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ESG—Overview and Practical Guide to the New EU Sustainable Finance Disclosure Rules

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Introduction

March 10 welcomes in new rules on sustainable investing in the European Union. Key parts of the EU's Sustainable Finance Disclosure Regulation[1] ("SFDR") have now come into force, with the full range of new rules being phased in over the coming months. The new rules are intended to channel capital flows towards sustainable investments with a view to supporting the UN's Sustainable Development Goals and the Paris Climate Change Agreement.

The rules set out disclosure obligations in relation to Environmental, Social, and Governance ("ESG") issues for asset managers and advisers. The rules apply principally to businesses located in the EU. However, U.K. and U.S. managers, amongst other "financial market participants" and "financial advisers"[2], will be caught by the new SFDR rules where they market products into the EU.

In developing its proposals for the SFDR, the European Commission found that there was a lack of transparency in how institutional investors, asset managers, and financial advisors considered sustainability risks in their investment decision making and advisory processes. This meant that clients did not get the full information they need to inform their investment decisions or recommendations. The new disclosure rules are intended to remove these information asymmetries.

In this note we provide a brief overview of the new obligations and go on to discuss some of the issues that firms have been grappling with in implementing the rules.

Key New Obligations

The SFDR is part of a package of EU reforms relating to sustainable investing. This also includes the Taxonomy Regulation, which comes into force in January 2022.[3]

The focus of the SFDR is on transparency and disclosure to investors of the approach that a firm takes to sustainability issues in its investment and advisory processes. The Taxonomy Regulation provides a legal framework to be followed in screening investments to determine whether they are "environmentally sustainable."

Neither SFDR nor the Taxonomy Regulation require firms to integrate ESG considerations across their activities. However, firms will need to disclose their approach to these issues and where products are promoted as sustainable, justify this in order to mitigate risks of so-called "green washing."

Although the new rules do not mandate adoption of ESG investing across the board, the transparency and "*comply or explain*" provisions in SFDR will undoubtedly exert indirect pressure on firms to adopt aspects of ESG in their investment and advisory processes. In addition to this, firms will need to

take clients' ESG preferences into account when providing investment advice or managing an investment portfolio as part of the suitability processes. It will, therefore, become increasing untenable for firms to avoid sustainable investing issues as a result of these new requirements.

We set out below a table summarising the main disclosure obligations under the SFDR. By way of introduction, obligations to disclose information apply at a legal entity level and also in relation to specific financial products. Where products promote sustainability or have sustainable investment as an objective, additional disclosure obligations arise including with respect to periodic reporting in relation to the relevant product.

Disclosure Obligation	Firm/Legal Entity Level	Financial Product Level
Integration of sustainability risks in investment processes	Firms must prepare policies on the way they integrate sustainability risks in their investment decision making and/or advisory processes. The information about these polices is required to be published on firms' websites. Sustainability risks in this context focus on ESG risks that could have a negative impact on the value of an investment. (Article 3)	In relation to individual financial products, firms must explain whether they integrate sustainability risks in their processes. Where they do, disclosures must cover how such risks are integrated and the "*likely impacts*" of risks on the returns of the financial products that they "*make available*" or advise on. Where firms do not take sustainability risks into account, they must explain why they do not do so. The disclosures must be provided within the sector specific pre-contractual disclosures to investors, including Article 23 AIFMD and Article 24 MiFID. (Article 6)
Principal adverse impact disclosures	Firms are required to disclose on their websites whether they take into account the "*principal adverse impacts*" of investment decisions on sustainability factors (PAI). The provisions relating to PAI concern the scope of due diligence undertaken by firms on environmental, social, employee, respect for human rights, and bribery/corruption matters. Consideration of PAI issues is not mandatory in call cases. Unless the firm concerned has 500 or more employees or is a parent	For each financial product, firms must provide a clear and reasoned explanation of whether and if so how the product considers principal adverse impacts of investment decisions on sustainability factors or a statement that the firm does not consider PAI. Firms must also state that information on PAI is available to be disclosed. This disclosure can be provided either in qualitative or quantitative terms. (Article 7)

Disclosure Obligation	Firm/Legal Entity Level	Financial Product Level
	undertaking of a large group under an EU Directive 2013/34/EU, there is no obligation to consider PAI matters. In such cases, firms will need to provide a clear explanation of why they do not do so. (Article 4)	
Remuneration Policies	Firms must include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks. That information, though not necessarily the remuneration polices, must be published on the firm's website. (Article 5)	
Products promoting environmental or social characteristics		For all products that promote environmental or social characteristics, firms must provide pre-contractual disclosure on how the product meets these requirements (i.e., how the product promotes environmental and/or social characteristics and how investee companies follow good governance). (Article 8) Firms must also publish and maintain on their websites a description of the relevant environmental or social characteristics and information on the methodologies used to assess, measure, or monitor the characteristics including data sources used and screening criteria (together with the information disclosed under Article 8). The purpose of this provision is to address greenwashing and the risk of products being held out as ESG

Disclosure Obligation	Firm/Legal Entity Level	Financial Product Level
		compliant when they do not meet required standards. (Article 10)
Products with a sustainable investment objective		Where a financial product has sustainable investment as its objective, a pre-contractual disclosure must be provided as to how that objective is to be attained. (Article 9) Firms must also provide and maintain on their websites a description of the objectives, and information on the methodologies used to assess, measure, or monitor the impact of the sustainable investment objective, including data sources used and screening criteria (together with the information disclosed under Article 9). (Article 10)
Periodic reporting for Article 8 and Article 9 financial products		Firms must carry out periodic reporting on Article 8 and Article 9 financial products. This needs to cover in relation to Article 8 products, the extent to which environmental and social characteristics are met and in relation to Article 9 products, the overall sustainability related impact of the product using sustainability indicators.

We discuss below a number of issues that firms have had to consider with regard to the implementation of the SFDR.

Territorial Scope of the New Rules – are U.K. or U.S. Firms in Scope?

The SFDR applies principally to EU licensed firms, including portfolio managers licensed under the EU's MiFID Directive and Alternative Investment Fund Managers licensed under the AIFMD. U.K., U.S., and other Third Country (i.e., non-EEA firms) are, therefore, in principle outside scope of the SFDR.

The SFDR is not part of the retained body of EU following Brexit so that it does not apply in the U.K. The U.K. is formulating its own green taxonomy and developing U.K. climate related disclosure requirements, but these are not presently in force.

A U.K. asset manager, which manages a portfolio from the U.K. and does not have any EU based investors will not need to comply with the provisions of the SFDR. However, U.K., U.S. and other Third Country firms marketing financial products to EU based investors will need to comply with the SFDR's requirements at the product level. This is on the basis that such firms will need to comply with National Private Placement Regimes in local markets, which mandate the use of disclosures, including Article 23 AIFMD disclosures. These disclosures must now include product related disclosures under SFDR.

U.K. and U.S. managers acting under a delegation, for example, from an EU AIFM are also likely to have to comply with aspects of SFDR under the delegation.

Products in Scope

Firms need to consider whether they make available financial products within the scope of the SFDR. The term "*financial product*" is defined in Article 2(12) of SFDR to include portfolios managed by a MiFID portfolio manager, an Alternative Investment Fund under the AIFMD, a UCITS and pension products. However, "*financial products*" do not include shares, debt or other securities.

In most cases it will be clear whether a financial product is being made available and, if so, what that product is. However, in the case of some fund type structures the position might be more ambiguous.

A CLO, for example, is likely to fall outside the definition of a "*financial product*." A CLO vehicle will not constitute an AIF and the notes that it issues will not be financial products within the SFDR definition.[4] On the other hand, a CLO manager will be carrying on the activity of portfolio management under MiFID and that portfolio will constitute the financial product. Where a CLO portfolio is managed from the U.K., it is likely that the CLO will fall outside the scope of the SFDR even though the notes are marketed to investors in the EEA.

Product Categorisation

Financial market participants, including AIFMs and portfolio managers, must categorise their products in order to determine which of the product categories they fall into. As noted above, these are Article 8 (products that promote environmental or social characteristics), Article 9 (products with sustainable investment their objective) and Article 6 (all remaining financial products).

"Promotion" of Environmental and Social Characteristics

Some uncertainty exists as to when a product should be regarded as "*promoting*" environmental or social characteristics.

Some alternative funds industry bodies have expressed the view that the word "promote" carries with it the notion of active marketing. However, it is likely that a firm and/or financial product could be deemed to be "promoting" even where the product is not specifically marketed in this manner. Firms must, therefore, exercise caution in relation to the statements made in connection with products and how they are position to the market.

The Joint European Supervisory Authorities Final Report on the SFDR RTS (of 2 February 2021) attached draft Commission Delegated Regulation, which refers to the following:

- The draft Delegated Regulation states that one of the ways in which financial products can promote environmental or social characteristics (and thereby fall within Article 8) is if they take into account the principal adverse impacts of investment decisions. Therefore, making a principal adverse impact statement could potentially bring a product within Article 8, even though the text of SFDR does not legally mandate this.

- Financial products that promote environmental or social characteristics cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions. Given the most products will include restricted investment lists of so called "excluded sectors" care needs to be exercised in how information is provided around investment strategies and appropriate disclaimer wording should be incorporated around the positioning of the product. Where appropriate, firms should state clearly that they do not promote ESG characteristics in order to minimise the risk of mis-classification.

- The draft Delegated Regulation also contrasts the position with Article 9 funds which have sustainable investment as an objective. In relation to this the draft Delegated Regulation indicates that Article 9 funds are funds that "*exclusively pursue*" sustainable investments, which sets a relatively high bar for a fund to be considered to fall within Article 9.

- Finally, the draft Delegated Regulation notes that firms need to exercise caution in how disclosures are made in relation to products that promote environmental or social characteristics. In particularly, investment criteria that are disclosed should be "binding" and not discretionary criteria that can be over-ridden.

In practice, an informal categorisation has arisen with the use of terms such as "*light-green*," "*moderately green*," and "*dark green.*" Light and moderately green funds are regarded as falling within Article 8. A moderately green fund could, for example, include a fund with a commitment to invest a certain amount of the portfolio in environmental or social investments, whereas a light green fund might promote such investments generally without a commitment to a specific allocation. A dark green fund will have an exclusive commitment to sustainable investments.

Many financial products will fall outside the scope of Article 8 and Article 9 products, in which case the product will fall within Article 6, which requires the disclosures around integration of sustainability risks in investment decision-making processes and consideration of principal adverse impacts on sustainability factors.

Consequences of Product Categorisation

The categorisation of financial products is important not only with regard to the positioning of products with investors but also in connection with the disclosure and ongoing reporting obligations that will apply.

The disclosure for Article 8 and Article 9 products will need to be made in the form of the templates mandated under the Delegated Regulation. Although these have not yet been finalised many firms are already working with the current drafts. The templates for disclosures relating to Article 8 and Article 9 financial products imply that firms will need to collate a broad range of information to support the disclosures and ongoing periodic reporting. Firms must therefore give careful consideration to their ability to comply with these requirements.

Overlap With the Taxonomy Regulation

The SFDR forms part of a package together with the Taxonomy Regulation. The Taxonomy Regulation is focused more closely on ESG risks, including climate change risks and does not come into force until January 2022. While the two Regulations are not formally legally linked, they are plainly closely connected.

One particular aspect of the connection between the Regulation is the principle of "do not significantly harm." This concept appears in the definition of "*sustainable investment*" under the SFDR and in the criteria under the Taxonomy Regulation in determining whether an investment is environmentally sustainable. The link might therefore import into SFDR assessments criteria under the Taxonomy Regulation.

Access to Information

The SFDR requires firms to obtain significant amounts of information about investee companies and investments. In the course of the implementation process material concerns have been raised about whether managers will be able to access the required information for the purpose of fulfilling their own disclosure obligations. Corporate reporting has tended to focus on financial data, which is of limited value to firms in collating and assessing data for compliance with SFDR requirements. Companies have, of course, begun to report publicly on environmental and other non-financial issues but data sets are not yet complete for SFDR purposes.

In order to address these concerns, in the EU the Non-Financial Reporting Directive requires listed companies to include a non-financial statement in their annual report covering environmental, social and employee matters, respect for human rights, anti-corruption, and bribery matters. Amendments made by the Taxonomy Regulation will require large entities to include additional information in their non-financial statement on how and to what extent their activities are associated with environmentally sustainable economic activities. This includes matters such as the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable.

While the EU has levers that it can use to procure disclosure within its "borders", firms investing outside the EU might have greater difficulties accessing relevant information.

Conclusion

Events over the last year have focused thoughts more closely on environmental and social issues. Though long in gestation, the SFDR's implementation coincides both with the broader societal trend in focusing on social and environmental issues and with strong investor demand for sustainable investing. Sustainable funds are forecast to make up more than 50% of the European funds market by 2022 and inflows into sustainable funds and investments are increasing rapidly. There are, therefore, strong commercial imperatives for firms to offer ESG or sustainable investment products. Demand for such products will grow and while not mandating the application of ESG to all investment and advisory processes, the legislation is quite clearly nudging firms in this direction.

The dichotomy between profitable investing and sustainable investing has proved to be a false one. With increasing regulation, fines, and other sanctions for non-compliance with ESG standards by investee companies, expanding the scope of due diligence to obtain a qualitative as well as quantitative view of a potential investment has become a key investment tool.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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[1] Regulation (EU) 2019/2088.

[2] Financial market participants also include insurance companies, pension products providers and banks that provide portfolio management services. Financial advisers also capture insurance intermediaries, banks, investment firms and investment managers that provide investment advice.

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[3] The SFDR and Taxonomy Regulation are part of the EU Sustainable Finance Action Plan of March 2018.

[4] Because the term "financial product" does not include debt securities.