engagement with management of investee companies. The ESA’s commentary states that “The ESAs are aware that it may not be straightforward to assess the adverse impact of an investment decision due to the lack of reported data on a particular indicator. Nevertheless, the ESAs are convinced that the situation is improving, as evidenced by the growing share of ESG data provided by data providers. Furthermore, as the ESAs propose that the application date of the RTS should be set as 1 January 2022, financial market participants have more time to prepare for the start of the reporting under these RTS.”

In terms of timing, the entity-level requirements on disclosure apply from 10 March 2021. However, as the RTS apply from 1 January 2022, the detail specified in the RTS for the additional reporting applies from that date. Information collected on performance of the PAI indicators that relates to a prior “reference period” (a calendar year) will first apply in respect of a reference period starting in 2022, meaning that the earliest date when information on the PAI indicators must be reported is 30 June 2023, six months following the end of a reference period starting on 1 January 2022.

Disclosures Under Articles 8 and 9 of the SFDR. The SFDR has specific sets of pre-contractual disclosures for products that promote environmental or social characteristics (Article 8) and products with “sustainable investment” (which bears a specific meaning) as their objective (Article 9). For Article 8, the level of “promotion” of environmental or social characteristics to be within scope of Article 8 remains unclear, although a recital states the importance of a fund “promoting environmental or social characteristics” in its name or marketing material to bring it within scope: “To ensure comparability, where a financial product promotes environmental or social characteristics in a pre-contractual or periodic document, in its product name or in any marketing communication about its investment strategy, financial product standards, labels it adheres to or applicable conditions for automatic enrolment, the financial product should include the pre-contractual and periodic disclosures set out in this Regulation.” For Article 9, a “sustainable investment” is an investment in an economic activity that contributes to an environmental objective (such as renewable energy) or a social objective (such as a disadvantaged community), provided that the investment adheres to the principle of “do no significant harm” to any other objective and that the investee company follows “good governance” practices, including good management structures and fair treatment of employees. The product pre-contractual disclosures are similar as those previously drafted, with the emphasis on disclosure of the sustainability indicators used to attain the characteristics promoted or objectives achieved. For both types of products, the requirement to include a “short description of the policy to assess good governance practices of the investee companies” remains. For Article 8 and Article 9 products, there is a requirement to disclose the “minimum proportion” of the investments of the product used to attain the environmental or social characteristics promoted or the sustainable investment objectives, although there is no indication as to what “minimum proportion” would be sufficient to qualify the product within Article 8 or Article 9.

For Article 9 products (and Article 8 products investing in “sustainable investments”), there is a requirement to disclose how the indicators for adverse impacts in Table 1 and any relevant indicators in Tables 2 and 3 are taken into account both to contribute to the sustainable investment objective (a new requirement compared to the prior draft) and to the “do no significant harm” test that is an important part of the “sustainable investments” concept, requiring the firm to assess whether, in contributing to one

environmental or social objective, it does not harm other objectives. It is unclear for the “do no significant harm” test whether this requires application of all the indicators in Table 1, although firms may take the view that they only should apply the most relevant indicators. It also may be open for firms not to qualify an impact investing fund within Article 9 if it is not able to reach the standard of “do no significant harm” testing against the range of required factors.

All the information that is disclosed at the pre-contractual and reporting stages under Article 8 and 9 must also be disclosed on the firm’s website, along with additional items of disclosure. These are largely the same in the final RTS as previously drafted, with disclosure of similar elements to the product disclosure (such as the strategy to obtain the environmental or social characteristics and the sustainability indicators used). It is worth mentioning that the website disclosure needs to be made in “one of the official languages of the home Member State”.

In their commentary, the ESAs express some sympathy for respondents who pointed out that information in relation to the portfolios of many segregated accounts and private funds is confidential. In response, the ESAs indicate that they cannot change the rule in the SFDR requiring public website disclosure (whether or not the product is private or public) and that the SFDR makes no provision for password-protected disclosure. However, in giving some support, the ESAs state that “website disclosures should respect EU and national rules on confidentiality of information”. Whether this would in practice allow firms to permit limited website access to observe confidentiality obligations is to be determined.

Article 8 and 9 Periodic Disclosures (Annual Report). The annual reports required for funds within scope of Articles 8 and 9 are quite similar as previously drafted, with the emphasis on disclosure of the performance of the sustainability indicators, and a requirement to produce a historical comparison on the performance of the fund’s relevant indicators is now required for the prior five reference periods. There is further detail on historical comparisons (e.g., where quantitative disclosures are made, figures with a relative measure such as impact per euro).

There is still a requirement to disclose information on the portfolio, reduced from the top 25 investments to top 15 investments. For an Article 8 or 9 product that makes “sustainable investments”, there must be an explanation of how the sustainable investments have contributed to a sustainable investment objective and have not significantly harmed any of the objectives during the reporting period, including “how the indicators for adverse impacts in Table 1, Table 2 and Table were taken into account”.

The final rules also adopt the Article 8 and 9 disclosure pre-contractual disclosure templates as mandatory.

There are also templates for periodic disclosure for Article 8 and 9 products.

The final draft rules specify the detailed information required with more clarity in comparison to the prior draft, but uncertainties still remain. The ESAs submitted a letter to the European Commission in January 2020 seeking “urgent clarification” on a number of key issues where the SFDR is somewhat unclear, including funds within scope of Article 8.

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Please do not hesitate to contact us with any questions.

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