DISCLOSURES UNDER THE EU SFDR AND INTERNATIONAL RECOMMENDATIONS TO PREVENT GREENWASHING

The journey to implementing the European Union's (EU) technical standards for ESG disclosures continues, and like any good thriller, we have been kept in suspense waiting for the next set to be published.

With time fast running out before the requirements become applicable in 2022, the European Supervisory Authorities (EBA, EIOPA and ESMA – the ESAs) delivered a report to the European Commission on 22 October 2021.[1]

This was followed, on 2 November 2021, by the International Organization of Securities Commissions (IOSCO) recommendations on sustainability-related practices, policies, procedures and disclosure in asset management as a final report (IOSCO Report).[2]

In this article we look first at the ESAs Report, followed by the IOSCO recommendations.

The ESAs Report

On 22 October 2021 the ESAs delivered to the European Commission (EC) their Final Report (ESAs Report) with draft Regulatory Technical Standards (RTS) regarding disclosures under the Sustainable Finance Disclosure Regulation (SFDR), as amended by the Regulation on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation – TR), to enable further progressing the technical standards under the SFDR.[3]

Background on the ESAs Report

The ESAs finalised draft RTS,[4] published on 4 February 2021, had already established the content, methodology and presentation of other disclosures to be made under the SFDR.

The ESAs aim now is to have the technical standards on disclosures rules function as a 'single rulebook' for sustainability disclosures for both of their original empowerments in the SFDR and the additional ones added by the TR, by including proposals in the following areas:

Article 8(4) of SFDR: development of additional pre-contractual disclosures relating to the content and presentation of Article 8 SFDR products subject to Article 6 of the TR, concerning climate objectives and other environmental objectives under Article 9 of the TR respectively.

Article 9(6) of SFDR: development of additional pre-contractual disclosures relating to the content and presentation of Article 9 SFDR products subject to Article 5 of the TR, relating to disclosures concerning climate objectives and other environmental objectives under Article 9 of the TR.

Article 11(5) of SFDR: development of additional rules on the content and presentation of information required under Articles 5 and 6 of the TR for periodic disclosures relating to climate objectives and other environmental objectives under Article 9 of the TR respectively.

The ESAs Report also contains the general background and rationale of the proposals presented in section 2, along with the RTS and the mandatory templates for the product disclosures in section 3. Section 4 is an impact assessment that analyses the ESAs proposals and includes a feedback statement. Whilst section 5 contains a draft consolidated SFDR RTS.

The proposals in more detail

The proposals presented in the ESAs Report break down changes in to information on how and to what extent investments underlying the financial product are economic activities that qualify as environmentally sustainable under the TR.

The RTS relating to this requirement requires that the financial product calculates the extent of taxonomy alignment of investments in two ways:

- By calculating the ratio between a weighted average of taxonomy-aligned investments in the numerator divided by all investments in the denominator; and
- A second ratio, calculated in the same way as the first, except by also including all sovereign exposures from both the weighted average of taxonomy-aligned investments in the numerator and from all investments in the denominator.

These two key performance indicators (KPIs) should be graphically presented and accompanied by the breakdown between enabling and transitional activities in accordance with Article 5 of the TR. The rules also propose an indication of whether the compliance of taxonomy-aligned activities will be subject, or for periodic disclosure, has been subject to an assurance provided by an auditor or a review by a third party.

Other changes

The ESAs have also taken the opportunity to propose some targeted revisions to the pre-contractual and periodic disclosures as follows:

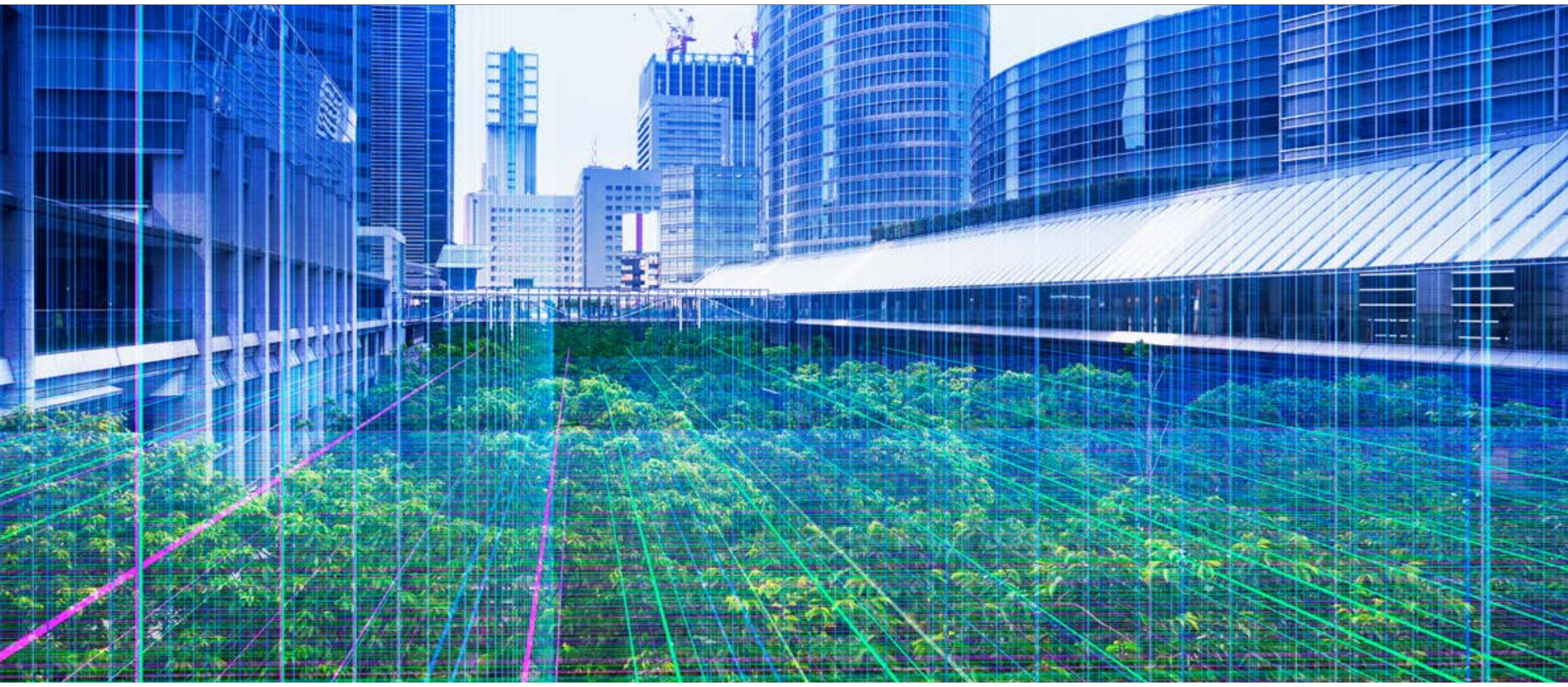
- **Pre-contractual and periodic disclosures** – where the ESAs Report provides inclusion of annexes with amendments to the mandatory templates for financial products that promote environmental and/or social characteristics or have a sustainable investment objective as defined in the SFDR, so that they include additional disclosures for Article 5 and 6 products under the TR.
- **Treatment of sovereign bonds** – the ESAs have decided to require the disclosure of the taxonomy-alignment of investments in two ways: one including sovereign exposures and one excluding sovereign exposures from the calculation.

To protect investors from the risk of greenwashing, the draft RTS contain a graph which includes all the investments of the financial product where all sovereign exposures are excluded from the calculation.

Talking of greenwashing

There is a lot of discussion amongst regulators internationally on the potential for inadvertent greenwashing in the asset management industry.

Adding to comments already published by other regulators globally[5], the IOSCO Report details a set of recommendations about sustainability-related practices, policies, procedures and disclosures in the asset management industry.



Ashley Alder, Chairman of IOSCO and CEO of the Securities and Futures Commission of Hong Kong, mentioned in the accompanying press release[6] that asset managers are a critical part of the sustainable finance ecosystem, and play a major role in helping investors achieve their investment objectives.

Therefore, greater clarity on regulatory guidance is needed on how asset managers consider material sustainability-related risks and opportunities, integrate them into the decision-making process, and make disclosures, so as to allow investors to understand the impact of their investment.

What instigated IOSCO's recommendations?

As well as regulators — industry participants, investors, and policy makers internationally have stepped up their efforts to address sustainability-related risks, opportunities, and impacts and to help improve sustainability-related disclosures.

Resulting from the Consultation Report: Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management, published on 30 June 2021,[7] the IOSCO Report aims to improve sustainability-related practices, policies, procedures and disclosures in the asset management industry through five recommendations for securities regulators and policymakers:

- Asset manager practices, policies, procedures and disclosure;
- Product disclosure;
- Supervision and enforcement;
- Terminology; and
- Financial and investor education.

The IOSCO Report also recognises a clear need to address the challenges associated with the lack of reliability and comparability of data at the corporate issuer level and the ESG data and ratings provided by third-party providers to enable the investment industry to properly evaluate sustainability-related risks and opportunities.

Data gaps at the corporate issuer level were previously addressed, in June 2021, in the IOSCO report on Sustainability-related Issuer Disclosures.[8] Recommendations for ESG data and ratings providers will be covered by IOSCO at a later date.

The recommendations

Recommendation 1: Asset Manager Practices, Policies, Procedures and Disclosure

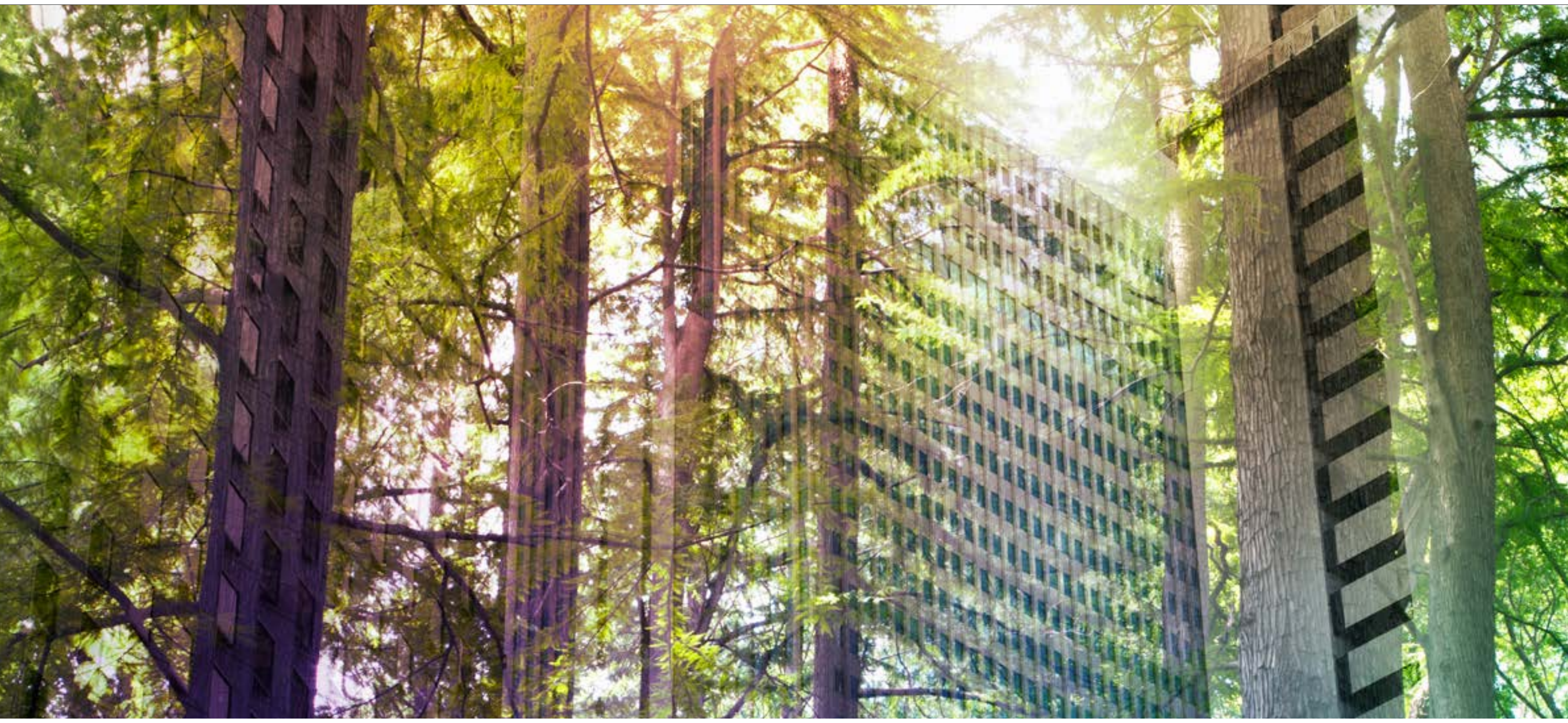
Securities regulators and/or policymakers, as applicable, should consider setting regulatory and supervisory expectations for asset managers in respect of the:

- Development and implementation of practices, policies and procedures relating to material sustainability-related risks and opportunities; and
- Related disclosure.

Recommendation 2: Product Disclosure

Securities regulators and/or policymakers, as applicable, should consider clarifying and/or expanding on existing regulatory requirements or guidance or, if necessary, creating new regulatory requirements or guidance, to improve product-level disclosure in order to help investors better understand:

- Sustainability-related products; and
- Material sustainability-related risks for all products.



Recommendation 3: Supervision and Enforcement
Securities regulators and/or policymakers, as applicable, should have supervisory tools to monitor and assess whether asset managers and sustainability-related products are in compliance with regulatory requirements and enforcement tools to address any breaches of such requirements.

Recommendation 4: Terminology
Securities regulators and/or policymakers, as applicable, should consider encouraging industry participants to develop common sustainable finance-related terms and definitions, including relating to ESG approaches, to ensure consistency throughout the global asset management industry.

Recommendation 5: Financial and Investor Education
Securities regulators and/or policymakers, as applicable, should consider promoting financial and investor education initiatives relating to sustainability, or, where applicable, enhance existing sustainability-related initiatives.

Mitigation against greenwashing
The recommendations in the report cover a range of areas, all of which IOSCO says can help prevent greenwashing. For example, requirements relating to the disclosure of material risks for sustainability-related products can help prevent greenwashing by enabling investors to better understand the potential risks associated with the product and the impact of those risks on a product's performance, including sustainability-related performance.

Similarly, requirements relating to naming for sustainability-related products can help prevent greenwashing by ensuring that products that identify themselves as sustainability-related through their names are accurately reflecting their focus on sustainability.

The recommendations also address the risk of greenwashing through other areas, including supporting sustainability-related financial and investor education initiatives and ensuring that there are adequate supervisory and enforcement tools to monitor and assess compliance with requirements in this area and address breaches of such requirements.

Next steps
In terms of the ESAs' Report, the EC will scrutinise the draft RTS and decide whether to endorse them within three months of their publication.

The EC has informed the European Parliament and Council that it intends to incorporate all the SFDR RTS, i.e., both the original ones submitted to the EC in February 2021 as well as the ones covered in the ESAs Report, into one instrument.

As regards the IOSCO Report, its five recommendations are designed to provide a list of potential areas for consideration as regulators and policymakers consider developing sustainability-related rules and regulations, consistent with their mandates and domestic regulatory frameworks.

1. jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf.
2. https://www.iosco.org/news/pdf/IOSCONEWS624.pdf.
3. jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf.
4. https://www.esma.europa.eu/press-news/esma-news/three-european-supervisory-authorities-publish-final-report-and-draft-rts.
5. Financial services regulators from the UK, Netherlands, Switzerland, and the European Supervisory Authorities (ESMA, EBA and EIOPA – the ESAs) for example have all commented on the potential risks of greenwashing in the asset management space.
6. https://www.iosco.org/news/pdf/IOSCONEWS624.pdf.
7. CR01/2021 Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management – Consultation Report, Report of the Board of IOSCO, 30 June 2021, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD679.pdf.
8. FR04/2021 Report on Sustainability-related Issuer Disclosures (iosco.org).

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