

BRIEFING NOTE

EU REGULATION ON SUSTAINABILITY-RELATED DISCLOSURES IN THE FINANCIAL SERVICES SECTOR

Updated November 2020

AT A GLANCE

The regulation ([EU 2019/2088](#)) on Sustainable Finance Disclosure Regulation (SFDR) introduces new requirements and clarifies the sustainability-related disclosure obligations in the financial services sector. Disclosure requirements are set out at entity and product level. The new requirements distinguish between all products and financial products targeting or promoting environmental and/or social objectives. The regulation applies to financial market participants from 10 March 2021.

In application of the SFDR, the European Supervisory Authorities (ESAs) are also developing Regulatory Technical Standards (RTS) detailing the content and the presentation of disclosure requirements, while taking into account the various types of financial products, their characteristics and the differences between them. The RTS will include sustainability indicators in relation to the adverse impacts of investment decisions in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

The ESAs issued a consultation paper¹ setting out the proposed Regulatory Technical Standards (RTS) in April 2020 which was open for comments until 1 September 2020. The ESAs are asked to submit the draft regulatory technical standards by 30 December 2020.

LINK TO TAXONOMY REGULATION

The regulation ([EU 2020/852](#)) on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation) is an amendment to the regulation on sustainability-related disclosures in the financial services sector (SFDR). The final text was published in the Official Journal of the European Union on 18 June 2020. The Taxonomy Regulation and the Sustainability Disclosures Regulation both apply to the same categories of funds and are designed to be complementary disclosure frameworks. In this briefing, key requirements of the Taxonomy Regulation are also identified. For more details on the Taxonomy, please see the [PRI's briefing note](#).

¹ [Joint ESA Consultation on Regulatory Technical Standards \(RTS\)](#)

WHO IS AFFECTED?

The regulation applies to financial institutions, defined as:

- Insurance undertakings making available Insurance-Based Investment Products (IBIPs);
- Institutions for Occupational Retirement Provision (IORPs);
- Manufacturers of pension products;
- Pan-European Personal Pension Product (PEPP) providers;
- Alternative Investment Fund Managers (AIFMs);
- Undertakings for Collective Investment in Transferable Securities (UCITS) management companies; and
- Investment firms or credit institutions providing portfolio management and investment advice.

DISCLOSURE REQUIREMENTS

Transparency requirements for financial market participants and financial advisers

Financial market participants and **financial advisers** shall publish on their website:

- Policies on the integration of sustainability risks in their decision-making or in their investment or insurance advice (Article 3, Disclosure Regulation);
- A **statement** on how they consider **Principal Adverse Impacts (PAI) of investment decisions on sustainability factors**². This is on a **comply or explain** basis for firms below 500 staff and mandatory for those above (Art. 4, Disclosure Regulation); The statement shall include:
 - policies on the identification, prioritisation and description of principal adverse sustainability impacts;
 - a summary on engagement policies and references to conduct codes and standards and;
 - where relevant the degree of alignment with the Paris Agreement.
- Information on how their **remuneration policies** are consistent with the integration of sustainability risks (Article 5, Disclosure Regulation).

Transparency requirements at product level

For all products, financial institutions must disclose:

- How sustainability risks are integrated in investment decisions, their likely impact on the return of the financial product (comply or explain) (Art. 6, Disclosure Regulation);
- Whether and how a financial product considers principal adverse impacts on sustainability factors (comply or explain) (Art. 7, Disclosure Regulation);
- How and to what extent the Taxonomy regulation has been used in determining the sustainability of the underlying investments, the environmental objective(s) to which the fund contributes and the proportion of the underlying fund that is Taxonomy-aligned, expressed as a percentage. If this is not provided, the fund must carry a disclaimer stating *‘the investments underlying this financial*

² Note: the European Supervisory Authorities are developing a regulatory technical standard which will contain sustainability indicators in relation to adverse sustainability impacts.

product do not take into account the EU criteria for environmentally sustainable investments.’ (Art. 7, Taxonomy Regulation).

For all products, financial advisers must disclose:

- How sustainability risks are integrated into their investment or insurance advice, their likely impact on the return of the financial product (comply or explain) (Art. 6, Disclosure Regulation).

Financial products promoting environmental and/or social objectives (“Article 8 products”):

- A description of the environmental and/or social objectives of the product; details of how they are met; information on the reference index and the methodology used if a benchmark has been used (Art. 8, Disclosure Regulation);
- How and to what extent the EU Taxonomy has been used in determining the sustainability of the underlying investments, the environmental objective(s) to which the fund contributes and the proportion of the underlying fund that is Taxonomy-aligned, expressed as a percentage. (Art. 5, Taxonomy regulation);
- Disclosures shall be accompanied by the following statement: *‘The “do no significant harm” principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’* (Art. 6, Taxonomy Regulation).

Financial products with a sustainable investment³ objective (“Article 9 products”):

- **With index as reference benchmark:** information on how the index is aligned with the objective and an explanation of why and how this differs from a broad market index (Art. 9 (1), Disclosure Regulation); source of methodology (Art. 9 (4), Disclosure Regulation);
- **Without index as reference benchmark:** explanation on how the objective is to be attained (Art. 9 (2), Disclosure Regulation);
- Where the **objective is a carbon emissions reduction**, information on the alignment with the Paris Agreement targets shall be disclosed (Art. 9 (3), Disclosure Regulation); source of methodology (Art. 9 (4), Disclosure Regulation);

³ ‘sustainable investment’ means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance (Art. 2(17), Disclosure Regulation).

- Products invested in economic activities that contribute to **environmental objective(s) set out in the Taxonomy** shall disclose to which environmental objective the product is contributing to and provide a description of how and to what extent the financial product is invested in environmentally sustainable activities⁴ (Art. 5, Taxonomy Regulation).

REGULATORY TECHNICAL STANDARDS

At the end of October 2020, ESMA published a [statement from the European Commission](#) on the application of the SFDR. The main points are:

- The Regulatory Technical Standards (RTS) will become applicable at a later stage.
- All application dates are being maintained as laid down by the Regulation, with effect from 10 March 2021. Financial market participants and financial advisers subject to the Regulation will need to comply with its high level and principle based requirements from that time.
- In relation to transparency of adverse sustainability impacts, numerous financial market participants currently comply with the non-financial reporting requirements under Directive 2013/34/EU or adhere to international standards and might consider using that information.

PRI ANALYSIS AND RECOMMENDATIONS

The [Directive 2013/34/EU](#) on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (Accounting Directive) is amended by the Non-Financial Reporting [Directive \(NFRD\) 2014/95/EU](#). The NFRD suggests that companies under the scope of the Directive may rely on recognised international frameworks when providing non-financial information such as the;

- United Nations (UN) Global Compact;
- Guiding Principles on Business and Human Rights implementing the UN 'Protect, Respect and Remedy' Framework;
- Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises;
- International Organisation for Standardisation's ISO 26000;
- International Labour Organisation's (ILO) Tripartite Declaration of principles concerning multinational enterprises and social policy;
- Global Reporting Initiative (GRI).

These recommendations overlap to a great extent with the minimum social and governance safeguards provided for in Article 18 of the Taxonomy Regulation.

In the absence of regulatory technical standards to specify the details of the presentation and content of the information to be disclosed under the SFDR, the PRI recommends signatories consider the following guidance and principles when preparing their disclosure related to Principal Adverse Impacts (PAI):

⁴ Criteria for environmentally sustainable economic activities is set out in Art. 3, Taxonomy Regulation

1 - Identifying Principal Adverse Impact

The minimum social and governance safeguards provided for in Article 18 of the Taxonomy Regulation with particular reference to:

- The OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs) can help identifying potential risks of adverse impacts in the following areas:
 - Human Rights;
 - Employment and Industrial Relations;
 - Environment;
 - Combating bribery, bribe solicitation and extortion;
 - Consumer interest;
 - Science and Technology;
 - Competition;
 - Taxation.
- The due diligence guidance for Responsible Business Conduct (RBC) for institutional investors developed by the Organisation for Economic Co-operation and Development (OECD) to guide investment behaviour and the assessment of adverse impacts;
- The precautionary principle of ‘do no significant harm’, ensuring that neither the environmental nor the social objective of “sustainable investment” is significantly harmed as pointed out in recital 17 of the SFDR regulation.

2 - Assessing adverse impacts

The guidelines for Responsible Business Conduct for Institutional Investors: Key Considerations for Due Diligence under the OECD Guidelines for Multinational Enterprises⁵, helps institutional investors implement the due diligence recommendations of the OECD Guidelines for Multinational Enterprises in order to prevent or address adverse impacts related to human and labour rights, the environment, and corruption in their investment portfolios.

- The guidelines help identifying actual and potential adverse impacts. Even though, for many enterprises, the term “risk” means primarily risks to the enterprise – financial risk, market risk, operational risk, reputational risk – the guidelines refer to the likelihood of adverse impacts on people, the environment and society that enterprises cause, contribute to, or to which they are directly linked. In other words, it is an outward-facing approach to risk.
- Furthermore, the guidelines point out a number of approaches for investment managers across different asset classes, before and after investment, to identify adverse impacts related to investee companies. Where an asset owner or asset manager appoints an external investment manager, they should ascertain that the investment manager has appropriate policies and procedures in place to identify actual and potential adverse impacts. They should also monitor the investment manager’s implementation of these policies and procedures on an ongoing basis.

⁵ [Responsible Business Conduct for Institutional Investors: Key Considerations for Due Diligence under the OECD Guidelines for Multinational Enterprises](#)

3 - Access to remedy

The OECD Guidelines for Multinational Enterprises point out that addressing actual and potential adverse human rights impacts consists of taking adequate measures for their identification, prevention, mitigation, remediation, and accounting for how the adverse human rights impacts are addressed. The term 'infringing' refers to adverse impacts that an enterprise may have on the human rights of individuals⁶.

PRI's recently published guide "[Why and how investors should act on human rights](#)" provides further guidance on the three-part responsibility investors have to respect human rights:

1. policy commitment;
2. due diligence processes;
3. enabling or providing access to remedy.

PRI POSITION

Through its work with the [Fiduciary Duty in the 21st Century Programme](#), the [High-Level Expert Group on sustainable finance](#), and [response to the consultation on the legislative proposals related to disclosure, benchmarks and taxonomy](#), the PRI demonstrated that ambiguity around investor duties has been a key barrier to the systematic ESG integration by investors. The PRI welcomes the creation of disclosure requirements for sustainability risks which will support integration of ESG issues across asset classes and geographies.

The regulation will also encourage investors to identify, assess and mitigate the potential adverse impacts of their investment on society and the environment. This is consistent with the direction of the broader sustainable finance agenda, as investors increasingly work to understand outcome focused investments.

The PRI has issued a [response](#) to the consultation on the forthcoming Regulatory Technical Standards and strongly believes that these should build from existing good practice in the investment industry.

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⁶ [OECD Guidelines for Multinational Enterprises](#)