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 (EU) 2019/2088 ("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 text requires institutional investor and financial advisers to explain how they take into account ESG factors in their investment and advisory processes. 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. The objective of SFDR is to increase transparency of ESG investment products, improve their comparability, avoid greenwashing and ultimately redirect capital flows toward sustainable activities.

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 published on 25 July 2022. The RTS applied from 1 January 2023. Some clarifications were published by the authorities on 24 May 22 EC FAQ, 2 Jun' 22 ESA statement, 17 Nov' 22 ESA Q&A and 14 Apr' 23 EC FAQ ("**EC FAQ 23.04**")[4].

We are now expecting a full review of SFDR, including a potential re-categorisation of Article 8 and 9 Products (see further below) and reporting obligations. This is further to the (i) ESA consultation on the RTSthat closed on 4 Jul '23 and (ii) EC targeted consultation open for comments until 15 Dec '23.In parallel, the EC has mandated the Platform for Sustainable Finance Platform ("PSF") to provide recommendations on the treatment of derivatives under SFDR products reporting within its ad-hoc derivatives working group feeding into Sub-Group 1 of the PSF advising on the usability of the EU Taxonomy. We expect initial reports by Q2 2024.

SFDR

Timelines:
Also link to ESMA timeline

10 Mar '21: application of SFDR L1

25 Jul `22: Level 2 **Regulatory Technical Standards** consolidating both SFDR and TR RTSs (the "RTS") have been published

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 RTS

30 Jun' 23: first FMP PASI statement (entity level)

30 Jun' 24: second FMP PASI statement

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.

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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" and to our Taxonomy FAQs.

[3] **CSRD:** 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.

[4] The authorities combined all the FAQs in May 23

• Key definitions

- **Sustainable Investment ("SI")**: this is an investment in an economic activity which:
  - contributes **either to** an **environmental** objective or a **social** objective,
  - **does not significantly harm** ("**DNSH**")[5] any environmental or social objectives, **and**
  - 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"**[6]) (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:

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

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[5] The industry is discussing the interpretation of the DNSH test and any potential reference to PASI indicators.
[6]SFDR Art 4: "Financial market participants shall publish and maintain on their websites:
(a) where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available;"
SFDR L2 Art 4: statement on PAI shall be published in accordance with Annex I (list of PAI, definitions & calculations) & Annex II templates (products specific questionnaires)
- Art 8 & 9 products must disclose whether PAI are taken into account - no indication as to disclosure must be qualitative or quantitative
- Art 8 with a SI pocket or Art 9 must disclose how the DNSH condition is fulfilled and how PASI have been taken into account SFDR L3 (ESA clarifications statement ESA 2 June 22' paragraph 13 & ESMA Q&A 17 Nov 22' Q.2 & 3 on PASI)
- PASI calculations include direct & indirect investments, of which derivatives.
- PASI of long & short positions should be netted at the level of the individual counterpart but without going below zero.

PAI in MiFID II ESG:
- EU manufacturers indicate whether they have taken PAI into account at product level (which will be the case for Art 8 & 9).
- EU Manufacturers usually report PAIs for the reporting needs of their distributors.

- Managers of qualifying venture capital funds and qualifying social entrepreneurship funds
- Financial or insurance advisers

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[7].

• 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[8]	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 passively tracks an index that qualifies as an EU Climate Transition or Paris-aligned Benchmark (see Benchmark section further below) qualifies as Art 9.

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)[9] 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:

[7] EC Q&A 14 Jul ’21 (Question 1) sfdr_ec_qa_1313978.pdf (europa.eu)
[8] 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
[9] https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf

- 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.
- 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.

• 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).
- **On 25 Oct’ 22,** The FCA consulted CP22/20 on Sustainability and **Disclosure Requirements & labelling regime applicable to UK asset managers** and their UK based fund products and portfolio management services, naming rules and a general **Anti-Greenwashing rule** applicable to all UK regulated entities (“SDR”) and is planning to publish the Policy Statement in Q4 2023. **We will then have more information on potential impacts.**

5. INTERPLAY WITH OTHER KEY EU ESG REGULATIONS

• TAXONOMY REGULATION (“TR”)[10]

- 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.

[10] **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. Taxonomy FAQs

- 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.[11]
- 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.

EU Taxonomy Regulation

What is the Taxonomy? **A list of economic activities** that are considered environmentally sustainable for investment purposes. For an economic activity to be on the list, it has to comply with four conditions:

Substantially contribute to at least one of six environmental objectives *	**Do no significant harm (DNSH)** to any of other environmental objectives *	Comply with **minimum safeguards**	Comply with quantitative or qualitative **Technical Screening Criteria (TSC)****

*The six environmental objectives are: (1) climate change mitigation; (2) climate change adaptation; (3) sustainable use and protection of water and marine resources; (4) transition to a circular economy, waste prevention and recycling; (5) pollution prevention and control; (6) protection of healthy ecosystems.
The Taxonomy also introduce additional disclosure obligations for products in a cope of SFDR and entities subject to NFRD.
** TSCs for the first 2 objectives "Climate DA" published on 9 Dec '21 applies from 1 Jan '22. Draft TSCs on the other objectives expected 2022). DA re Art8 TR published on 10 Dec 2'21 applies from 1 Jan '22 and specifies the KPI to be disclosed by non-financial and financial undertakings

MIFID II ESG AMENDMENTS[12]

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

- **Client's suitability questionnaire**[13]: 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**[14]: 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[15]

The EC FAQ 04.23 clarified that SFDR funds passively tracking a PAB/CTB will automatically qualify for Art9 SFDR products.

EU GREEN BOND STANDARD

[11] Recital 19 of Taxonomy Regulation
[12] Please refer to our GM ESG MiFID factsheet
[13] 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.
[14] 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.
[15] 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.

Bonds issued under the EU GBS automatically qualify as Sustainable Investment under SFDR.

6. 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).

7. FOR FURTHER INFORMATION

If you have any further questions, please contact GM SUSTAINABLE CAPITAL MARKETS dl.sustainablecapitalmarkets@uk.bnpparibas.com

Updated September 2023

[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.