Syntax

Breaking Down the Basics: Sustainable Finance Disclosure Regulation

Lea Mayer September 6, 2023

What is the Sustainable Finance Disclosure Regulation?

In March 2021, the Sustainable Finance Disclosure Regulation (SFDR) was established as the first European Union (EU) Action Plan on Sustainable Finance, introduced by the European Commission alongside the Taxonomy Regulation and the Low Carbon Benchmarks Regulation. The SFDR consists of mandatory disclosure requirements for asset managers, along with financial service providers, to enable a more consistent approach to comparing sustainability factors across various funds. According to the SFDR, investors in the EU, as well as investors marketing themselves to the EU, must now classify their funds as either Article 6, 8, or 9, depending on the investment strategy as it relates to sustainability incorporation.

The SFDR regulation seeks to increase transparency around sustainable financial products, paired with the creation of a common set of standardized reporting disclosures. The long-term goal, however, is targeted at encouraging market participants to improve their ESG performance, ultimately increasing investments towards sustainability-related products and services.

Additionally, in July 2020, the EU began the development of the EU Taxonomy, the first-of-its-kind sustainable business classification system that aims to standardize what qualifies as an investment in a sustainable business for the investment community. The EU Taxonomy is a key component of the SFDR, which aims to govern sustainability labeling for financial products and services marketed in the EU.

Categorizing Article 6, 8, and 9 Investments

Article 6 is considered "Grey"

- A fund where sustainability risks are integrated into investment decisions, without the fund promoting environmental or social characteristics or targeting sustainable investments.

Article 8 is considered "Light Green"

- A fund that promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.

Article 9 is considered "Dark Green"

- A fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective.

What are the Principle Adverse Impacts?

The Principle Adverse Impacts (PAIs) are a series of metrics that financial market participants are required to consider whether material or likely to be material, of investment decisions on sustainability factors. They should integrate into their processes, including in their due diligence processes, the procedures for considering the principal adverse impacts alongside the relevant financial risks and relevant sustainability risks.[1] The scope of the PAIs is broad ranging from CO2 and GHG Emissions to governance and social issues, including board gender diversity and exposure to controversial weapons, respectively. In addition, if market participants have investments in supranatural and sovereign entities and/or real estate, then additional PAIs are required to be reported on.

The List of Mandatory PAIs[2]

- GHG emissions total (Scope 1, Scope 2, and Scope 3)[3]
- Carbon footprint
- GHG intensity of investee companies MT CO2e /$M Revenue
- Fossil fuel sector
- Non-renewable energy consumption
- Energy consumption intensity per high-impact climate sector

- Biodiversity sensitive areas
- Emissions to water
- Hazardous waste ratio
- Violations of UN Global Compact principles and OECD Guidelines
- Lack of processes and compliance with UN Global Compact principles and OECD guidelines
- Gender pay gap
- Board gender diversity
- Exposure to controversial weapons
- GHG intensity (Applicable to Sovereigns and Supranational Investments)
- Investee countries subject to social violations (Applicable to Sovereigns and Supranational Investments)
- Exposure to fossil fuels through real estate assets (Applicable to Real Estate)
- Exposure to energy-inefficient real estate assets (Applicable to Real Estate)

What are the Reporting Requirements for Articles 6, 8, and 9?

Moving from Article 6 to Article 8 to Article 9 requires meeting an increasingly stringent level of standards.

Article 6 Requirements:

Although funds do not need to incorporate environmental or social factors within the investment strategy, funds must disclose how they are considering sustainability risks that have the potential to negatively impact business operations.

Examples of Sustainability Risks Integrated into Investment Decisions:

- Physical impacts of climate change on vulnerable assets
- Bribery and corruption
- Inequality, unfair treatment of labor, and/or human rights abuse

Article 8 Requirements:

Article 8 funds are obliged to publish pre-contractual and periodic disclosures.

Good Governance Practices - This can be expressed on a spectrum of qualitative language or metrics.

- Sound employee relationships (United Nations Global Compact compliance, human rights)
- Management structure (business ethics, bribery)
- Remuneration of staff (consistent remuneration)
- Tax compliance (no significant controversies, policies related to tax compliance)

Principle Adverse Impacts - For financial market participants who consider PAIs, a general rule of thumb is the requirement to disclose the PAIs at the entity level on their website. Additionally, for fund administrators with over 500 employees, all 18 mandatory PAIs are required to be reported. For those with less than 500 employees, there is a "comply or explain" clause that allows fund administrators to state whether or not they are capturing the PAIs, and if not, the reason why they are not considered.

Article 9 Requirements:

Article 9 funds have more stringent reporting requirements. Similar to Article 8 funds, Article 9 funds need to publish pre-contractual and periodic disclosures. In addition to setting a sustainable investment as their objective, Article 9 funds, with a designated index selected as a reference benchmark, cannot utilize a broad market index.

Technical Screening Criteria - The technical screening criteria in Delegated Acts for the Taxonomy Regulation provide the conditions under which economic activities can be considered Taxonomy-aligned.[4]

Do no Significant Harm - A fund must prove that its sustainable investments cause no significant harm (DNSH) to environmental and social objectives. For example, if a company that builds and operates rail infrastructure does not follow particular waste recycling practices, its business would be deemed to cause significant harm to the goal of promoting a circular economy and therefore, unaligned with the environmental objective.

Principle Adverse Impacts - In order to prove the DNSH criteria, the product disclosures must include a full consideration of all mandatory Principal Adverse Impact indicators (PAI indicators). In order to accurately capture the PAIs, investment funds are obliged to collect all the critical information from their portfolio companies, ranging from climate and social policies to ESG metrics.

Minimum Safeguards - Through analysis of the standards referred to in Article 18 of the Taxonomy Regulation (OECD guidelines for Multinational Enterprises), United Nations

Guiding Principles on Business and Human Rights (UNGPs), the eight International Labour Organization conventions on fundamental principles and rights at work, and the international bill of human rights, the minimum safeguards identifies four core topics defined as:

- Human rights, including workers' rights
- Bribery/corruption
- Taxation
- Fair competition[5]

What Reporting is Mandatory across Asset Managers, Advisors, and Financial Products?

	Asset Managers	Advisors	Products
Sustainability Risk	• A policy on the integration of sustainability • Risks in the investment decision-making process	• A policy on the integration of sustainability • Risks into the investment advice or insurance advice	• Publish the manner in which sustainability risks are integrated into their investment decisions and the assessment of likely impact of sustainability • Risks on the return of the product
Principal Adverse Impact	• Consideration of PAIs of investment decisions on sustainability factors • Statement on due diligence policies • Mandatory for large entities and large holdings • Comply or explain for all other entities	• Consideration of the Principal Adverse Impacts on sustainability factors in investment or insurance advice • Comply or explain	• Disclose how each financial product considers the adverse impacts on sustainability factors

Examples of Sustainable Disclosures Featured in Article 8 Products

1. Exclusions and Norms-Based Screening:

Exclusions and norms-based screening products have long been the most straightforward form of ESG investing practices. These types of products simply exclude certain sectors, or set thresholds based on investor preferences, for prohibiting the inclusion of companies whose products and services are misaligned. For example, companies that are engaged in fossil fuels, gambling, and/or animal products might be excluded from funds.

2. Exclusions and ESG Scoring:

Similar to the above exclusions, funds may also partake in ESG scoring, where issuers are rated by a third-party ESG ratings provider or can be based on an in-house, proprietary ESG scoring methodology, where a minimum threshold is set to determine a fund's eligibility.

Example of Sustainable Disclosures Featured in Article 9 Products

3. Impact Focus:

Article 9 products have a non-financial objective and alternatively, are mandated to make a positive environmental or social contribution to society through its sustainable investment objective. For example, funds that are aligned with the Paris Agreement, with the primary investment objective being carbon emissions reduction, are eligible as Article 9 products. These funds need to be assessed against climate benchmarks to measure progress towards emission reductions aligned with the Paris Agreement.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088

[2] https://www.eiopa.europa.eu/system/files/2021-02/jc-2021-03-joint-esas-final-report-on-rts-under-sfdr.pdf

[3] Scope 1 CO2 Emissions: Direct emissions from a company's owned or controlled assets. This includes fleets, buildings, airplanes, etc. For example, not only the number of vehicles within the fleet but also the burning of fuel required to power the fleet falls within this scope.

Scope 2 CO2 Emissions: Indirect emissions from a company's operations, also known as "purchased electricity." This type of emission encompasses the energy (including electricity, steam, heat, or cooling) that is purchased and utilized by companies. An example of Scope 2 emissions would be the electricity that is used within office buildings.

Scope 3 CO2 Emissions: All upstream and downstream supply chain emissions. This includes a wide variety of activities, including but not limited to employee commuting, waste generation, purchased goods and assets, and the transportation of products.

[4] https://www.esma.europa.eu/sites/default/files/library/jc_2022_62_jc_sfdr_qas.pdf

[5] https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-minimum-safeguards_en.pdf

[6] http://am.jpmorgan.com/us/en/asset-management/insitutional/investment-strategies/sustainable-investing/understanding-SFDR/