EU Sustainable Finance Disclosure Regulation Fact Sheet

BNP Paribas
SFDR ESG Fact Sheet

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EU Sustainable Finance Disclosure Regulation (SFDR)

The Sustainable Finance Disclosure Regulation "SFDR" came into force in March 2021 and sets out ESG mandatory disclosures for institutional investors and financial advisers. The following factsheet gives an overview of SFDR obligations and timeline for its implementation. It also explains the interplay with other EU ESG regulations (MIFID II ESG amendments, Taxonomy, BMR).

1. BACKGROUND

The EU Sustainable Finance Disclosure Regulation (EU) 2019/2088 ("**SFDR**") is a regulation that is designed to make easier for investors to distinguish and compare between many sustainable investment products that are now available. It requires various **product and entity level disclosures** to be made by **in-scope firms** (known as financial market participants or "**FMPs**", and financial advisers or "**FAs**"), which are broadly EU institutional investors, such as fund managers, and financial and insurance advisers.

SFDR is one of ten action plans of the EU Sustainable Finance Action Plan of March 2018, which features a series of interlinking regulations (notably the Taxonomy Regulation "**TR**"[2] and the coming Corporate Sustainability Reporting Directive "**CSRD**"[3]) designed to encourage sustainable investing.

The level 1 SFDR came into force on 10 March 2021. The detailed provisions of the Level 2 Regulatory Technical Standards consolidating both SFDR and TR RTSs (the "**RTS**") have been adopted by the EU Commission on 6 April 2022 and are now subject to scrutiny by the European Parliament and the Council. The RTS will be applicable on 1 January 2023. As such until that time, FMPs are required to comply with the Level 1 provisions only. In the meantime, actors subject to SFDR face the challenge of implementing complex level 2 requirements in a limited time.

Timelines:

10 Mar '21: application of SFDR L1

2 Aug'22 MiFID2[1] ESG amendment re Suitability Preferences applies

22 Nov'22 MiFID2 amendment re Product Governance applies

1 Jan '23: application of SFDR L2 incl Art5&6 TR product disclosures for all environmental objectives

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[1] Please refer to our GM ESG **MiFID** factsheet and section below "Interplay with MiFID"

[2] Please refer to the section below "Interplay with Taxonomy".

[3] **CSDR:** on 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive which would amend the existing reporting requirements of the NFRD. The proposal (i) extends the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises) (ii) requires the audit (assurance) of reported information (iii) introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards and (iv) requires companies to digitally 'tag' the reported information, so it is machine readable and feeds into the European single access point envisaged in the capital markets union action plan. **NFRD:** Non-Financial Reporting Directive (Directive 2014/95/EU) amends the **Accounting Directive** 2013/34/EU and lays down the rules on disclosure of non-financial and diversity information by certain large companies.

2. KEY CONCEPTS UNDER SFDR

To achieve the transparency goal, SFDR imposes to in-scope firms to disclose the manner in which they consider two key factors: **Sustainability Risks** and **Principal Adverse Impacts** (**PASI**). In-scope firms are also required to classify their products based on their sustainability ambitions and comply with disclosure and product eligibility requirements that flow from the categorisation.

• Key definitions

- **Sustainable Investment**: this is an investment in an economic activity which:
  - Contributes **either to** an **environmental** objective or a **social** objective
  - **Does not significantly harm** (DNSH)**4** any environmental or social objectives, **<u>and</u>**
  - The investee company follows good **governance** practices .
- **Sustainability Risk:** this is an environmental, social or governance event or condition which, if it occurs, could cause a material negative impact on the value of an investment. This is the financial risk dimension of ESG matters.
- **Sustainability Factors**: this means environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
- **Principal adverse impacts on sustainability factors** (**PASI**) (Art4): potential negative effects of investment decision on ESG matters.

• Product classification

SFDR Products are classified along three categories:

- **"Dark green" – "Article 9 Products**": products that have a "Sustainable Investment objective" and which are expected to exclusively target Sustainable Investments.
- **"Light green" – "Article 8 Products**": products that promote, among other characteristics, environmental or social characteristics, a combination of those characteristics, provided that the companies in which they investments are made follow good governance practices.
- **"Non green" – "Article 6 Products**": products that do not purport to promote any kind of ESG objective.

💣**Article 8 products can have a "pocket" of sustainable investments**: they can include taxonomy-aligned investments. According to the **RTS**, the pre-contractual documentation will specify if the product will have a pocket of Sustainable Investment expressed as a percentage of total assets. Pre-contractual documentation will also indicate the proportion of taxonomy-aligned investments.

3. SCOPE

• Entities in scope

SFDR applies to EU financial market participants **FMPs** (mainly institutional investors), and to certain non-EU FMPs (see below). These entities include:

- Investment firms or credit institutions which provide portfolio management services
- Insurance undertakings which offer insurance-based investment product (IBIP)
- IORPs (institution for occupational retirement provision)
- Manufacturers of pension products and PEPP provider (pan-European personal pension product)
- Managers of qualifying venture capital funds and qualifying social entrepreneurship funds

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[4] The industry is discussing the interpretation of the DNSH test and any potential reference to PASI indicators

- Management companies of UCITS funds and AIFM (alternative investment fund manager)

SFDR also applies to financial and insurance advisers (FAs), albeit with lighter requirements, mostly to explain how they take into account sustainability matters when they recommend a product to their clients.

Geographical application:

SFDR applies to EU-regulated entities, according to sectoral legislation such as UCITS or AIFMD. The extraterritorial impacts of the regulation are therefore limited since it captures activities done or products offered in the EU. However, the Commission has clarified that SFDR applies to non-EU AIFMs marketing their funds into EU under AIFMD National Private Placement Regime rules[5].

Financial Products in scope

SFDR applies to funds and funds-like products as follows (**SFDR Products**):

Product types	Specific in-scope products	Regulation Acronym	Legislation
Funds	UCITS investment funds	UCITS IV	Directive 2009/65/EC
	Alternative Investment Funds	AIFMD	Directive 2011/61/EU
	European Venture Capital Funds	EuVECA	Regulation (EU) 345/2013
	European Social Entrepreneurship Funds	EuSEF	Regulation (EU) 346/2013
	European Long-term investment funds	ELTIF	Regulation (EU) 2015/760
IBIPS	Investment Based Insurance Products	IBIPS	Regulation 1286/2014
Pension products	Occupational Retirement Schemes	IORP II	Directive (EU) 2016/2341
	Specified Pension Products	PRIIPS	Regulation (EU) 1286/2014
	Pan European personal Pension Products	PEPP	Regulation (EU) 2019/1238
Portfolio Management[6]	Portfolio Management by Credit Institutions	MiFID II	Directive 2014/65/EU
	Portfolio Management by Investment Firms	MIFID II	Directive 2014/65/EU

- **Structured products: are not SFDR Products**. SFDR captures funds and fund-like products but is not applicable to bonds or structured products. However, since structured notes may be included in SFDR Products (for instance distributed via our insurers clients through life insurance contracts), they are indirectly captured.
- **Derivatives are not SFDR Products,** however FMP are required to explain how the use of derivatives, if any, meet the sustainable investment objectives or sustainability characteristics of their products.
- **Indices/ Benchmarks are not SFDR Products,** however, a product in-scope of SFDR that tracks an index that qualifies as an EU Climate Transition or Paris-aligned Benchmark (see Benchmark section further below) may be treated in different ways under SFDR.

[5] EC Q&A 14 Jul '21 (Question 1) sfdr_ec_qa_1313978.pdf (europa.eu)

[6] This last inclusion is a bit counterintuitive since it is a service offered by an investment firm rather than a product. From the perspective of the SFDR regulation, it is seen as being similar to an investment fund

4. DISCLOSURE REQUIREMENTS

FMPs and FAs are required to publish statements and disclosures at entity and product level. The **RTS** includes the mandatory templates (Annexes II-IV)[7] for PASI reporting at entity level and the pre-contractual and periodic reporting for Article 8 and 9 Products.

• Legal entity level disclosures (on website):

Disclosures on their website include:

- How they integrate sustainability risks within their investment management/advisory services and in their remuneration policies and procedures.
- PASI: how they assess the PASI of their investment management/ advisory activities on the environment, Society etc. This obligation can be implemented on a comply or explain basis for FMPs (however this PASI disclosure is mandatory for large FMPs).
    - The RTS sets-out a prescribed list of 16 mandatory PASI indicators that firms should consider and report against. PASI indicators should be calculated quarterly and reported annually.
    - The PASI disclosure obligations on FAs do not require them to annually report in the same way, but rather they must explain ex ante how they consider the PASIs of financial products they advise on.

• Product level disclosures (in the pre-contractual documentation, e.g. prospectus)

FMPs are also required to:

- Classify their products according to the Art 9, 8, 6 categories defined above.
- Describe, according to the content, format and language requirements set out in the RTS templates how sustainability risks are integrated into their investment decisions.
- With respect to Art 9, 8, 6 Products, the TR provide Taxonomy disclosures and mandatory statements and disclaimers.
- The RTS provides detailed templates to be inserted in pre-contractual documentation of Art 8 and 9 Products.

FAs are required to disclose:

- How sustainability risks are integrated into their investment or insurance advice.
- The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available or they advise on.
- They can adopt a "comply or explain approach".

• Product level periodic disclosures (e.g. annual report)

The **RTS** mandatory templates set out the detailed requirements for periodic disclosures for Art 8 and 9 Products, such as:

- FMPs have to disclose 15 top investments instead of 25. Where the number of investments constituting 50% of the investments of the financial product during the reference period is less than 15, the list must contain only those investments.
- Historical comparisons are only required for up to five reference periods.

• Product level website disclosures

The **RTS** for product website disclosures set out the details of the content of the presentation of the information to be disclosed for Art 8 and 9 Products.

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[7] https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf

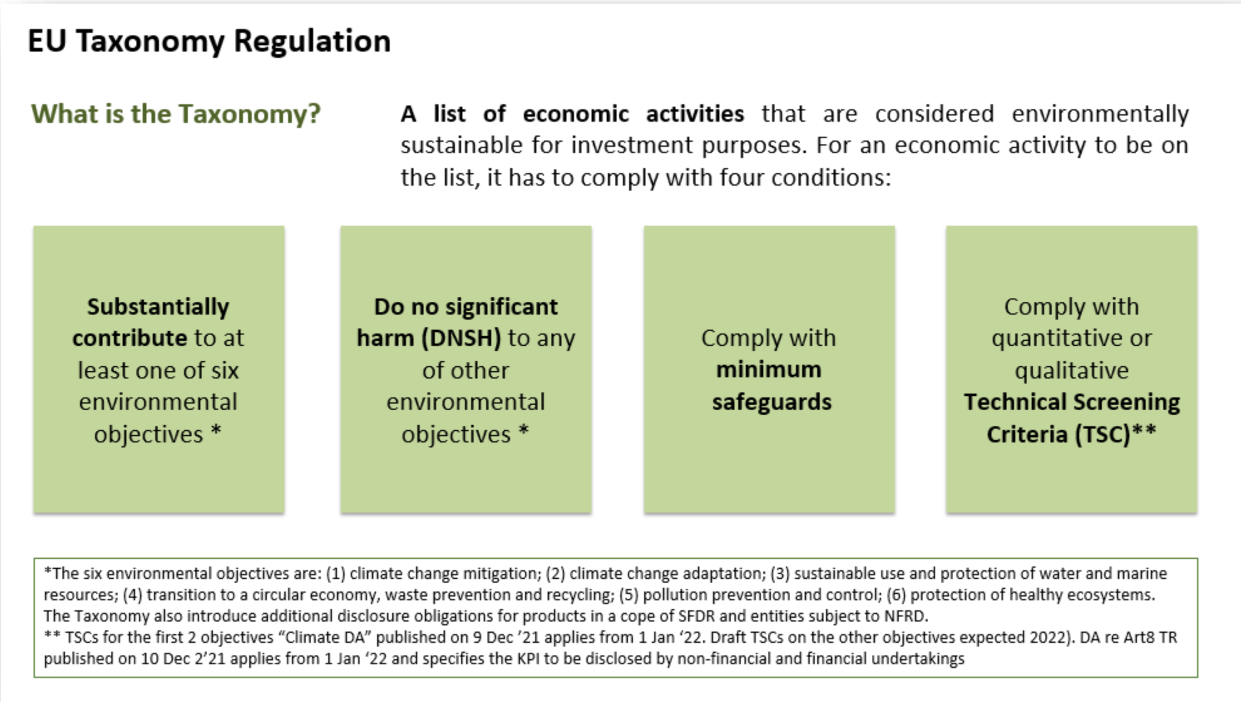
5. UK POSITION

- **"EU" SFDR does not apply in the UK, as the UK government did not convert it into UK law** ("onshore") before the end of the Brexit transition period. UK entities that market their products in the EU may be in scope (refer to the above "Scope" section).
- However the UK is working on a project for sustainability disclosures too; on 3 November 2021 the FCA published a **discussion paper**[8] on sustainability disclosure requirements and investment product labels which proposes product and entity level disclosures on sustainability matters.
- **Timing**: the FCA plans to **consult on draft rules in Q2 2022**, and **we will then have more information on scope and potential impacts.**

6. INTERPLAY WITH OTHER KEY EU ESG REGULATIONS

• TAXONOMY REGULATION (TR)[9]

- The Taxonomy Regulation was designed after SFDR. It establishes a taxonomy, or glossary, for assessing whether certain economic activities are considered "**environmentally sustainable**" TR will be the reference for the labels and green products in the EU.
- The SFDR definition of "**sustainable investments**" is not tied to the TR's definition of "**environmentally sustainable investments**". However, taxonomy-aligned investments are considered to be in scope of the SFDR "sustainable investments" definition.[10]
- TR relies on the definition of FMPs, and FAs given by SFDR.
- TR add additional transparency obligations and modified SFDR in order to include taxonomy considerations in the RTS.



[8] Discussion Paper published on 3 Nov 2021: https://www.fca.org.uk/publication/discussion/dp21-4.pdf

[9] **Taxonomy Regulation ("TR")** (EU) 2020/852 "on the establishment of a framework to facilitate sustainable investment and amending SFDR" came into force on 12 July 2020..

[10] Recital 19 of Taxonomy Regulation

- ## MIFID II ESG AMENDMENTS[11]

MiFID has been amended to incorporate ESG criteria in the tagging of MiFID 2 products

- **Client's suitability questionnaire**[12]: investment firms providing investment advice or portfolio management must now obtain information from Clients on "**sustainability preferences**" that are defined according to new ESG products criteria under MiFID 2.
- MiFID now defines 3 sets of "ESG" products by reference to SFDR Products or TR alignment. **The SFDR Products classification can be used to identify the MiFID 2 eligible products to "Client's sustainability preferences**".
- **Product governance obligations**[13]: manufacturers (e.g. asset managers or structured product issuers) now have to incorporate "sustainability factors/objectives" (as defined under MiFID amendment) of their MiFID instruments in the target market and broader product governance framework.
- All MiFID financial instruments are covered under MiFID ESG amendments (including bonds, shares..) not just SFDR products.

- ## BENCHMARK REGULATION[14]

- In recent SFDR Q&A[15], the European Commission stated that **where EU Paris-aligned benchmarks or EU climate transition benchmarks are used by FMPs under SFDR to create Article 9 SFDR products, the benchmark administrators must additionally ensure compliance with the SFDR "sustainable investments" requirements** with respect to the selection of constituent companies in the EU Paris-aligned/climate transition benchmark. This was an unexpected development as the methodologies for EU Paris-aligned benchmarks and EU climate transition benchmarks are very detailed already, and whilst they meet some limbs of the SFDR "sustainable investments" test, they do not tick off all the requirements.
- The industry associations are in the process of clarifying this EC Q&A.

7. EU DOMESTIC DOCTRINES OR INITIATIVES[16]

There are several EU domestic initiatives, doctrines or guidelines, aiming to create national label for funds which want to qualify as "sustainable" and may reinforce their disclosures obligations (e.g. the AMF Doctrine, the BaFin Guidelines).

[11] Please refer to our GM ESG MiFID factsheet
[12] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investments firms.
[13] Commission Delegated Regulation (EU) 2021/1269 of 21 April 2021 amending Delegated Regulation (EU) 2017/563 as regards the integration of sustainability factors into the product governance obligations.
[14] Regulation (EU) 2019/2089 on Low Carbon Benchmarks ("**LCBR**") amending the Benchmarks Regulation 2016/1011 that introduces 2 new categories of low carbon benchmarks "EU Climate Transition" and "EU Paris-aligned" benchmarks and (ii) introduce new ESG disclosure obligations for benchmark administrators. Administrators of benchmarks (or families of benchmarks) need to disclose whether the benchmark pursues ESG objectives, and if it does, administrators need to: (a) publish an explanation of how the key elements of the methodology reflect the ESG factors; and (b) explain in the benchmark statement how ESG factors are reflected for each benchmark or family of benchmarks.
[15] EC Q&A on sustainability-related disclosures (europa.eu)

[16] **AMF Doctrine:** The French Financial Regulator and Supervisor, the Autorite des Marches Financiers ("AMF") published a Position-Recommendation 2020-03 on "information to be provided by collective investment schemes incorporating non-financial approaches" in March 2020 (with an update published in July 2020) – the "Position Paper".It applies to fund managers that market their funds into France. Funds with ESG ambitions are categorised as "significantly engaging" or "non-significantly engaging" and must have minimum standards that differ from SFDR.As a result, French fund managers and other managers that are in scope of these rules will likely demand enhanced ESG disclosures and information from broker-dealers/banks on their products. so that they can comply with the AMF's strict eligibility requirements for "significantly engaging" or "non-significantly engaging" funds. The AMF is revising its doctrine to converge with SFDR.

BaFin draft guidelines On 2 August 2021, the German Financial Regulator BaFin published draft guidelines for sustainable investment funds as part of a public consultation process. The guidelines set out how certain German investment funds must be structured so that they qualify as "sustainable" or can be marketed as "sustainable" in Germany. Firms distributing German funds in Germany may be indirectly impacted as the managers of such products may look to impose strict guidelines on how they are marketed from an ESG perspective to avoid triggering these requirements. BaFin emphasises that the guidelines shall not affect the European legal framework, i.e. SFDR and the Taxonomy Regulation, and points out that these instruments focus on disclosure and transparency regarding the integration of sustainability risks and adverse sustainability impacts, as well as sustainable investment objectives, but do not include further quantitative or qualitative standards. BaFin does not explicitly state from when the guideline will apply.

8. FOR FURTHER INFORMATION

If you have any further questions, please contact GM SUSTAINABILITY gm.sustainability@bnpparibas.com or via your usual relationship or sales contact.