EU Action Plan

October 2020

Building a better working world

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Foreword

Over the past 300 years, four industrial revolutions have changed the face of the world as we know it. Many of these advances have contributed positively to the world we inhabit, but perhaps, have not always been far sighted enough to take account of the damage caused.

Over the past three years, we have witnessed increasing global movements to redress some of the unintended harm caused by progress.

- In 2018, the word of the year was 'Single-use', resulting in a quick behavioural shift to not accepting single-use disposables, such as coffee cups, straws etc.
- 2019 marked the year of Greta Thunberg, who captured the mood globally and became our active spokesperson against the environmental damage caused through years of neglect.
- And 2020, well 2020 marked the year of Covid-19, when as humans we finally recognised that notwithstanding the sophistication and progress that we have made in sciences, mother nature can wreak devastating and lasting damage on us all.

The EU Action Plan on Sustainable Finance aims to channel private sector finance towards the mitigation of climate change and other environmental threats.

As a father and a firm believer in EY's purpose, to build a better working world, never has a piece of regulation been so important and with the potential to do such good. Inevitably, there will be complexity and challenges in implementing such regulation and potentially a short-term anxiety associated with missing out on some opportunities. However, the long-term benefit associated with doing the right thing together with the fact that we are making a real positive contribution to our planet and society should more than offset the challenges along the way.

For more insights on this important topic please visit www.eyfs.ie/ESG and as ever, don't hesitate to reach out if you have a question.

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ESG creates value for investors

The bailout of Fannie Mae and Freddie Mae; the collapse of Lehman Brothers; the takeover of Merrill Lynch by Bank of America; the liquidity crisis at AIG, and locally, the Irish banking crisis fundamentally shone the spotlight on the effectiveness of investors in their ability to influence corporate governance as shareholders.

Investors were criticised by regulators and the media for failing to use their shareholder rights to sanction companies that were taking too many short term risks. Institutional investors can exercise their rights as shareholders to influence corporate behaviour and have a duty to act in the long-term best interests of their beneficiaries and clients.

The origin of Environmental, Social, and Governance (ESG) can be traced back to the 18th century when religious groups established socially responsible investing guidelines for their followers. There has been a recent profound shift in investors' sentiment; the majority of investors now consider ESG factors alongside other business and market factors in their decision-making. They recognise that applying ESG principles into their analysis, policies and practices, and requiring disclosures in corporate reporting, will align them with the broader objectives of society to the benefit of the environment and society as a whole.

Sustainability professionals find that investors and asset managers do not value the depth and breadth of ESG factors. Investors generally find the information contained in sustainability reports are difficult to use and can struggle to understand the relationship between ESG factors and their value as an investment analysis input.

ESG has many names including Responsible Investment, Impact Investing, Stewardship, Socially Responsible Investment, and Sustainability Investment. However, under any name, how ESG engagement creates value can be unclear.

The United Nations-supported Principles for Responsible Investment (PRI) initiative published a set of six investment principles. These principles are encouraging the incorporation of ESG matters into investment practice. The Principles for Responsible Investment were developed by investors for investors, and major institutions have since become signatories. PRI commissioned research which identified the types of value ESG engagement dynamics create as being communicative, learning, and organisational for companies and investors.

Communicative Value

ESG engagements allow corporates an opportunity to understand and clarify investors' expectations and enhance accountability through transparency and communication to investors. Companies can create awareness among the investors relating to ESG strategies and performance in many ways. These include reports and investor letters, investor calls, roadshows, meetings, and social media.

ESG engagements can be used as a medium to periodically explain management's side of the story to their investors by providing reliable, relevant, and up-to-date information. ESG key performance indicators (KPIs) can be integrated into the standard presentation of corporate strategy to mainstream investors to help develop long-term relationships with investors.

ESG can also be translated into financial risk or opportunity. Applying a financial mindset and terminology, finance professionals together with sustainability professionals can bring the rigour and discipline used in accounting to the collection, analysis, and reporting of ESG data. They can also help communicate how prioritising ESG issues is linked to the financial value within a company - for example, the financial impact of emission reduction can be translated into cost reduction.

Learning Value

ESG disclosure in corporate reporting helps a company to demonstrate that it is managing its wider stakeholder impacts and risks and is mindful of its ESG performance. The communication between investors and their investee companies through ESG engagement also creates new opportunities for learning about ESG issues. Engagements can help companies to identify emerging trends, signals and the socio-political environment within which they operate. Interactions related to ESG activities with investors can be useful for companies to understand where they are placed in the ESG space compared to their peers and provide opportunities to develop deeper knowledge of their impact on society.

Risk management practices of companies can be developed based on broader industry, regulatory and societal risks to drive long-term sustainable performance and shareholder value. Investors' knowledge of ESG can be enhanced in specific industries by engaging with multiple companies and interacting with other investors.

Organisational Value

ESG engagements help companies secure and nurture relationships with investors - particularly long-term investors. ESG risks can overrule the investment thesis and result in the sale of investments or the decision not to invest in companies' securities.

Asset managers have publicly disclosed that as a consequence of their ESG lens they have engaged with the management of corporates to better understand their ESG strategies, and sold off certain investments that failed to pass standard. ESG communication can be a channel to attract and secure the investment of specialist ESG investors as well as mainstream institutional investors interested in ESG values.

If ESG and financial analysts work more closely together on engagements, organisational benefits can be derived internally. ESG engagements can also be used in overcoming the "silo" mentality that may exist within companies and between the various stakeholders within the investment value chain. Better collaboration between the investors and companies can help develop and refine engagement policies, objectives and accountability mechanisms, to create and maintain long-term relationships with investee companies' external organisational value can be gained.

The EU Action Plan on Sustainable Finance

In March 2018, the European Commission issued an action plan on sustainable finance as part of a strategy to integrate environmental, social and governance considerations into its financial policy framework.

In May 2018, the Commission released the first legislative package under the action plan. The plan includes ten action points and three regulations in the areas of taxonomy, disclosure and low carbon benchmark. It also covers amendments to the existing MiFID II, UCITS and MIFMD level 2 regulations, alongside other consultations and non-legislative measures.

The main objectives of the action plan are:

- to finance the transition to a more sustainable and inclusive growth,
- to manage financial risks arising from climate change, resource depletion, environmental degradation and social issues;
- and to foster transparency and long-termism in financial decisions.

The proposal on disclosure of ESG risks will require institutional investors to consider and disclose in a consistent and harmonised manner how ESG factors are adopted in their decision making and advisory processes. The proposed regulation will apply to asset managers (including AIF management companies), insurance undertakings, pension funds and investment advisors.

In January 2019, the Commission published draft rules on how investment firms and insurance distributors should take sustainability issues into account when providing advice to their clients.

In February 2019, the EU Parliament and Member States reached an agreement on two new low-carbon benchmarks to help boost investment in sustainable projects and assets. In March 2019 the Commission welcomed the political agreement reached by the European Parliament and EU Member States on new rules on disclosure requirements related to sustainable investments and sustainability risks. The agreed rules should strengthen and improve the disclosure of information by manufacturers of financial products and financial advisors to end-investors. The new regulation sets out how financial market participants and financial advisors must integrate ESG risks and opportunities in their processes, as part of their duty to act in the best interest of clients. It also sets uniform rules on how those financial market participants should inform investors about their compliance with the integration of ESG risks and opportunities.

Following the mandate granted by the EU Commission, the European Securities and Markets Authority (ESMA) has issued two consultations on possible amendments to MiFID II, UCITS and AIFMD level 2 in order to include sustainability risks requirements. All management companies, AIFM and MiFID firms will need to review processes and resources as well as sustainability risks within risk management processes.

EU Action Plan: summary for asset managers

To institutional investors' consolation and true to asset managers' predictions, EU financial services regulation is leading the way with bold and ambitious regulations towards meeting the challenges of climate change. The European Commission has put together a sustainability package that includes three components - Taxonomy, Disclosures, and Benchmarks Regulation. These regulations are expected to have profound ramifications on asset managers within the EU and beyond.

Taxonomy Regulation

This regulation establishes the conditions and the framework to gradually create a unified classification system ('taxonomy') for determining whether an economic activity is environmentally sustainable. It applies to Financial Market Participants (FMPs) making available financial products. FMPs include a broad range of investment funds, product manufacturers and asset managers, including insurance undertakings, pension funds, AIFMs and UCITS management companies.

What are the key obligations of Taxonomy Regulation and when will it take effect?

The regulation sets out six environmental objectives and is to be implemented through delegated acts which will be developed in two phases. The first phase comprises two objectives; 1) climate change mitigation and 2) climate change adaption to be adopted by the Commission by 31 December 2020 and applicable from 31 December 2021. The second phase relates to the remaining four objectives: 1) sustainable use and protection of water and marine resources, 2) transition to a circular economy; 3) pollution prevention and control and 4) protection and restoration of biodiversity and ecosystems. The phase should be adopted by the Commission by 31 December 2021 and apply from 31 December 2022.

The Taxonomy imposes three key obligations on member states at the EU, FMPs, and large public-interest entities:

- EU Member states should apply the Taxonomy when regulating environmentally sustainable financial products or corporate bonds,
- FMPs need to make statements about the alignment of investments with the Taxonomy when making available financial products,
- Large public-interest entities to include information about how their activities align with the Taxonomy in the non-financial disclosure part of their financial statements.

Disclosure Regulation

This regulation introduces disclosure obligations on how institutional investors and asset managers integrate ESG factors into their risk management processes. It applies to all FMPs and investment firms authorised under MiFID providing portfolio management services. It also applies to financial advisers (FAs), including certain insurance intermediaries and providers of investment advice (unless employing less than three employees). It can also apply to non-EU asset managers.

What are the key obligations of the Disclosure Regulation and when will it take effect?

The new transparency requirements include disclosures on internal policies through the website about the integration of sustainability risks in the investment decision-making and advice process, the consideration of principal adverse impacts of an investment decision on sustainability factors, and information on how remuneration policies are consistent with the integration of sustainability risks.

It also requires disclosure of information through pre-contractual documents on how sustainability risks are part of the investment process. If deemed not relevant a clear and concise explanation of why not and the adverse sustainability impact of the investment decisions is required.

At product level (UCITS, AIFs, and separate accounts), FMPs will be expected to describe how sustainability risks are integrated into their investment decisions, the likely impacts of sustainability risks on the returns of the financial products made available, and how the financial products consider principal adverse impacts on sustainability factors.

Financial products which promote environmental characteristics, and which invest in an economic activity that contributes to an environmental objective will need to disclose in pre-contractual or offering memorandum detailed information on how those characteristics are met and if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.

The annual reports of ESG focused UCITS, AIFs and separate accounts will need to provide details of how the relevant ESG objectives are being met in their annual report.

The Regulation will apply from 10 March 2021, with certain obligations taking effect later. Obligations related to the provision of first annual reports were delayed until 1 January 2022.

Benchmark Regulation

The Regulation was created by an amendment to the existing EU Benchmark Regulation, it introduces two new climate-related benchmark classifications: EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks as two distinct categories of low carbon benchmarks. The aim is to ensure consistent understanding among benchmark users. It focuses on benchmark administrators however can have some indirect impacts for benchmark users such as asset managers.

There is a grave risk that dangerous climate change will occur that will endanger the lives, welfare and living environment of many people all over the world. EU regulations are being developed to address climate change risk and asset managers must embed ESG factors in their decision-making process and act now to be compliant with regulations.

EU Action Plan: timeline for asset managers

When?	Legislation	What	Whom	Level	Where	Precontractual periodic?
10/03/2021	SFDR (art.3)	Integration of sustainability risks	FMPs, FAs	Entity & Product	Website	Pre-contractual & periodic
	SFDR (art.4)	Consideration of PAI- PAI Statement: comply or explain • If yes • If no	FMPs, FAs	Entity & Product	Website • Prospectus & annual report • Prospectus only	Pre-contractual & periodic (annually)
	SFDR (art. 6/7, art. 8 and art.9)	ESG disclosures on environmental and social characteristics (art. 8) and on sustainable investments (art.9) or solely integration of sustainability risks (art. 6/7)	FMPs, FAs	Product	Website, prospectus	Pre-contractual
	SFDR (art.5)	Remuneration policies & integration of sustainability risks	FMPs, FAs	Entity	Website	Pre-contractual & periodic
30/06/2021	SFDR (art. 4(3))	Mandatory consideration of PAI for FMPs > 500 employees	FMPs	Entity	Website	Pre-contractual & periodic
01/01/2022	Taxonomy (art. 8)	Environmental sustainable investments (taxonomy aligned disclosures)	FMPs, NFRD companies	Entity	Non-financial statement or separate report	Pre-contractual & periodic
	NFRD	Companies to report on taxonomy aligned activities	NFRD companies	Entity	Annual report or sustainability report	Precontractual & Periodic
	SFDR (art.11)	Reporting on product disclosures art. 8 and art. 9 SFDR products	FMPs	Product	Annual report	Periodic

EU Taxonomy Regulation

Background

On 22 June 2020, the long-awaited Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the "EU Taxonomy Regulation"), and amending Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "SFDR") was published in the Official Journal of the European Union.

The EU Taxonomy Regulation is the unified classification system for sustainable activities at the core of the EU action plan on financing sustainable growth, published by the European Commission in March 2018.

Primary Change

The EU Taxonomy Regulation should enable investment fund managers ("IFMs") to gather reliable, consistent and comparable sustainability related indicators from in-scope investee companies and incorporate this data into their investment decision and risk management process and fulfil their disclosure duties under SFDR or applicable sectorial legislation.

The EU Taxonomy Regulation also provides further details on the content of sustainability-related disclosures required in pre-contractual and periodic reports of environmentally sustainable investment funds and investment funds promoting environmental characteristics.

Key Dates

22 June 2020	Publication in the Official Journal of the EU
31 December 2020	Adoption of delegated acts for the technical screening criteria with respect to climate-related objectives
31 December 2021	1. Adoption of delegated acts for the technical screening criteria with respect to all other environment-related objectives 2. Commission to publish a report describing the provisions that would be required to extend the scope of the Taxonomy to cover: - Economic activities that do not have a significant impact on environmental sustainability - Economic activities that significantly harm environmental sustainability - Specific disclosure requirements related to enabling and transitional activities - Other sustainability objectives, such as social objectives
1 January 2022	Application of the requirements for climate-related objectives
1 January 2023	Application of the requirements for all other environment-related objectives

Key Points

The EU Taxonomy Regulation aims to define EU-recognised criteria for identifying sustainable activities. This defines the minimum criteria that economic activities should comply with in order to be considered environmentally sustainable.

- An environmentally sustainable economic activity contributes substantially to one or more of the following environmental objectives:
  - Climate change mitigation
  - Climate change adaptation
  - Sustainable use and protection of water and marine resources
  - Transition to a circular economy
  - Pollution prevention and control
  - Protection and restoration of biodiversity and ecosystems
- It does not significantly harm ("DNSH") any of the other environmental objectives
- It is carried out in compliance with minimum safeguards set out in the Regulation (including the OECD Guidelines for Multinational Enterprises, the International Labour Organisation, etc.)
- It complies with the technical screening criteria developed by the Technical Expert Group in the form of delegated acts, applicable from 1 January 2022 for climate-related objectives and from 1 January 2023 for the other environmental objectives
- An activity, referred to as 'enabling activity', can be considered to be contributing substantially to one or more environmental objectives laid down by the Taxonomy if it directly enables other activities to contribute to these objectives, provided that such economic activity:
  - does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets
  - has a substantial positive environmental impact, on the basis of life-cycle considerations

An activity, referred to as 'transitional activity', can be considered to be contributing substantially to the environmental objective of climate change mitigation under the following conditions:

- There is no technologically and economically feasible low-carbon alternative
- It supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1.5°C above pre-industrial levels
- That activity:
  - Has greenhouse gas emission levels that correspond to the best performance in the sector or industry
  - Does not hamper the development and deployment of low-carbon alternatives, and
  - Does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets

The EU Taxonomy Regulation also lays down disclosure obligations that supplement the SFDR and the Non Financial Reporting Directive[1] ("NFRD") with regards to activities that contribute to an environmental objective:

- Undertakings that are required to report on non-financial information under the NFRD must include in their non-financial statement:
  - The proportion of their turnover derived from products or services associated with environmentally sustainable economic activities
  - The proportion of their capital and operating expenditures related to assets or processes associated with environmentally sustainable activities
- Financial products that invest in environmentally sustainable economic activities must disclose the proportion of investments in environmentally sustainable activities selected for the financial product, including the proportion of enabling and transitional activities, as a percentage of all investments selected for the financial product. This information shall be disclosed in the pre-contractual disclosures and in the periodic report.

The EU Taxonomy Regulation will be further developed over time to cover economic activities that are socially sustainable.

Practical Considerations

The Disclosures of investee companies should enable investment funds to report the proportion of their fund invested in Taxonomy-aligned activities for each investee company. For climate change mitigation, turnover can be recognised where an economic activity meets the Taxonomy technical screening criteria for substantial contribution to climate change mitigation and relevant DNSH criteria. For climate change adaptation, turnover can be recognised only for activities enabling adaptation but not for adapted activities.

Companies that disclose their capex investments in economic activities as part of a plan to be Taxonomy-aligned should provide invaluable information for constructing green portfolios, and for analysing companies' transition plans and/or environmental sustainability performance and strategies.

As part of their risk-based due diligence, IFMs should pay attention to what extent investee companies, and other issuers disclosures cover Taxonomy required information on whether they:

- Comply with minimum safeguards
- Embed responsible business conduct into their policies and management systems
- Identify, assess, prevent or mitigate actual or potential adverse impacts
- Gain and use leverage to prevent and mitigate the impacts
- Track performance
- Communicate and report publicly
- Enable remediation when appropriate

Significant challenges are expected for investments in EU companies and bond issuers that do not fall under the scope of the NFRD, and non-EU companies. In such situations, the EU Technical Expert Group recommends a five-step approach:

1. Identify the activities conducted by the company or issuer or those covered by the financial product (e.g., projects, use of proceeds) that could be aligned, and for which environmental objective(s)
2. For each potentially aligned activity, verify whether the company or issuer meets the relevant screening criteria – e.g., electricity generation <100 g CO2e/kWh
3. Verify that the DNSH criteria are being met by the issuer. IFMs would most likely use a due diligence-type process for reviewing the performance of underlying investees and would rely on the legal disclosures of eligibility from those investees
4. Conduct due diligence to avoid any violation of the social minimum safeguards
5. Calculate alignment of investments with the Taxonomy and prepare disclosures at the investment product level

For more information, please visit:

EU Taxonomy Regulation

EU TEG Final Report on Taxonomy

[1] Directive 2014/95/EU which is currently being reviewed by the European Commission to potentially expand its scope and improve granularity and standardization of disclosures

Draft delegated acts on the integration of sustainability factors and risks in the UCITS Directive, AIFMD and MiFID II

Background

The European Commission has published on 8 June 2020 a set of draft delegated acts, including, *inter alia*:

- A draft delegated directive amending the Commission Directive 2010/43 implementing certain provisions of the UCITS Directive
- A draft delegated regulation amending the Commission Regulation 231/2013 implementing certain provisions of AIFMD
- Two delegated acts amending two delegated acts implementing MiFID II requirements on product governance, organisational requirements and operating conditions of investment firms

These delegated acts are part of a broader action plan on sustainable finance and look to streamline sectoral legislation with the emerging framework and reinforce the regulations:

- On sustainability-related disclosures in the financial services sector ("SFDR")
- On low-carbon benchmarks ("LCBR")
- On the EU taxonomy for sustainable activities ("Taxonomy")

Primary Change

The sustainable finance action plan will bring significant changes in the investment fund value chain.

The UCITS Directive and AIFMD draft delegated acts clarify notably the duties of investment fund managers ("IFMs") to take into account the social and environmental factors and risks in their governance, organisation, conflicts of interest policies, investment due diligence as well as their risk policies and procedures.

Investment firms will be required to integrate investors' sustainability preferences, i.e. the appetite of their clients for dark green and light green products, as defined in SFDR, in product governance, financial advice, portfolio management and distribution activities. Ex-post information disclosure, relying on funds and management companies disclosures, will be required to explain how a recommendation to the client to purchase an investment fund meets his investment objectives, risk profile, capacity for loss bearing and sustainability preferences.

Key Points

The UCITS Directive and AIFMD delegated acts provide very similar requirements.

<table>
<tr><th>UCITS (delegated directive)</th><th>AIFMD (delegated regulation)</th></tr>
<tr><td colspan="2">Alignment of definition of sustainability risks with SFDR</td></tr>
<tr><td colspan="2">Requirement to consider sustainability risks in management companies or AIFMS:
• establishment, implementation and maintenance of clear and document decision-making procedures and organisational structure specifying reporting lines
• allocation of responsibilities with proper discharge
• internal control mechanisms to ensure compliance with decisions and procedures
• internal reporting and communication and effective information flows with any third party involved
• maintenance of adequate and orderly records of business and internal organisation</td></tr>
<tr><td colspan="2">Requirement to maintain resources and expertise for the effective integration of sustainability risks</td></tr>
<tr><td>Requirement to integrate sustainability risks in the management of UCITS in a proportionate manner</td><td></td></tr>
</table>

UCITS (delegated directive)	AIFMD (delegated regulation)
Requirement to ensure that senior management of the management company is responsible to take sustainability risks into account in: • the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents • the approval process for investment strategies • the compliance function • the investment policy/strategy/risk limits implementation/compliance for each managed UCITS • the approval/periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed UCITS • the approval/periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system	Requirement to ensure that senior management of the AIFM is responsible to take sustainability risks into account in: • the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents • the approval process for investment strategies • the valuation policies • the compliance function • the investment policy/strategy/risk limits implementation/compliance for each managed AIF • the approval/periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed AIF • the approval/periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system • the remuneration policy
Requirement to identify conflicts of interest arising from the integration of sustainability risks in processes, systems and controls	
Consideration of sustainability risks and, where applicable, principal adverse impacts of investment decisions on sustainability factors when applying investment due diligence requirements	
Requirement to consider sustainability risks in the risk management policy	

Practical Considerations

IFMs should conduct their analysis jointly with the project carried out to reach compliance with the SFDR and the Taxonomy.

The practical reach of the rules in terms of organisation, governance, policies, and operational procedures will need to be proportionate to strategic choices and size (in terms of consideration of principal adverse impacts of investment decisions) as well as the extent to which the investment funds managed by the IFM pursue sustainability-related objectives or promote environmental or social characteristics.

However, some minimum standards stemming from upcoming UCITS Directive, AIFMD and SFDR rules will also be applicable to fund managers who do not consider principal adverse impacts and do not manage light green or dark green products. In particular, all IFMs need to review and update their governance structures, resources and allocation of responsibilities, their investment decision-making and due diligence policies as well as their risk policies and control framework to adapt them in a proportionate manner to the scope of their activities.

Consideration should also be given notably to the legislation applicable to benchmark administrators, investee companies and distributors or advisors in order to set up appropriate communication and data flows.

For more information, please visit:

Draft UCITS delegated directive as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities

Draft AIFMD delegated regulation as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers

Draft MiFID delegated directive as regards the integration of sustainability factors and preferences into the product governance obligations

Draft MiFID delegated regulation as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

European supervisory agency joint consultation on ESG disclosures

Background

Regulation 2019/2088 on sustainability-related financial disclosures ("SFDR") was adopted on 27 November 2019 with the objective to improve transparency in relation to Environmental, Social and Governance (ESG) factors, risks and impacts. It is applicable notably to fund managers ("entities") and investment funds ("products"). On 23 April 2020, the European Supervisory Agencies ("ESAs") launched a consultation with respect to draft regulatory technical standards ("draft RTS") discussing:

- The disclosure of principal adverse impacts ("PAIs") of investment decisions, required for all entities:
  - Who are employing 500 persons or are the parent company of a group employing 500 persons on a consolidated basis from 18 months after the date of entry into force of SFDR
  - Other entities which do not publish a clear explanation why they do not consider PAIs
- Precontractual, website and periodic disclosures required at product level for both:
  - Products with environmental or social characteristics among other characteristics ("light green products")
  - Products with a sustainable investment objective ("dark green products")

Investment fund sponsors and managers need to make strategic business and policy decisions well ahead of any applicable disclosures which will have to comply with SFDR and the final RTS.

Primary change

The draft RTS provide granular requirements for the content, the methodology and the presentation of disclosures and a template for principal adverse impacts and metrics to be used by entities. While the objective is to improve standardisation and comparability of the information provided to investors, the proposed template is likely to bring significant changes to fund managers.

The ESAs also intend to develop templates for precontractual and periodic report disclosures, but they are not included in the draft RTS.

Key Points

Principal Adverse Impacts

Context, scope and implications:

The overall objective of the RTS is to ensure that the entities disclose relevant information regarding their adherence to the "do not significantly harm" principle where their financial products invest in sustainable investments. The objective is to inform end-investors about how the product does not significantly harm the environmental objectives it is not contributing to. The ESAs are of the view that this should be facilitated for those entities which consider the PAIs of their investment decisions since they will already have incurred the costs of assessing their investment decisions against the indicators provided in annex 1 of the RTS.

According to the upcoming Taxonomy Regulation art. 19(1)e, the technical screening criteria developed by the Technical Expert Group to assess under which conditions an economic activity contributes to a sustainable environmental objective should, where feasible, use these sustainability indicators to assess PAIs from these RTS.

Information on PAIs is required to be disclosed first on the entities websites. Any entities that employ less than 500 persons or that are parent undertakings of a group employing less than 500 persons on a consolidated basis during the financial year may opt not to consider PAIs. If they decide to not consider PAIs, they will still need to make a clear statement about this decision, explain the reasons and whether and when they intend to comply. Consideration of PAIs is compulsory for large entities which must disclose on their website the statement in the format prescribed by European Securities and Market Authority Commission (ESMA).

Disclosures of PAI will also be required in offering documents and periodic statements as from 30 December 2022. Where information in periodic reports includes quantifications of principal adverse impacts on sustainability factors, that information may also rely on the provisions of these RTS[1].

Elements of disclosure

Annex 1 provides a PAI statement template structured in three parts including adverse sustainability indicators and associated metrics. One table provides sixteen mandatory environmental indicators and sixteen mandatory social indicators. Two tables provide eleven additional environmental indicators and seven additional social indicators. Entities must disclose metrics for all mandatory indicators, at least one additional environmental indicator and one additional social indicator as well as any other PAI deemed to be relevant.

[1] Art. 7(1) SFDR

The content is proposed to be structured as follows:

Section	Disclosure item	Specifications
Summary	(i) name of the entity (ii) statement that PAIs are considered (iii) reference period of the statement (vi) summary of the PAI statement	Maximum two pages for the summary
Description of principal adverse sustainability impacts	(i) mandatory PAIs (ii) at least one additional PAI on a climate or other environment-related sustainability factor (iii) at least one additional PAI on a social, employee, human rights, anti-corruption or anti-bribery sustainability factor (iv) any other adverse impact that qualifies as principal	• Mandatory metrics expressed in market value for (i), (ii) and (iii) • Historical comparison with the shortest of: a. The previous ten years b. From the date the IFM considered first a PAI
Description of policies to identify and prioritise adverse sustainability impacts	(i) date of approval of the policies by the governing body (ii) allocation of responsibilities for the implementation within organisational strategies and procedures (iii) description of the methodologies used to assess PAIs, their probability of occurrence and severity, including their irremediable character (iv) an explanation of any associated margin of error within those methodologies (v) description of the data sources methodologies used to assess PAI, their probability of occurrence and severity, including their irremediable character	Where information related to indicators is not readily available, entities should disclose: a. Best efforts used to obtain information from investee companies b. If this is not possible, best efforts used to assess PAIs, including a description of any reasonable assumptions used, additional research carried out, cooperation with third party data providers or use of external experts
Description of actions to address principal adverse sustainability impacts	(i) description of actions taken during the reference period and planned for the next period to avoid or reduce PAIs (ii) explanation of the reduction in PAIs achieved by the actions taken	
Engagement policies	brief summaries of engagement policies required pursuant to SRDII, any other relevant engagement policies and an explanation of the reduction in PAIs achieved of the actions taken during the reference period	
References to international standards	description of the adherence to responsible business conduct codes and international standards for due diligence and reporting and their degree of alignment with objectives of the Paris agreement, including at least forward-looking climate scenarios.	Adverse indictors used in PAI assessment should be specified
No consideration of PAIs statement	(i) clear reasons (ii) whether it intends to comply and if so when	

Disclosures applicable to light green and dark green products

General framework and interaction with the upcoming Taxonomy Regulation

The draft RTS provide a comprehensive list of information and sections to be included for precontractual documentation, website information and periodic report for both dark green and light green products. Most disclosure items are common to each support or closely related: logically, pre-contractual information focuses on the description of product features, the definition of investment strategy indicators and the means used to attain the investment objective. Website information provides more information on the data used, the methodological aspects and policies. Periodic reports focus on metrics and sustainability performance measures.

At present, it must be noted that the definition of sustainable investments in SFDR includes both environmental and social objectives while the draft taxonomy is only limited to environmental objectives. Article 25 of the draft taxonomy constitutes an occasion for the ESAs, through the RTS they are empowered to develop, to strengthen the link between sustainable investments as defined under SFDR and investments financing taxonomy-compliant activities but there is no full correspondence between both yet, hence the proposed requirement to disclose proportion of investments in taxonomy-compliant activities.

Elements of disclosure

Light green colour requirements apply only to light green products and dark green colour requirements apply only to dark green products. Other requirements are substantially the same for both types of product.

<table>
<tr><th>Category</th><th colspan="2">Information to disclose</th><th>Pre-contractual</th><th>Website</th><th>Periodic report</th></tr>
<tr><td rowspan="10">Environmental or social characteristics (E/S characteristics)
or
sustainable investment objective</td><td colspan="2">summary of the information contained in website disclosure of a maximum length of two sides of A4-sized paper when printed</td><td></td><td>x</td><td></td></tr>
<tr><td colspan="2">a description of the E/S characteristics or the sustainable investment objective of the product</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td rowspan="3">graphical representation of investments</td><td>total of sustainable investments with a breakdown between E/S objectives</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>total of investments contributing to the attainment of the E/S characteristics promoted by the investment product with a breakdown between E/S characteristics</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>remainder of investments</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td rowspan="4">narrative representation of investments</td><td>planned (or actual) proportions with a breakdown of direct holdings/other exposures</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>purpose of the planned (or actual) remainder, including any minimum safeguards and whether these investments are used for hedging, relate to MMIs[2] or are investments for which there is insufficient data</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>the planned (or actual) proportion of investments in different sectors and sub-sectors, including the fossil fuel sector</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>25 top investments constituting on average the greatest proportion of investments of the financial product during the reference period, including the sector and location of those investments or, investments constituting on average 50% if they are less than 25</td><td></td><td></td><td>x</td></tr>
<tr><td colspan="2">reference to PAI statement</td><td>x</td><td></td><td></td></tr>
<tr><td rowspan="3">No significant harm to the sustainable investment</td><td colspan="2">statement that the product does not have as its objective sustainable investment</td><td>x</td><td>x</td><td></td></tr>
<tr><td rowspan="2">explanation of how a sustainable investment does not significantly harm the other sustainable investment objectives</td><td>how indicators for adverse impacts are taken into account</td><td>x</td><td>x</td><td>x</td></tr>
<tr><td>no significant harm to the sustainable investment objectives and disclaimer</td><td>x</td><td>x</td><td>x</td></tr>
</table>

[2] Money Market Instrument

Category	Information to disclose		Pre-contractual	Website	Periodic report
Investment strategy	description of the strategy, its binding elements and how it is implemented in the investment process on a continuous basis		x	x	
	the rate, where there is a commitment to reduce the investment universe prior to the application of the strategy by a minimum rate		x	x	
	Investment strategy		x		
	description of the policy to assess good governance practices of the investee companies...			x	
		...in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance		x	
Sustainability indicators	list of sustainability indicators used to measure attainment of each E/S characteristics or the sustainable investment objective		x	x	
	monitoring of E/S characteristics or the sustainable investment objective (sustainability indicators) throughout the lifecycle of the financial product and the related internal or external control mechanisms			x	
	Sustainability indicators				x
	historical comparison (shortest of previous ten years, from the date sustainability indicators were considered or 01/01/2022) between the reference period and previous reference periods (if indicator excluded from previous report or pre-contractual document, explanation and justification of the use of that indicator should be provided)	annual average performance net of fees, including identification of charges and fees included or excluded from the calculation figures			x
		where quantitative disclosures are made, figures with a relative measure such as the impact per euro invested			x
		whether each indicator is subject to assurance provided by an auditor or a review by a third party			x
		the proportion of underlying assets which are not sustainable or enabling investments			x
Due diligence	description of due diligence carried out on the underlying assets, including internal and external controls on that due diligence			x	
	description of the index designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index. In case part or all of that information is published on the website of the administrator of the reference benchmark, a hyperlink may be provided to that information.			x	
Engagement policy	if engagement is part of the environmental or social investment strategy, a description of the engagement policies implemented including any management procedures applicable to sustainability-related controversies in investee companies			x	
	actions taken within the reference period to attain the E/S characteristics promoted by the financial product or the sustainable investment objective , including shareholder engagement as defined in Article 3g of Directive 2007/36/EC and any other relevant shareholder engagement.				x
Data sources and processing	data sources used to attain each of the E/S characteristics or sustainable investment objective			x	
	measures taken to ensure data quality			x	
	data sources and processing			x	
	the proportion that is estimated			x	

Category	Information to disclose	Pre-contractual	Website	Periodic report
Limitations to methodologies and data	description of any limitations to the methodologies and the data sources used to measure the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective as well as how such limitations do not affect the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective, including the actions taken to address such limitation		x	
Use of derivatives	information on how the use of derivatives meets each E/S characteristic or the sustainable investment objective	x		
Website reference	reference to product information available on the website	x		
Benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	explanation of how the reference benchmark is continuously aligned with each E/S characteristic or the sustainable investment objective and the investment strategy	x		
	Website reference	x		
	benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	x		
	indication whether an index is designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index; (may be hyperlink to the benchmark administrator website)		x	
	an explanation of how the index designated as a reference benchmark differs from a broad market index, including at least the performance during the reference period of the sustainability indicators deemed relevant by the financial market participant to determine the alignment of the index with the sustainable investment objective and the sustainability factors referred to in the benchmark statement of the benchmark administrator			x
	a comparison of the performance during the reference period of the financial product with regard to the indicators measuring the sustainability factors of the index (table or graphical)			x
	if the number of investments constituting on average 50 percent of the investments of the index during the reference period is less than 25, the section referred to in point (c) of Article 43 shall contain a list of those investments, in descending order of size, including the sector and location of those investments			x
Products with a CO2 emissions reduction objective	a statement that the reference benchmark qualifies as a CTB/PAB[3] Benchmark	x	x	
	products with a CO2 emissions reduction objective			x
Financial products with underlying investment	summary list of those investment options with a clear distinction between options qualifying as products with E/S characteristics or the sustainable investment objective and options with a sustainable investment objective and cross references to the disclosures required by sectoral legislation	x		
	information provided by those options with a clear indication to which options the information relates to	x		
	summary of information required for periodic report by selected investment that qualify as a product with E/S characteristics or have a sustainable investment objective, with a clear indication to which options the information relates			x

[3] Climate Transition Benchmarks and EU Paris-Aligned Benchmark, as defined in Regulation (EU) 2019/2089 of 27 November 2019

Practical considerations

Investment fund managers ("IFMs") should carefully consider the final RTS but also review, decide and formalise whether and to what extent they have to or wish to comply with the disclosure principal adverse impacts of their investment decisions. Factors to consider include, *inter alia*:

- Whether the funds managed by the IFM qualify as light green, dark green or other funds
- The greater transparency arising from other mandatory requirements applicable to all IFMs such as the establishment of a policy on the integration of sustainability risks in the investment decision-making process and the consistency of such policy with the remuneration policy

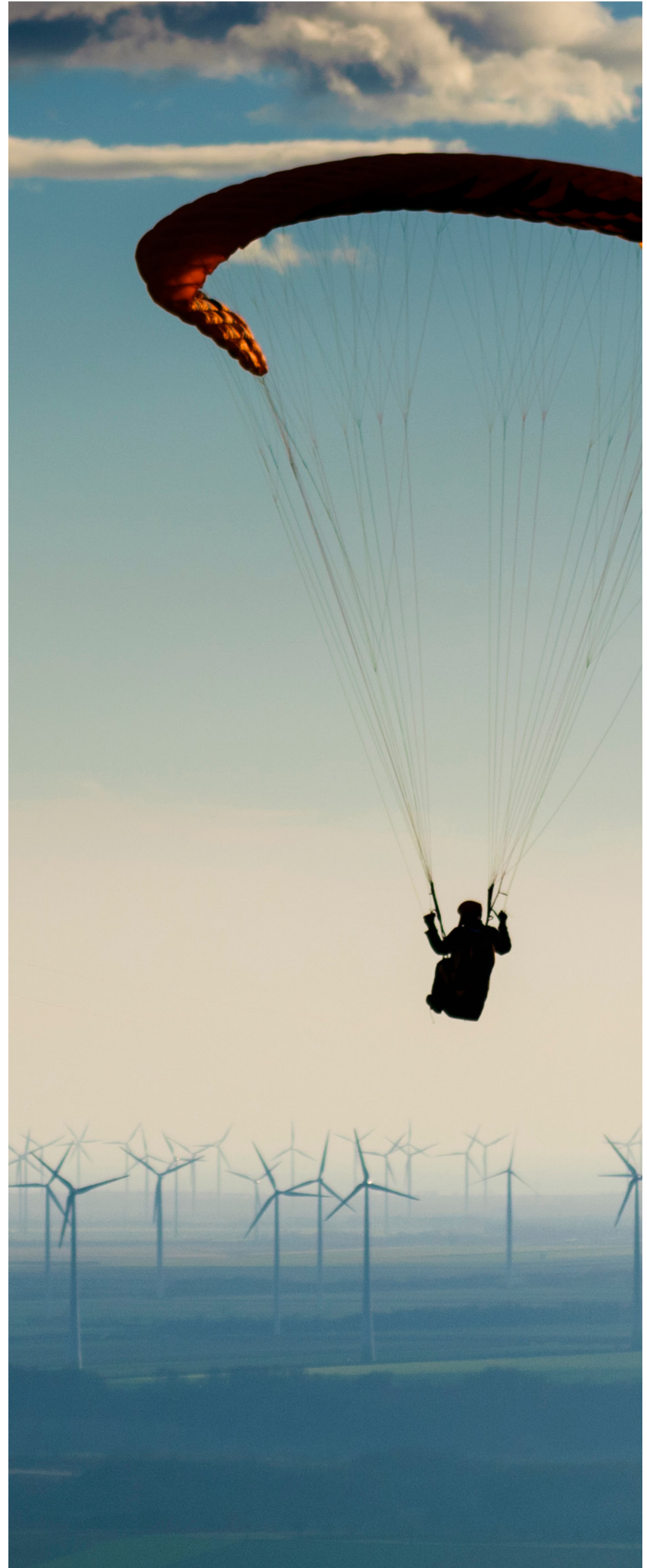
Where they comply with the disclosure of PAIs, a comprehensive action plan should be launched to create or update the policies, the procedures, the data flows, the methodologies, the systems and disclosures which have to be implemented both at entity and product level. Should they decide not to disclose PAIs, IFMs will still need to review their documentation to ensure that the mandatory SFDR requirements which are not covered by these draft RTS are met.

Fund managers should notably:

- Determine whether the products they manage qualify as a light green or dark green product
- Assess how the product promotes E/S characteristics or contributes to a sustainable investment objective
- Establish the list of the sustainability indicators to be used, the data sources, and the methodologies (including the use of benchmarks) for monitoring and reporting purposes
- Prepare disclosures and ensure their consistency with any marketing material

For more information, please visit:

ESA consultation on draft RTS



2020 global institutional investor survey results - how will ESG performance shape your future?

Investors raise the ESG stakes

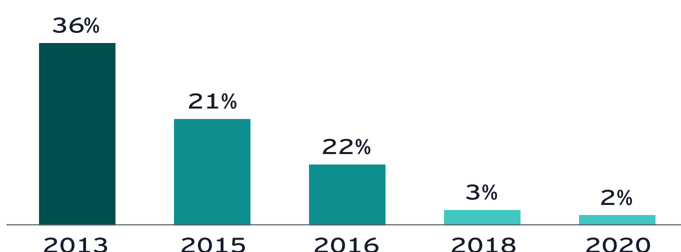
EY's latest research, from the 2020 global institutional investor survey, finds that investors are stepping up the game when it comes to assessing the performance of companies using nonfinancial factors. Overall, 98% of investors surveyed evaluate nonfinancial performance based on corporate disclosures, with 72% saying they conduct a structured, methodical evaluation. This is a major leap forward from the 32% who said they used a structured approach in 2018. When this research series began back in 2013, more than a third of investors said that they conducted "little or no review of nonfinancial disclosures." This cohort has dropped significantly over the years, to the extent that it represented just seven of the investors surveyed this year (see figure 1).

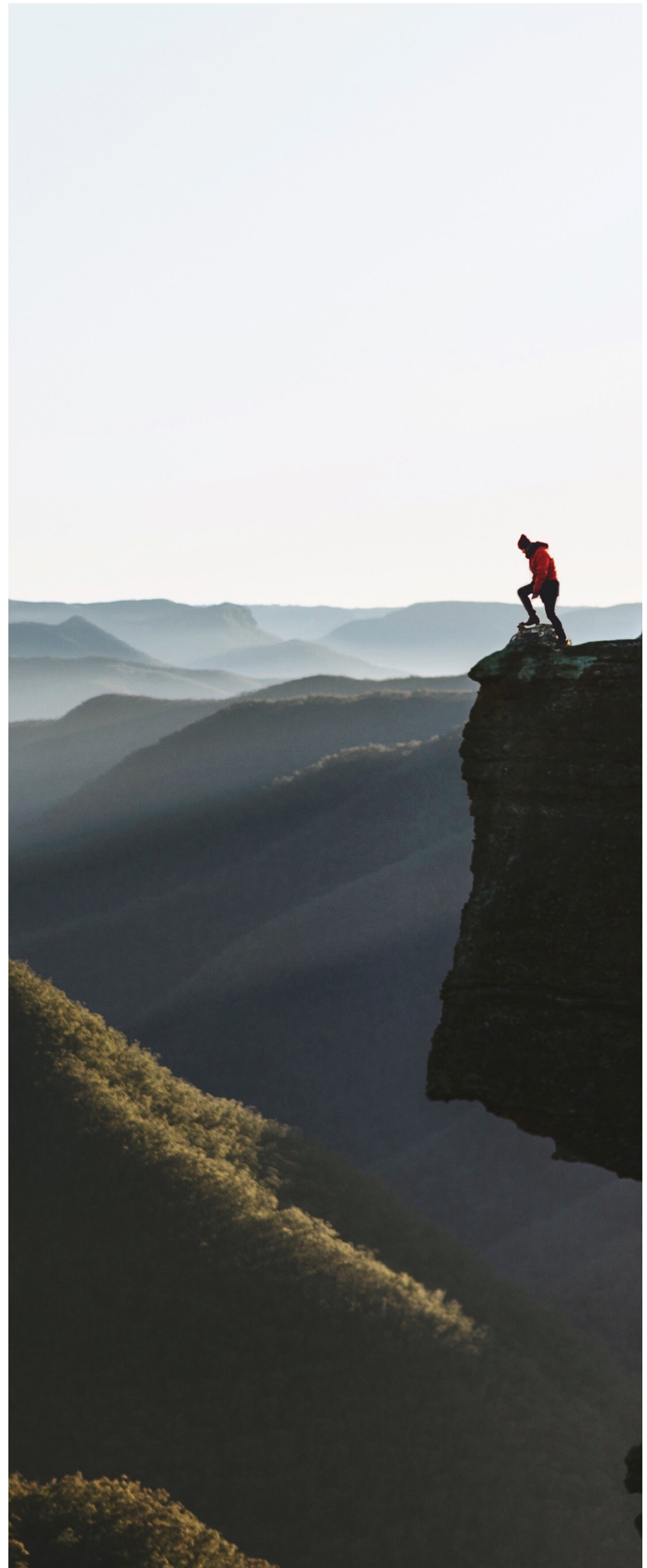
Investors are also building their understanding of the ESG reporting universe, factoring in disclosures made as part of the Task Force on Climate-related Financial Disclosures (TCFD) framework. In fact, EY's research found strong evidence that investors see the TCFD framework as a very valuable approach for wider nonfinancial disclosures, beyond climate-related information. And, as they look to build insight into long-term value, investors expressed a strong desire for a formal framework for measuring and communicating intangible value, and a closer connection between mainstream financial and ESG reporting.

Figure 1: Very few investors do not conduct a detailed review of nonfinancial disclosures

Which of the following statements best describes how you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company's performance?

Percentage of respondents who say they conduct little or no review of nonfinancial disclosures





The ESG performance disconnect: environmental risk in the spotlight

For formal evaluation of ESG performance to be more effective, investors need more standardisation and rigorous nonfinancial data from corporates to support their approach. However, investor dissatisfaction with the information they receive on ESG risks has increased since 2018: for example, the number of investors that are dissatisfied with environmental risk disclosures has increased 14 percentage points since 2018. This is a concern, given the focus investors are placing on robust environmental risk insights. This appetite is reflected in the fact that investors identify the climate-focused TCFD framework as the most valuable way that companies can report their nonfinancial performance. However, more must be done to meet this need for environmental risk insight. In particular, investors surveyed feel more should be done by corporates to provide robust insight into how they identify, assess and manage key climate and other ESG risks.

Investors are holding companies accountable

The importance of strong alignment between corporates and investors is reinforced by the central and decisive role that ESG plays in investment decisions: 91% of investors surveyed say that nonfinancial performance has played a pivotal role in their investment decision-making over the past 12 months, either frequently or occasionally. And, the proportion of investors that say this happens frequently jumped to 43% from 34% in 2018. Climate risk in particular plays a significant part in decision-making: 73% of investors surveyed say they will devote considerable time and attention to evaluating the physical risk implications of climate change when they make asset allocation and selection decisions; 71% say the same of the transitionary risks due to climate change. A significant number of investors surveyed are also making extensive use of exclusionary screening, with positive screening of growing importance in sustainable investment decision-making.

The future of ESG performance: trusted and credible

Credible information strengthens confidence in companies and markets. Investors need ESG disclosures that are clear and transparent, founded on high-quality data, and produced using robust and reliable processes and systems. The research found significant appetite from investors for an independent lens on ESG performance. For example, 75% said they would find value in assurance of the robustness of an organisation's planning for climate risks. They also see a strong need to build confidence and trust in green investment disclosures, with 82% saying it would be useful to have independent assurance of the impact of green investments.

What next?

Action in three areas is suggested for companies to meet the expectations of investors and ensure their ESG performance plays a critical role in a crisis-hit world:

- First, build a stronger connection between nonfinancial and financial performance. Investors can focus on building more credible and nuanced approaches to understanding what influences long-term value for certain sectors and companies, while corporates themselves can focus more on their materiality – reporting on what environmental, social and economic factors are most relevant to their stakeholders and could impact their ability to create value over the longer term.
- Second, build a more robust approach to analysing the risks and opportunities from climate change and the transition to a decarbonised future, and communicate this more comprehensively through TCFD reporting. Critical actions range from understanding the resilience of business strategies and assets under a range of possible climate scenarios, to assessing avenues for capitalising on the economic opportunities of
a decarbonised future - including attracting and accessing capital.
- Third, instill discipline into nonfinancial reporting processes and controls to build confidence and trust. Establishing effective governance practices and seeking independent assurance of nonfinancial processes, controls and data outputs can help build trust and transparency with investors. This is an area where CFOs and their finance teams – which have extensive experience in establishing processes, controls and assurance of financial information – can bring their best practices and experience to bear. The input of CROs and risk teams can also be valuable, as can treasury function input when green finance is involved.

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