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Alert | Environmental, Social & Governance

March 2021

The EU Sustainable Finance Disclosure Regulation Enters into Force

On March 10, 2021, "Regulation (EU) 2019/2088 of the European Parliament and of the Council of November 27, 2019 on sustainability-related disclosures in the financial services sector" (as amended and supplemented by the Taxonomy Regulation ((EU) 2020/852, June 18, 2020 on the establishment of a framework to facilitate sustainable investment) (the **SFDR**) entered into force in respect of the so-called "Level-1 disclosures". In summary, this means that certain financial market participants are now required to make mandatory environmental, social, and governance (ESG) disclosures. This GT Alert summarizes the scope of this new requirement.

The SFDR, although not directly applicable to investors, will have a meaningful impact on both investors and borrowers.

The SFDR was initiated by the European Commission in light of its action plan on sustainable finance that was issued prior to launching the EU Green Deal. The aim of the action plan is to create a stable, sustainable, and transparent financial system. It seeks to establish a reorientation of capital flows towards sustainable investment, promote the inclusion of sustainability in risk management, and foster transparency and long-term thinking into financial and economic strategy. The EU Taxonomy Regulation is one of the key pieces of legislation created out of this action plan. As the next regulation in this context that has now entered into force, the SFDR requires compliance with the EU Taxonomy Regulation.

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1. General

The SFDR prescribes new standardized disclosure obligations on how 'financial market participants' and 'financial advisors' integrate ESG factors (sustainability risks and the consideration of adverse sustainability impacts) both at the entity level (in their investment decision processes) and at the product level (in the provision of sustainability-related information with respect to financial products), designed to make it easier for end-investors to make informed investment decisions, improve industry-wide comparability, and prevent greenwashing (i.e., giving a false impression or misleading information about how a company's products are more environmentally sound). The SFDR applies to, broadly speaking, all asset managers and financial advisors, whose business is in Europe, non-EU asset managers and financial advisors (and their subsidiaries) who do business in the EU or sell products to the EU, and non-EU firms that sub-manage EU assets or funds.

Pursuant to the first stage of the SFDR, all in-scope asset managers and financial advisors must publish information on their sustainability processes on their websites and in their pre-contractual disclosures. Furthermore, they must divide financial products into three categories: dark green, light green, and non-sustainable, depending not only on their environmental but also on their social and governance impact. They must also disclose considerations of adverse sustainability impacts (the "do no significant harm" principle) on a comply or explain basis. The so-called level-1 disclosures must be complied with as from March 10, 2021. The "explain" option is not available starting from June 30, 2021, to those managers with more than 500 employees during the financial year (or managers that are the parent undertaking of a group with more than 500 employees).

2. Level 1 disclosures applicable from March 10, 2021

Level 1 disclosures are to be made on a comply-or-explain basis. This means that starting from March 10, 2021, the in-scope asset managers and financial advisors, when they choose to comply, are obliged under the SFDR to:

a. publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making process or their investment advice or insurance advice; and

b. include descriptions of the following in pre-contractual disclosures:

    i. the manner in which sustainability risks are integrated into their investment decisions or investment or insurance advice; and

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

Where they deem sustainability risks not to be relevant, they must disclose and explain the reasons therefor.

c. in respect of financial products, in the pre-contractual phase (and from the beginning of 2022 periodically), provide information on certain features of financial products that:

    i. promote environmental or social characteristics (so-called article 8-products or light green products); or

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ii. have a sustainable investment as their objective (so called article 9-products or dark green products).

3. Level 2 disclosures applicable starting from the beginning of 2022

The second stage of the SFDR – the level-2 disclosures – is expected to enter into force at the beginning of 2022. In-scope asset managers and financial advisors will have to start disclosing the above ESG factors periodically and align the disclosures with the EU Taxonomy Regulation and the regulatory technical standards (**RTS**) currently being drawn up by the Commission and the European Supervisory Authorities. These RTS will provide further detail on:

a. content;

b. methodologies; and

c. presentation of information in respect of the sustainability factors in relation to adverse impact:

   i. on the climate and other environment-related adverse impacts; and

   ii. in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

On March 15, 2021, the European Supervisory Authorities published a first consultation paper setting out the proposed RTS.

4. Potential impact on investors and borrowers

Although the SFDR is based on “comply or explain”, asset managers will likely be conscious of reputational risks and aim to ensure that they incorporate sustainability risks into their investment policies to avoid the perception of inadequate risk management.

It may lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed.

Finally, investors will need company ESG data in order to quantify sustainability risks and evaluate the extent to which they represent investment material risks as well as adverse sustainability risks to society.

The SFDR may thus have an immediate trickle-down effect on investors who require the information from businesses to ascertain the level of sustainability risk on their investments, and on the businesses that will have to provide such information in a manner that aligns with the EU Taxonomy, to remain an interesting prospect for investors.

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