

# A brief on Sustainable Finance Disclosure Regulation July 2024

A Green Project Technologies Guide





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## **What is SFDR and Who does it impact?**

As of 10 March 2021, the European Commission's Sustainable Finance Disclosure Regulation (SFDR) came into effect. This regulation was introduced alongside the Taxonomy Regulation and the Low Carbon Benchmarks Regulation, aiming to bring transparency to investment products with sustainability claims. This is part of the EU's bid to transition towards more sustainable growth with a goal of achieving net zero emissions by 2050. SFDR is supported by EU Taxonomy for sustainable activities, and is applicable to two categories of financial firms:

**Financial Advisers (FAs):** organizations offering advice on investment- and insurance-based investment products.

**Financial Market Participants (FMPs):** organizations that sell financial products and offer management services within the EU. A financial product is defined as any product used to manage money, such as a bank account, credit card, insurance, etc.

The SFDR mainly applies to financial institutions such as asset managers, investment firms, insurance companies and banks with operations in the EU, with publication of statements mandatory for any financial company with over 500 employees. By extension, non-EU firms are also impacted if they have subsidiaries and services offered in the EU and meet company size criteria.

The main components to SFDR reporting are Principal Adverse Impact (PAI) Statements, Entity Level Disclosures and Product Level Disclosures, each explained in more detail below. It's also important to note that SFDR requires periodic/annual disclosures for Article 8 and Article 9 funds which we discuss at the end of this article.

## **Principal Adverse Impact (PAI) Statements**

SFDR requires that financial advisers and financial market participants disclose the consideration of adverse sustainability impacts of their investment advice and products through Principal Adverse Impact, or PAI statements. A PAI is an impact of investment advice and products that result in negative consequences on sustainability factors, including environmental, social and governance considerations. PAIs are used to measure one or more ESG aspects of a financial product. The mandatory PAIs defined by SFDR involve your company's greenhouse gas emissions, biodiversity, water, waste management, social and employee matters. Further, some PAIs are mandatory and applicable only to investments in real estate and investments in sovereigns and supranationals.

## **Level 1: Entity-Level Disclosures**

SFDR disclosures are separated into Level 1 and Level 2.

Level 1 entity-level disclosures (article 4 SFDR) are applicable to both financial market participants and financial advisers. An annual PAI statement must be made public on the company website which includes information about the company's policies to identify and prioritize PAIs. A description of the PAIs and of relevant actions taken, applied metrics, actions planned for the future and engagement policies must also be disclosed. Essentially, entity-level disclosures consist of:



**Sustainability risk policy** – A statement on how sustainability risks are evaluated in the company’s investment decisions.

**Principal adverse impact** – A description or assessment of how the company’s investments affect the range of sustainability factors.

**Sustainability risk remuneration policy:** A statement on how sustainability risks are considered in remuneration policies.

Publication of this PAI statement or entity-level disclosure is mandatory if the financial market participant has over 500 employees during the financial year. If not, a statement of explanation or a status update will suffice. Entity-level disclosure of PAIs apply from 10 March 2021 (Level 1). Companies with over 500 employees must comply, and those with fewer than 500 must explain.

### **How to structure information on entity-level disclosures:**

1. Information about your company’s Principal Adverse Sustainability Impact policies
2. Description of the principal adverse impacts and actions taken or planned
3. Summary of the company’s shareholder engagement approach
4. Adherence to responsible business codes and international standards
5. Statement about adverse impacts of investment advice and also regulatory guidance and general industry or market practice as applicable

## **Level 2: Product-Level Disclosures**

Level 2 product-level disclosures (article 7 SFDR) apply to financial market participants only. This involves publishing PAI information in pre-contractual financial product documentation, for example, in fund information memorandum or prospectuses. This obligation does not apply to financial advisers. Again, for financial market participants with 500 or more employees it is mandatory to comply. For others the “comply or explain” principle may be applied. Detailed entity and product level 2 disclosures, which are more onerous came into effect and are applicable as of 1 January 2022.

If PAIs on sustainability factors have not been considered for a certain financial product, a statement about this must be disclosed transparently in the pre-contractual information. The statement must explain the reasons why they have not been considered for the reporting year. If the PAIs were considered, a detailed explanation of how this was done must be provided in the pre-contractual disclosure statement of each individual financial product.

### **How to structure information on product-level disclosures:**



#### Pre-contractual disclosure

A detailed explanation of how a financial product takes the PAI on sustainability factors into consideration.

#### Periodic disclosure

A statement declaring that PAI information on sustainability factors will be disclosed in a periodic or annual report.

The SFDR and the SFDR Delegated Regulation currently do not stipulate detailed requirements on how to publish PAI information in pre-contractual information, other than: “a clear and reasoned explanation”.

## **Pre-contractual disclosures: Article 6, Article 8 and Article 9 funds**

These articles explain what needs to be reported as part of product-level pre-contractual disclosures for your fund and vary depending on the type of fund.

Article 6 applies to funds that do not have a sustainability focus. These are pre-contractual disclosure requirements for funds that do not prioritize sustainability as part of their investment strategy. For example, it could include stocks currently excluded by ESG funds such as tobacco companies or thermal coal producers. As per this article,

“Financial market participants shall include descriptions of the following in pre-contractual disclosures:

The manner in which sustainability risks are integrated into their investment decisions; and

The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.

Where financial market participants deem sustainability risks not to be relevant, the descriptions referred to in the first subparagraph shall include a clear and concise explanation of the reasons therefore.”

“Sustainability risk” is defined in the SFDR as an environmental, social or governance event or condition which, if it occurs, could cause an actual or potential material negative impact on the value of the investment.

Article 8 applies to financial products that promote social or environmental characteristics. It states that

“Where a financial product promotes among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed shall include the following:

Information on how those characteristics are met;



If an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.”

Article 9 applies to financial products which have sustainable investment as their objective and for which an index has been designated as a reference benchmark. It includes a further category for financial products with the objective of reducing carbon emissions.

“Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to article 9 shall be accompanied by the following:

Information on how the designated index is aligned with that objective;

An explanation as to why and how the designated index aligned with that objective differs from a broad market index.”

A broad-based index is also known as a market index. It is designed to reflect the movement of a group of stocks or an entire market. Article 8 funds are categorized as [light green](#), while Article 9 funds are classified as dark green. Asset managers must determine whether a financial product is in or out of the scope of Articles 8 and 9 of the SFDR, and an explanation can be provided as part of the pre-contractual disclosures.