

New ESG disclosure regulation (SFDR) – what private banks, wealth managers and advisers need to know

1. Speed read

Sustainable investing and ESG are rising to the top of the agenda in the financial services industry, with a vast array of new industry bodies and initiatives both in the EU and globally. New regulations are also emerging as the EU Commission seeks to reorient private capital flows towards sustainable investments, to meet its climate and energy targets. As a further development in the roll out of its green agenda, a new disclosure regulation will shortly come into force – referred to as the Disclosure Regulation or Sustainable Finance Disclosure Regulation (SFDR). This will require certain firms, including private banks, wealth managers and advisers, to comply with new rules on disclosure as regards sustainable investments and sustainability risks. This briefing gives further detail on the new requirements and when they will come into effect.

2. How did we get here?

The EU Council adopted the Disclosure Regulation (2019/2088) on 27 November 2019.¹ It entered into force on 29 December 2019 and will start to apply from 10 March 2021.

The EU Council subsequently adopted the Taxonomy Regulation (Regulation 2020/852),² which entered into force on 12 July 2020. The Taxonomy Regulation both supplements and amends certain provisions in the Disclosure Regulation.

3. Will it apply to advisers, wealth managers and private banks?

Yes, the new regulation applies to investment firms and credit institutions which provide investment advice and/or portfolio management, including via model portfolios. It also applies to firms that provide advice in relation to insurance based investment products - e.g. fund linked life policies.

The new regulation will also apply to certain other types of firms, including asset and fund managers - if you want a copy of our separate briefing on this, let us know.

01_ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32019R2088>

02_ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852>.

The full name of this regulation is “Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088”.

4. Will it have extraterritorial effect?

It is not clear on the face of the regulation itself whether it will apply to firms outside the EU; however, based on statements by the European Commission, the likely answer is that it will.

- In an FAQ³ on the Taxonomy Regulation, the European Commission stated as follows: **“What extra-territorial reach will the Taxonomy Regulation have? What will be its effect on non-EU companies? And on EU companies’ activities located outside the EU? • The disclosure obligations for financial market participants in the Taxonomy Regulation apply to anyone offering financial products in the EU, regardless of where the manufacturer of such products is based.”** As relevant terms in the Taxonomy Regulation are defined by reference to the Disclosure Regulation, **the same view is likely to apply to the Disclosure Regulation.**
- The policy intention is presumably to ensure a level playing field (i.e. so EU firms are not having to compete with third country firms not subject to the new requirements), to ensure that potential investors and clients in the EU obtain the information the new law considers they need to encourage them to choose firms and products that are “ESG-friendly”, and finally, to avoid “greenwashing”.

5. What are the new requirements?

There are new ESG related rules for relevant firms on transparency, disclosure, internal policies and reports. To navigate the new rules, you need to know three key concepts:

“Sustainability factors”

Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

A “sustainability risk”

An environmental, social or governance event or condition that, if it occurs, would cause a negative material impact on the value of an investment.

A “sustainable investment”

An investment in an economic activity that:

- contributes to an **environmental** objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, **OR**
- contributes to a **social** objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that:
 - such investments do not significantly harm any of those objectives, PLUS
 - the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

In short, a “sustainable investment” must therefore advance either a specific “E” OR “S” objective, PLUS it must “do no significant harm” as regards any such objective and involve “G”.

A shorthand way to remember this is “E or S + DNSH + G”.

⁰³ Frequently Asked Questions about the work of the European Commission and the Technical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard (10 June 2020) - https://ec.europa.eu/info/files/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en

6. Summary of key points

Different requirements apply under the Disclosure Regulation depending on whether you provide advice, portfolio management or both. Portfolio management includes both bespoke mandates and model portfolios.

The new requirements include the following:

- You need certain new disclosures
- You need certain new policies
- You need to update certain existing policies
- You need to make certain new pre-contractual disclosures to clients
- For portfolio managers, you need to make additional disclosures where you offer mandates with certain ESG related objectives – up-front and in periodic reports
- You need to publish certain documents on your website and maintain them on an ongoing basis.

A summary of some of the detailed requirements is as follows:

REQUIREMENT	OVERVIEW	SCOPE
1. DISCLOSURES – You need certain new disclosure on sustainability factors	PRELIMINARY ANALYSIS Decide whether you will vs will not consider the principal adverse impacts of sustainability factors when giving advice or providing portfolio management (as applicable) To be clear, on the face of the regulation, it is possible for a firm to decide “no” here. But given the increasingly intense focus by the European Commission on the need to “green” the EU, this may be frowned on by regulators. In making your decision, you should also bear in mind how important these factors are considered to be: <i>“The consideration of sustainability factors in the investment decision-making and advisory processes can realise benefits beyond financial markets. It can increase the resilience of the real economy and the stability of the financial system. In so doing, it can ultimately impact on the risk-return of financial products”</i> (recital 19). In any case, the “opt-out” will cease to be available after 30 June 2021 for portfolio managers that (in broad terms) have more than 500 employees	Article 4 (1) SFDR Advisers and portfolio managers
	PORTFOLIO MANAGERS – Where the answer is “yes” – Prepare a disclosure explaining the due diligence policies you will use. This should also include: <ul style="list-style-type: none"> – information about your policies on identifying and prioritising principal adverse sustainability impacts and indicators – a description of the principal adverse sustainability impacts and any actions you have taken or planned on them – summaries of your engagement policy – any responsible business conduct codes and internationally recognised standards for due diligence and reporting you adhere to, and how much they align with the Paris Agreement objectives – Where the answer is “no” – Prepare a disclosure giving clear and concise reasons why, including information as to whether and when you intend to consider such impacts	Article 4 (2) SFDR Portfolio managers only
	ADVISERS A more narrow disclosure obligation applies: <ul style="list-style-type: none"> – Where the answer is “yes” – Prepare a disclosure giving information on whether you consider in your advice the principal adverse impacts on sustainability factors – Where the answer is “no” – Prepare a disclosure giving information on why you do not consider adverse impacts of investment decisions on sustainability factors in your advice, and, where relevant, information on whether and when you intend to consider such adverse impacts 	Article 4 (5) SFDR Advisers only
	GUIDANCE You should also consider the due diligence guidance for responsible business conduct developed by the Organisation for Economic Co-operation and Development (OECD) and the United Nations-supported Principles for Responsible Investment	Advisers and portfolio managers

REQUIREMENT	OVERVIEW	SCOPE
2. POLICIES – You need new policies	SUSTAINABILITY RISK POLICIES Prepare a policy on how you integrate sustainability risks into your advice or portfolio management (as applicable). Basically this means a policy on how you consider what could go wrong in terms of ESG, and how you deal with those risks	Article 3 SFDR Advisers and portfolio managers
3. REMUNERATION POLICIES – You need to update certain existing policies	REMUNERATION POLICIES IN RELATION TO SUSTAINABILITY RISKS Include in your remuneration policies information as to how they are consistent with the integration of sustainability risks The concern here is to achieve more transparency, and to ensure that the remuneration policies of advisers and managers promote sound and effective risk management with respect to sustainability risks. It is also to ensure that the approach to remuneration does not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance	Article 5 SFDR Advisers and portfolio managers



REQUIREMENT	OVERVIEW	SCOPE
4. PRE-CONTRACTUAL DISCLOSURES – You need to update your disclosures	SUSTAINABILITY RISKS Include a description as to: <ul style="list-style-type: none"> – how you integrate sustainability risks into your advice or portfolio management investment decisions (as applicable) – i.e. how an ESG event or condition may have a material adverse impact on the value of an investment, and how you deal with those risks – the likely impacts of sustainability risks on returns OR if you decide (for all of your business or just certain products or services) that sustainability risks are not relevant, explain why This requirement applies regardless of whether the client has indicated an ESG preference or not	Article 6 SFDR Advisers and portfolio managers
	SUSTAINABILITY FACTORS – If you decide “yes” in (1) above Include a clear and reasoned explanation of whether (and if so, how) your portfolio considers principal adverse impacts on sustainability factors – ie environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters State that information on principal adverse impacts on sustainability factors is available in the information to be disclosed in periodic reports – If you decide “no” in (1) above If this relates to all your portfolios/mandates OR just specific ones, you must include a statement in relevant pre-contractual disclosures that you do not consider the adverse impacts of investment decisions on sustainability factors and the reasons why This requirement is being phased in, with a transition period that ends on 30 December 2022	Article 7 SFDR Portfolio managers only
	PROMOTION IN PRE-CONTRACTUAL DISCLOSURES You need to update your pre-contractual disclosures if you have certain types of ESG badged mandates or model portfolios: <ul style="list-style-type: none"> – If you offer a portfolio management service, mandate or model portfolio that promotes environmental (E) and/or social (S) characteristics: <ul style="list-style-type: none"> – include information as to how those characteristics are met – if you have designated an index as a reference benchmark, include information on whether and how the index is consistent with those characteristics and indicate where the methodology used for the calculation of that index can be found <i>[Note: In due course, the Taxonomy Regulation will add further requirements here and in relation to periodic reports, for mandates or model portfolios that promote environmental characteristics. See more on this below]</i>	Article 8(1) SFDR Portfolio managers only <i>[New Article 8(2a) of SFDR inserted by the Taxonomy Reg]</i>
	TRANSPARENCY OF SUSTAINABLE INVESTMENTS <ul style="list-style-type: none"> – If you offer a portfolio management service, mandate or model portfolio with “sustainable investment” as its objective: <ul style="list-style-type: none"> – Option 1 – If you have designated an index as a reference benchmark, include information on how that index is aligned with that objective and explain why and how that index differs from a broad market index – Option 2 – If not, explain how (instead) the fund’s sustainable investment objective is going to be met NB: If no index is referenced because no EU Climate Transition or EU Paris-aligned Benchmark is available under the Benchmarks Regulation, you must include a detailed explanation as to <i>“how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement”</i> <ul style="list-style-type: none"> – If you offer a portfolio management service, mandate or model portfolio with a “reduction in carbon emissions” objective, <i>“the information to be disclosed ... shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement”</i> 	Article 9(1) and (2) SFDR Article 9(3) SFDR

REQUIREMENT	OVERVIEW	SCOPE
5. PROMOTION OF ENVIRONMENTAL OR SOCIAL CHARACTERISTICS – additional obligations	ADDITIONAL OBLIGATIONS Extra requirements apply if you have a mandate or model portfolio that: <ul style="list-style-type: none"> – promotes environmental (E) or social (S) characteristics (Article 8(1)), or – has sustainable investment as its objective (Article 9(1)), or – has a reduction in carbon emissions as its objective (Article 9(3)) – Disclosure document – You need to prepare and maintain a new disclosure containing: <ul style="list-style-type: none"> – a description of the environmental or social characteristics or the sustainable investment objective – information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments you select – the pre-contractual disclosures mentioned in (5) above – the information referred to in the next paragraph – Periodic report – In your periodic reports: <ul style="list-style-type: none"> – for a mandate or model portfolio that promotes environmental or social characteristics – report on the extent to which environmental or social characteristics are met – for a mandate or model portfolio that has sustainable finance or a reduction in carbon emissions as its objective – report on the overall sustainability-related impact of the portfolio by means of relevant sustainability indicators, OR if an index has been designated as a reference benchmark, compare the overall sustainability-related impact of the portfolio with the impacts of the index and of a broad market index through sustainability indicators The periodic disclosure requirements begin to apply on 1 January 2022. <i>[Note: In due course, the Taxonomy Regulation will add further requirements here and in relation to periodic reports, for mandates or model portfolios that promote environmental characteristics. See more on this below]</i>	Articles 10 and 11 SFDR Portfolio managers only <i>[New Articles 9 (4a) and 11(1)(c) and (d) of the SFDR inserted by the Taxonomy Reg]⁴</i>
6. WEBSITE	WEBSITE PUBLICATIONS Publish and maintain on your website: <ul style="list-style-type: none"> – The disclosures on sustainability factors as mentioned above – Information on your policies on the integration of sustainability risks as mentioned above – The information on remuneration mentioned above – i.e. an explanation as to how your remuneration policies are consistent with the integration of sustainability risks – For portfolio managers, the additional disclosures mentioned above where relevant 	Articles 3, 4, and 5 SFDR Advisers and portfolio managers Articles 10 and 11 SFDR Portfolio managers only

⁴See Articles 5 and 25(3) of the Taxonomy Regulation.

7. Additional requirements for managers – Taxonomy regulation

The Taxonomy Regulation is a key plank in the European Commission's work programme for a carbon neutral, sustainable EU. In general terms, it is a classification framework that will essentially define what economic activities are "green" and what are not.

The Taxonomy Regulation supplements and amends the Disclosure Regulation in certain respects, with the following intention, as relevant to portfolio managers:

"To avoid harming consumer interests, [firms such as portfolio managers] should disclose how and to what extent the criteria for environmentally sustainable economic activities are used to determine the environmental sustainability of the investments. The information disclosed should enable investors to understand the share of the investment funding environmentally sustainable economic activities as a percentage of all economic activities and thus the degree of environmental sustainability of the investment. Where a [portfolio] invests in an economic activity that contributes to an environmental objective, the information to be disclosed should specify the environmental objective or environmental objectives, to which the investment underlying the [portfolio] contributes, as well as how and to what extent the investments [in the portfolio] fund environmentally sustainable economic activities, including details on the respective proportions of enabling and transition activities ... Where financial market participants [e.g. portfolio managers] do not take into account the criteria for environmentally sustainable investments they should provide a statement to this end."

In particular, the Taxonomy Regulation will require the following:

(a) It will impose⁵ further requirements on you if you are a portfolio manager with a mandate or model portfolio that:

- promotes environmental characteristics (Article 8(1)); OR
- has sustainable investment or a reduction in carbon emissions as its objective (Articles 9(1) or 9(3)), and the portfolio invests in an economic activity that contributes to an environmental objective within the meaning of the Disclosure Regulation.

In this case, the Taxonomy Regulation will require you to include the following additional information in your pre-contractual disclosures and periodic reports:

- the information on the environmental objective/s set out in the Taxonomy Regulation⁶ to which the investments in the portfolio contribute
- a description of how and to what extent the investments in the portfolio are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. This description shall specify the proportion of investments in environmentally sustainable economic activities selected for the portfolio, including details on the proportions of enabling and transitional activities referred to in the Taxonomy Regulation, as a percentage of all investments made.

(b) If you are a manager of a mandate or portfolio that promotes environmental characteristics (Article 8(1)), you may also need to include the following in pre-contractual disclosures and periodic reports: *"The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities."*⁷

(c) In general terms, if a mandate or model portfolio is not subject to Article 8(1) or to Article 9(1), (2) or (3) of the Disclosure Regulation, the following statement must be made in relevant pre-contractual disclosures and periodic reports: *"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."*⁸

The Taxonomy Regulation applies in a staggered way starting from 1 January 2022.

⁰⁵ See new Articles 8(2a), 9(4a) and 11(1)(c) and (d) of the Disclosure Reg, inserted by the Taxonomy Reg. In particular, see Articles 5, 6 and 25(3) of the Taxonomy Regulation.

⁰⁶ From Article 9 of the Taxonomy Regulation: "(a) climate change mitigation; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems."

⁰⁷ Article 6 of the Taxonomy Regulation.

⁰⁸ Article 7 of the Taxonomy Regulation.

8. Technical standards and templates

ESMA, the EBA and EIOPA have been mandated to develop draft regulatory and implementing technical standards to give further detail on the prescribed requirements. The Taxonomy Regulation also inserted a new provision into the Disclosure Regulation, under which these bodies are to develop a regulatory technical standard on the content and presentation of information relating to the "do no significant harm" principle.

Some of these technical standards are now being consulted on. If you want a copy of our separate briefing on this, please contact your usual A&O contact. The standards are due for finalisation on 30 December 2020.

If you are a portfolio manager, you should also be aware that on 21 September 2020, ESMA, the EBA and EIOPA published a survey with suggested templates for some of the new disclosures required by "financial market participants", which is defined to include portfolio managers. The goal is to standardise these disclosures and make it easier for clients to compare what is disclosed by different firms in relation to different products and services. Three template mock-ups have been created for the survey.

The suggested templates will apply to you if you offer a portfolio management service or mandate that:

- promotes environmental and/or social characteristics;
- has sustainable investment as its objective; or
- has a reduction in carbon emissions as its objective.

The survey closes on 16 October 2020, and a number of industry associations are preparing responses. Again, if you want a copy of our separate briefing on this, please get in contact with your usual A&O contact.

9. Brexit

The UK government has not made clear whether the Disclosure Regulation will apply in the UK following the end of the implementation period of the Withdrawal Agreement.

At present, this is considered **likely**, although it is less clear what the UK's approach would be to any relevant technical standards.

The Brexit transition period is currently scheduled to end on 31 December 2020.

10. Recommendations

In terms of what firms should be doing now:

- Get up to speed on the new disclosure regulation
- Consider establishing a cross-functional internal team to consider what changes will be required within your business
- Review the consultations on the technical standards and (if they apply to you) the templates – so you know the "direction of travel" being taken with the applicable requirements
- Undertake a preliminary gap analysis
- In light of the outcome of the gap analysis, identify actions required to put in place the necessary internal systems, procedures, policies and expertise in order to comply with the requirements.

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