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Andrea Gasperini
Head of Sustainability Aiaf

Sonia Artuso
Financial Analyst CESGA, CIIA, CEFA

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andrea.gasperini@aiaf.it
sonia.artuso@aiaf.it

How do investment choices impact the planet? This is the question that drives the complex Sustainable Finance Disclosure Regulation (SFDR). There is no escaping the truth: SFDR is complicated, varied and often, slightly enigmatic.

SFDR 2019/2088: THE OPERATIONAL IMPACT

AIAF ESG Expert Group | Viewpoint edited by

Nadia Giuliani, CESGA®

Head Liquid Investments Office and ESG Strategy Referent – Inarcassa

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Introduction

The goal of this viewpoint is to untangle the various disclosure provisions. SFDR Level 1 became effective on March 10, 2021, and compliance is currently required on a high-level and principle basis. Due to the length and technical detail of those 13 regulatory technical standards (RTS), and in order to facilitate the smooth implementation of the delegated act by product manufacturers, financial advisers and supervisors, the EU Commission would defer the date of application of the delegated act to 1 January 2023. Given the overall deferral of the application of the delegated act, it is anticipated that financial market participants will be required to comply with the key adverse sustainability impact disclosure requirements set forth in the delegated act the first time by June 30, 2023, which is the first reporting period under the regulatory technical standards that runs from January 1, 2022 to December 31, 2022.

Key highlights of this project are:

- Sustainable Finance Disclosure Regulation (below "SFDR") – Imposes transparency and disclosure requirements on firms and products
- Taxonomy Regulation – Establishes criteria for determining whether an economic activity is environmentally sustainable and includes additional product-level reporting requirements for products that promote environmental characteristics
- Low Carbon Benchmarks Regulation – Introduces a new framework for climate related benchmarks
- Amendments to AIFMD, UCITS and MiFID – Require AIFMs and UCITS to integrate sustainability risks into their risk management processes, and require sustainability factors to be taken into account in the product governance and suitability processes of firms subject to MiFID.

The new Sustainable Finance Disclosure Regulation - SFDR that introduced various disclosure-related requirements for financial market participants and financial advisors at entity, service and product level. It aims to provide more transparency on sustainability within the financial markets in a standardised way, thus preventing greenwashing and ensuring comparability. The majority of the new disclosure obligations are applicable as of 10 March 2021. Therefore, SFDR is the first set of a regulatory wave aiming to reorient capital flows towards a more sustainable economy.

The main requirements of SFDR are to disclose "ESG information" for both entities and products, but also Ex-ante requirements (KIID, Prospectus and websites) as well as ex-post (Annual Reports and MiFID clients reports). It also aims to make information differentiated according to the "degree of ESG", for example if the products are standard "non-ESG": this information should be clearly mentioned in the Prospectus, while for funds with "ESG characteristics" and funds with "sustainable objectives" a higher level of disclosure needs to be met. Requirements to disclose information on how ESG characteristics are met and objectives are to be attained respectively.

In order to implement SFDR at the operational level the Financial Market Participants must:

a) classify products range in 3 categories: ESG products (Article 8), Sustainable Investment products (Article 9), and other products that do not meet the qualifications of the two first groups (Article 6);

b) disclose information with descriptive information like how funds take sustainability risks into account in their investment decisions or what are the ESG characteristics; and data indicators adverse sustainability impacts also called PAI – Principle Adverse Impacts).

c) make sure that all the information disclosed are consistent across different materials (pre-contractual documentation, websites etc.) on an on-going basis

d) publish the required information on climate, environmental and social specificities of funds' assets

Implementation of the SFDR links to and deepens other key sustainable investment themes. In particular, it complements with:

1. **Governance aspects**

   Governance issues or considerations related to how a firm manage itself, board diversity and executive pay, are treated specifically in Article 5 of the SFDR. According to this article, a manager must include in its remuneration policy information on how the policy is consistent with the integration of sustainability risks. It is required to publish on its website the updated policy or a statement explaining how the policy is consistent with the integration of sustainability risks. The inclusion in the remuneration policy, of information on how its remuneration policy is consistent with the integration of sustainability risks implies, for companies, the review of the existing remuneration policies and transparency. It may explain how these policies promote sound and effective risk management with respect to sustainability risks and it also need to clarify that the remuneration structure does not encourage excessive risk-taking with respect to sustainability risks and in term ofrisk-adjusted performance.

2. **Shareholder Rights Directive II (below SRD II)**

   The Directive aims to enable more effective engagement between investors and companies, while at the same time encouraging long-term thinking. There is clear evidence that the current level of 'monitoring' of investee companies and the engagement by institutional investors and asset managers are often inadequate and focus too much on short-term returns. Shareholder's short term actions are the driving force behind the management of the company and can lead to the detriment of a broader set of stakeholders, including also investors and clients. While strategies, purpose and stewardship process vary across investors, the Regulation (EU) 2019/2088 strongly encourages both institutional investors and asset managers to consider their stewardship opportunity and responsibility, whether undertaken directly or through intermediaries. The SFDR complements the SRD II since It requires financial institutions to identify and integrate ESG factors (or disclose they do not), Instead the SRD II provides that investors will engage on these identified ESG risks. Therefore, there is no specific link between the new SFDR regulation and SRD II, but rather a cross-sectional and impacting effect precisely by virtue of transparency that is a key issue on which the SFDR is built.

3. **Fiduciary duty**

   The Regulation (EU) 2019/2088 embraces an evolution of fiduciary expectations. It should be remembered that the revised Markets in Financial Instruments Directive (MiFID II) requires firms to act honestly, fairly and professionally in accordance with the best interests of their clients, when providing investment services or ancillary services, which can be viewed as a positive - regulatory - duty with fiduciary characteristics. As a general rule, the scope of fiduciary duties is to be defined by the terms of the agency contract, so long as they are clear, unambiguous and reasonable, and consistent with limits imposed at common law on the construction of exclusion clauses. The fiduciary duties require the manager to pursue the client's financial objectives where this is the purpose of the portfolio's mandate. As such, there is no legal basis for an investment manager to prioritise moral or ethical considerations over financial performance, unless agreed under the mandate. However, the consideration of ESG factors may also contribute to achieving the client's financial objectives, which means that there can be an alignment of ethical considerations and financial returns. The consideration of ESG factors may be compatible with a requirement to serve the client's best interests, even where fiduciary duties are defined by the pursuit of financial returns, so long as this is undertaken in order to promote the client's financial objectives rather than the ethical views of the investment manager.

Therefore, the introduction of the Sustainable Finance Disclosure Regulation (SFDR) is seen as one of the key

milestones for the accomplishment of the EU action plan for financing sustainable growth. Even as the guidelines for the implementation of the technical standards of this regulation are not finalized yet, it is worthwhile to analyze how fund promoters and investors act with regard to fund launches and investments under the new SFDR classifications according to the articles six, eight, and nine.
While the former can be measured by the number of funds (primary share classes) classified as article six, eight, or nine compliant, the latter can be measured by the estimated net flows in each of the categories.
It should be noted that disclosure requirements under the Taxonomy Regulation (TR) related to climate mitigation and adaptation goals begin to apply on January 1, 2022, while the SFDR RTS has an anticipated application date of July 1, 2022.

Conclusions

It is worth bearing in mind a few suggestions to better elaborate the proposals for the market (asset manager side) and to analyse in depth the offer of financial instruments (investor side):

1. There is still little clarity and alignment on definitions, including what ratings or data products are intended to be measured;
2. Still little transparency on the methodologies behind ESG ratings or data products;
3. While there is wide divergence within the ESG ratings and data products industry, there is not uniform coverage of products offered, with some sectors or geographies benefiting from greater coverage than others, leading to gaps for investors seeking to follow certain investment strategies;
4. Concerns could be incurred, related to managing conflicts of interest where the provider of ESG ratings and data products performs consulting services for the companies subject to such ESG ratings or data products;
5. increased and improved communication with companies that are the subject of ESG ratings or data products is an area that deserves further attention given the importance of ensuring that ESG ratings or other data products are based on accurate information.

This article is current as of the date of its publication and does not necessarily reflect the present state of the law or relevant regulation.

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