

# New European ESG Disclosure Standards for Funds: Consultation on Key Provisions

May 7, 2020

From 10 March 2021, new environmental, social and governance (“ESG”) disclosures will be mandatory for fund managers, financial advisers and many other regulated firms in the European Union (“EU”), as well as non-EU fund managers marketing their products in the EU. [As we have discussed in a prior update](#), the Regulation on sustainability-related disclosures in the financial services sector<sup>1</sup> (the “[Disclosure Regulation](#)”, as amended and supplemented by the “[Taxonomy Regulation](#)”) sets out detailed EU-wide rules that will require many firms, including most private fund managers, to disclose policies and procedures dealing with “sustainability risks” and “adverse sustainability impacts”.

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## Who Is Affected?

The Disclosure Regulation applies to asset managers pursuing any strategy not only impact funds, or products marketed as “ESG-friendly” although there are more onerous obligations for funds which specifically promote sustainability characteristics or objectives.

Furthermore, the Disclosure Regulation does not explicitly distinguish between EU and non-EU fund managers, nor between EU and non-EU financial advisers. Non-EU fund managers marketing their funds in the EU under the national private placement regimes will have to add, when relevant, pre-contractual and periodic information to the AIFMD required disclosures that are made to EU regulators and investors.

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## The Level 2 Consultation: Background

As discussed in our previous update, the Disclosure Regulation is very high-level, but requires the European Supervisory Authorities (“ESAs”) to draft regulatory technical

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<sup>1</sup> 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.

standards (“RTSs”) with respect to certain disclosure rules to specify how those disclosure requirements will apply in practice. These rules will be adopted by the European Commission and become a “Level 2 Regulation”.

On April 23, the ESAs published a [consultation paper](#), including a draft of the RTSs (the “Consultation”). This represents an important step towards the finalisation of the detailed rules, and will help firms to begin their preparations for implementation. However, the rules are not yet final, and the Consultation is clearly an opportunity to shape the final form of the RTSs.

It is important to note that the RTSs only cover a limited number of articles of the Disclosure Regulation. In particular, two important provisions of the Disclosure Regulation, mandatory disclosure of sustainability risk policies and disclosure statements on remuneration policies, are not the subject of any further Level 2 regulation. Nevertheless, firms should bear in mind that these obligations will be effective from March 2021, alongside the others that are dealt with in this note.

The Consultation divides the disclosure items covered by the draft RTSs into two categories:

- **Adverse impact reporting at entity level:** the RTSs provide details of the disclosure of “principal adverse impacts of investment decisions on sustainability factors”, which is required by the Disclosure Regulation for all financial market participants<sup>2</sup> (the “Adverse Impacts Statement”)<sup>3</sup> including detailed indicators for environmental and social sustainability factors. This Statement, which must be published on a website, will need to specify whether “sustainability factors”<sup>4</sup> are taken into account in investment decisions and due diligence policies<sup>5</sup> and, if not, why not.
- **Product Disclosure:** the RTSs cover pre-contractual, website and periodic product disclosures (referred to as “Product Pre-Contractual Disclosure”<sup>6</sup>, “Product Website Disclosure”<sup>7</sup> and “Product Periodic Disclosure”<sup>8</sup> respectively), as they apply to products with “environmental or social characteristics” (as described in Article 8 of the Disclosure Regulation) or with “sustainable investment objectives” (as separately

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<sup>2</sup> Financial market participants include in particular fund managers, insurance undertakings, investment firms and credit institutions providing portfolio management.

<sup>3</sup> Arts 4(6) and 4(7) Disclosure Regulation.

<sup>4</sup> Art 4(1)(a) Disclosure Regulation.

<sup>5</sup> Art 4 (1)(a) Disclosure Regulation.

<sup>6</sup> Arts 8 and 9 Disclosure Regulation.

<sup>7</sup> Art 10(2) Disclosure Regulation.

<sup>8</sup> Art 11(4) Disclosure Regulation.

described in Article 9). The draft RTSs give further detail on the proposed form of those disclosures for such sustainability-oriented products.

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## General Principles

The Disclosure Regulation aims to protect investors. In line with other EU legislation, it requires that disclosures be clear, not misleading and up to date<sup>9</sup>. The RTSs specify that such information is made available in searchable electronic format<sup>10</sup>.

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## Entity Disclosure of Principal Adverse Impacts of Investment Decisions in Sustainability Statement

An Adverse Impacts Statement, which must be disclosed on the website of an affected firm, is a statement that either describes the due diligence policies that are applied by the firm to identify the adverse impacts of investment decisions on sustainability factors or that clearly states that adverse impacts are not taken into account.

For firms that choose to consider adverse impacts, the RTSs identify 32 adverse impact indicators (16 environment- and climate-related indicators and 16 indicators relating to social and employee matters, respect for human rights, anti-corruption and anti-bribery matters) that must always be included in the statement. These include (for example) greenhouse gas emissions, biodiversity, human rights and anti-corruption matters. The full list is included as an Annex to this note.

In addition, there is a further list of other possible adverse impact indicators that could be included, with a requirement to include at least one additional climate and environmental impact indicator and one additional social or governance impact indicator.

The ESAs have also included a proposed template for this website disclosure by the firm. This sets out the mandatory information that will be required, including the order in which it must appear. According to the proposed template, the statement will need to include the following sections:

- a summary<sup>11</sup>, which contains generic information such as the time period considered;

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<sup>9</sup> Art 2(1) Draft RTSs.

<sup>10</sup> Art 2(2) Draft RTSs.

- details of the assessment of principal adverse sustainability impacts<sup>12</sup>, which requires completion of a form breaking down the adverse sustainability indicators by category, including (for example) “climate and other environment-related indicators”<sup>13</sup> such as “greenhouse gas emissions”, “energy consumption from non-renewable sources”, “water emissions” and “deforestation”<sup>14</sup>, and “social and employee, respect for human rights, anti-corruption and anti-bribery matters”, such as “gender pay gap”<sup>15</sup> and “operations and suppliers at significant risk of incidents of child labour”<sup>16</sup>;
- a description of the policies used to assess principal adverse sustainability impacts<sup>17</sup>;
- a description of actions taken to address principal adverse sustainability impacts<sup>18</sup>;
- the engagement policies employed by the relevant firm<sup>19</sup>; and
- a description of the firm’s adherence to international standards<sup>20</sup>.

There is also a requirement to provide a “historical comparison” in the Adverse Impacts Statement. This means a comparison of the current reference period with the previous reference periods covering at least the shortest of: (a) the previous ten years; (b) the period from the date on which the financial market participant first considered principal adverse impacts of its investment decisions on sustainability factors; or (c) the period beginning 10 March 2021.

There is little direct guidance on how these sections of the template should be completed, but the recitals<sup>21</sup> do give some helpful examples of actions which financial market participants can take to show they have considered principal adverse sustainability impacts; these include “exercising voting rights as a shareholder, sending letters to or attending meetings with the management of investee companies, setting up documented and time-bound engagement in actions or shareholder dialogue with specific sustainability objectives, planning escalation measures in case those objectives are not achieved, including reductions of investments or exclusion decisions”.

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<sup>11</sup> P.53 Consultation.

<sup>12</sup> P.53 Consultation.

<sup>13</sup> P.53 Consultation.

<sup>14</sup> P.55 Consultation.

<sup>15</sup> P.57 Consultation.

<sup>16</sup> P.59 Consultation.

<sup>17</sup> P.63 Consultation.

<sup>18</sup> P.63 Consultation.

<sup>19</sup> P.63 Consultation.

<sup>20</sup> P.63 Consultation.

<sup>21</sup> Recital 15, p. 21 Consultation.

The requirements regarding this Statement are less onerous for “financial advisers”<sup>22</sup>, i.e., firms that do not take investment decisions.

The Adverse Impacts Statement may impose significant additional costs on firms. Completing such a statement will require firms to carry out extensive due diligence in connection with a contemplated investment, which may go beyond the due diligence already being conducted. The recitals of the draft Level 2 Regulation suggest that financial market participants “employ external market research providers, internal financial analysts and specialists in the area of sustainable investments, undertake specifically commissioned studies, use publicly available information or shared information from peer networks or collaborative initiatives”<sup>23</sup> to better understand the risk of adverse impacts on sustainability factors.

As mentioned above, most firms are not required to consider the adverse impact of sustainability factors in their investment process; they may instead disclose that they do not do so. Firms that choose to take this approach will have to publish a prominent statement that they not consider the adverse impacts of their investment decisions on sustainability factors, clearly explain why they do not and, “where relevant”, whether they intend to do so in the future. Such a statement may have an effect on the attractiveness of the product to some investors.

From 30 June 2021, this “comply or explain” approach will only be permitted for financial market participants with less than 500 employees. Firms and “large groups”<sup>24</sup> that exceed this size during the financial year will have to explain how they consider adverse impacts and will not be able to state that they do not.

In the Consultation, the ESAs invite stakeholders to comment on the indicators that are included in the draft template. They are also asked to consider whether the indicators should be mandatory, optional, or a mix of both.

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<sup>22</sup> Art 4(5) Disclosure Regulation.

<sup>23</sup> Recital 7, p. 20 Consultation.

<sup>24</sup> Directive 2013/34/EU defines large groups as “groups consisting of parent and subsidiary undertakings to be included in a consolidation and which, on a consolidated basis, exceed the limits of at least two of the three following criteria on the balance sheet date of the parent undertaking: (a) balance sheet total: EUR 20 000 000; (b) net turnover: EUR 40 000 000; (c) average number of employees during the financial year: 250.”

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## Product Disclosure for Products Which Are Promoted with Sustainable Characteristics or Which Pursue Sustainable Investment Objectives

As mentioned above, for financial market participants who offer products which claim to pursue an environmental, social or sustainable investment strategy (“impact funds”) or potentially much more broadly those that “promote ... environmental or, social characteristics”, the environmental or social characteristics or sustainable investment objectives must be disclosed in pre-contractual and periodic disclosures and on the firm’s website. The draft RTSs also set out additional disclosures that should be provided by products that have designated an index as a reference benchmark.

The draft RTSs provide some colour on how the sections of these disclosures will be organised, but do not yet specify a detailed template. We understand that a separate process will be undertaken by the ESAs to prepare these templates.

For products that are promoted as having sustainable characteristics or sustainable investment objectives, the draft RTSs propose that “narrative and graphical representations” should be included in the Disclosure to illustrate the planned proportion of the total investments that are “sustainable investments” and, where relevant, the subdivision of those sustainable investments between environmental or social objectives<sup>25</sup>. This is true of the Pre-Contractual Disclosure, the Product Periodic Disclosure<sup>26</sup> and the Product Website Disclosure<sup>27</sup>.

### Pre-contractual Product Disclosure

The draft RTSs set out the elements that should be included in this pre-contractual disclosure:

- the sustainable characteristics or sustainable investment objective of the product;
- how the product does not “significantly harm” other sustainable investment objectives (and, in this respect, the ESAs have also made proposals on the “do not significantly harm” principle);
- a description of the investment strategy;
- a list of the sustainability indicators used;

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<sup>25</sup> Art 15(2) draft RTSs, p.32 Consultation.

<sup>26</sup> Art 41 draft RTSs, p.44 Consultation.

<sup>27</sup> Chapter IV draft RTSs, p.38 Consultation.

- whether derivatives are used to attain the characteristics or objectives; and
- a reference to a website for more disclosure and information for products designating an index as a reference benchmark on how the product is aligned with the benchmark and how the benchmark differs from a broad market index.

### **Public Website Product Disclosure**

Product Website Disclosure must be contained in the same part of the website as the other information relating to the financial product, but in a section headed 'Sustainability- related disclosures'<sup>28</sup>. The website disclosures must include the methodologies used to assess, measure and monitor the environmental or social characteristics and the RTSs include a list of items to be included. These focus on the methodology employed, the data sources used and any screening criteria employed which implies, importantly, that there cannot be any confidentiality as to the methodology. Control mechanisms, internal or external, used to monitor such compliance should be maintained in the website disclosures on an ongoing basis.

### **Periodic Product Disclosure**

Periodic product disclosure requirements are intended to show the track record of the product in terms of how successful it is in attaining its sustainable characteristics or objectives. Therefore, the ongoing disclosures in periodic reports should be up to date and are not limited to the fundraising period. The RTSs include a granular list of items to be included in reports, focusing on the success of the product in attaining its environmental or social characteristic(s) or sustainable investment objective(s), such as:

- how the sustainable characteristics or objectives have been met;
- how the product did not harm significantly sustainable objectives;
- the top 25 holdings of the product;
- for products designating an index as a reference benchmark, the sustainable performance of that index;
- the proportion of sustainable investments; and
- actions taken to attain the sustainable characteristics and objectives.

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<sup>28</sup> Art 33 draft RTSs, p.38 Consultation.

There is also some guidance on presentation. For example, it is proposed that the first three items in periodic reports should be in the following order “(a) Attainment of the sustainable investment objective/environmental or social characteristic promoted by the product (b) No significant harm of sustainable investment objectives (c) Top investments of the financial product.”

Periodic disclosures will also include a historical comparison that compares the current reference period with previous reference periods covering at least one of the following: the previous ten years; the date on which the fund manager first considered the relevant sustainability indicator; or from 1 January 2022<sup>29</sup>.

The Disclosure Regulation contemplates that Product Periodic Disclosure, Product Pre-Contractual Disclosure and Product Website Disclosure are only applicable to financial market participants (including asset managers), not financial advisers, which is logical given that financial advisers are offering advice rather than a financial product.

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## Promotion of Products with Sustainable Characteristics: No Template Yet

As mentioned above, templates other than the Adverse Impacts Statement are not annexed to the Level 2 Regulation. The presentation of Product Periodic Disclosure, Product Pre-Contractual Disclosure and Product Website Disclosure is “to be developed”<sup>30</sup>, though we do know the general headings that will be present in each<sup>31</sup>.

The ESAs’ say that their preferred option is to adopt common minimum standards on Product Pre-Contractual Disclosure and Product Website Disclosure rather than high level disclosures (which would defeat the purpose of greater comparability) or very granular rules (which would be overly burdensome). The ESAs are generally of the opinion that only a template can achieve the goal of easy comparability between products, but they are aware of the need to strike a balance between the objective of enabling comparability and the constraints for firms. Stakeholders are invited to comment on the approach.

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<sup>29</sup> Art 51 draft RTSs, p.47 Consultation.

<sup>30</sup> P.68 Taxonomy Regulation.

<sup>31</sup> See for example p.35 of the Consultation, Art 23, for Presentation of pre-contractual information.

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## Interplay with the Taxonomy Regulation

The ESAs are concurrently developing the RTSs and draft provisions for the Taxonomy Regulation, a regulation designed to embody the EU Taxonomy Regulation which was agreed at political level in December 2019. The Taxonomy Regulation is designed to provide a framework for assessing environmental sustainability but its relationship to the Disclosure Regulation has not yet been fully ironed out. For example, the ESAs identified that the Disclosure Regulation defines “sustainable investments” without reference to the detailed definitions in the Taxonomy Regulation, which risks regulatory divergence<sup>32</sup>.

At present, the Taxonomy Regulation only covers environmental sustainability goals, whilst the sustainability indicators in the Disclosure Regulation (and indeed the very definition of “sustainable investment” in the Disclosure Regulation) cover both environmental and social goals. The fact that a “sustainable investment objective” under the Disclosure Regulation is not the same as one that complies with one of the six Taxonomy objectives means that the application of these similar concepts across the two Regulations is somewhat different.

In addition, for a financial product to be “taxonomy compliant”, as well as making a significant contribution to one of the six specified objectives, it must “do no significant harm” (“DNSH”) to any of the other Taxonomy objectives (and must comply with certain social standards). As mentioned above, the concept of DNSH also exists in the Disclosure Regulation but, in this case, not as a precisely defined concept but only as a “precautionary principle”<sup>33</sup> that captures both environmental objectives and economic activities contributing to social objectives. The DNSH principle, in the Taxonomy Regulation, only addresses environmental objectives.

Furthermore, the DNSH statement is a key part of the information to be provided in Product Pre-Contractual, Periodic and Website Disclosure. However, the principle of DNSH does not feature in the Adverse Impacts Statement, although it is not entirely clear how “significant harm” and “adverse impacts” may be related. The ESAs recommend that the Commission should consider clarifying the relationship between the two concepts<sup>34</sup>.

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<sup>32</sup> P.8 Consultation.

<sup>33</sup> Recital 17, Disclosure Regulation.

<sup>34</sup> See p.9 Consultation.

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## Next Steps

Stakeholders can respond to the Consultation by 1 September 2020. The ESAs will review the RTSs based on the responses received. Within the fourth quarter of 2020, the ESAs must deliver their final report with the Level 2 Regulation to the European Commission for endorsement before being published in the Official Journal of the European Union. Most provisions of the Disclosure Regulation, including the RTSs, will apply from 10 March. The Periodic Product Disclosures will apply from 1 January 2022.

**Annex: Proposed mandatory adverse sustainability indicators**

- Carbon emissions (broken down by scope 1, 2 and 3 carbon emissions—including agriculture, forestry and other land use (AFOLU) emissions—and in total)
- Carbon footprint
- Weighted average carbon intensity
- Solid fossil fuel sector exposure
- Total energy consumption from non-renewable sources and share of non-renewable energy consumption
- Breakdown of energy consumption by type of non-renewable sources of energy
- Energy consumption intensity
- Energy consumption intensity per sector
- Biodiversity and ecosystem preservation practices
- Natural species and protected areas
- Deforestation
- Water emissions
- Exposure to areas of high water stress
- Untreated discharged waste water
- Hazardous waste ratio
- Non-recycled waste ratio
- Implementation of fundamental ILO Conventions
- Gender pay gap
- Excessive CEO pay ratio

- Board gender diversity
- Insufficient whistleblower protection
- Investment in investee companies without workplace accident prevention policies
- Human rights policy
- Due diligence
- Processes and measures for preventing trafficking in human beings
- Operations and suppliers at significant risk of incidents of child labour
- Operations and suppliers at significant risk of incidents of forced or compulsory labour
- Number and nature of identified cases of severe human rights issues and incidents
- Exposure to controversial weapons (land mines and cluster bombs)
- Anti-corruption and anti-bribery policies
- Cases of insufficient action taken to address breaches of standards of anti-corruption and anti- bribery
- Number of convictions and amount of fines for violation of anti-corruption and anti-bribery laws

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