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News Alert

Banking and Finance Department

Sustainability-related disclosures in the financial services sector

Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

On Wednesday, 10 March 2021, Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (the “**Regulation**”) became applicable, which establishes the bases to be followed by financial market participants and financial advisers, in terms of disclosures to end investors on the integration of sustainability risks, on the consideration of adverse sustainability impacts, on sustainable investment objectives, or on the promotion of environmental or social characteristics, in investment decision-making and in advisory processes.

I. Subject Matter

The Regulation lays down harmonised rules for financial market participants and financial advisers on transparency with regard to (i) the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and (ii) sustainability-related information with respect to financial products.

The Regulation falls within the framework of the European Union’s response to the consequences of climate change, resource depletion and other sustainability-related issues; a process in which urgent action is needed to mobilise capital through the financial services sector as well as through public policies. Within this framework, the European legislator requires financial market participants and financial advisers to disclose specific information regarding how they address the integration of sustainability risks and the consideration of adverse sustainability impacts.

By increasing transparency obligations, the aim is to reduce the risk of the absence of harmonised European Union rules on sustainability-related disclosures to end investors, causing significant distortions of competition as a result of significant differences in disclosure standards between the different Member States and the varying approaches in the different financial services sectors.

Likewise, with the increase in transparency obligations, the aim of the Regulation is to make it easier for end investors to effectively compare the different financial products in Member States in terms of their environmental, social, and governance risks and sustainable investment objectives.

The Regulation defines relevant concepts on the subject of sustainability as follows:

- “*sustainability risk*”: means an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact (real or potential) on the value of the investment;
- “*adverse sustainability impact*”: impacts of investment decisions and advice that result in negative effects on sustainability factors.
- “*sustainability factors*”: all information related to environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
- “*sustainable investments*”: 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 an investment in an economic activity that 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 and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;

II. Subjective scope of application

The obligations established in the Regulation are applicable to financial market participants when they create financial products and to financial advisers when they provide advice on investments or insurance. Under the concept of “*financial market participant*”, the Regulation includes:

- management companies of undertakings for collective investment in transferable securities (UCITS);
- credit institutions that provide portfolio management services;
- alternative investment fund managers (AIFM) that manage or market alternative investment funds, including European long-term investment funds (ELTIF);
- insurance companies that offer insurance-based investment products (IBIP);
- investment service companies that provide portfolio management services;
- institutions for occupational retirement provision (IORP);
- managers of qualifying European venture capital funds (VCF) or social entrepreneurship funds (SEF);

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- pan-European personal pension product providers;
 - Creators of pension products.

Under the term “financial adviser,” the Regulation includes:

- any insurance intermediary that provides insurance advice with regard to IBIPs;
- any insurance undertaking that provides insurance advice with regard to IBIPs;
- any credit institution that offers investment advice;
- any investment services firm that offers investment advice (including but not limited to financial advisers);
- any alternative investment fund manager or management companies for UCITS funds that provide advice on investment;

The provisions of the Regulation must be understood without prejudice to the rules on the integration of risk established in applicable European and national regulations, including but not limited to the relevant applicable proportionality criteria, such as size, internal organisation and the nature, scope and complexity of the activities in question.

The Regulation shall neither apply to insurance intermediaries that provide insurance advice with regard to IBIPs nor to investment firms that provide investment advice when they employ fewer than three (3) persons, without prejudice to the fact that they must also consider and include sustainability risks in their consulting processes.

III. Principles of action

The general principles of action, with regard to transparency, arising from the Regulation are as follows:

- Integration of sustainability risks in decision-making processes, and disclosure of such information.
- Integration of the consideration of the main adverse impacts, whether material or likely to be material, of investment decisions on sustainability factors in decision-making processes, and disclosure of such information.
- Integration of sustainability risks in personnel remuneration policies and disclosure of such information.
- Increase in transparency when a financial product promotes environmental or social characteristics (provided that the companies in which the investment is made follow good governance practices).
- Increase in transparency when a financial product has sustainable investments as its objective.

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- Keeping information disclosed on websites up to date, and clearly explaining any revisions or changes made.

IV. Main obligations arising from the Regulation

1. Regarding sustainability risks:

- A. Financial market participants and financial advisers should integrate relevant sustainability risks, whether material or likely to be material, in their investment decision-making processes, including the organisational, risk management and governance aspects of such processes, and in their advisory processes concerning investments or insurance, respectively, and should publish and maintain concise information about those policies on their websites.
- B. Where, as a result of the evaluation, financial market participants deem sustainability risks not to be relevant to the financial product, the reasons for this must be explained. Where the assessment leads to the conclusion that those risks are relevant, the extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms.
- C. The sustainability risk assessments and corresponding information disclosures by financial market participants should be included in their pre-contractual information. Financial advisers should disclose how they take sustainability risks into account in the selection process of the financial product that is presented to the end investors before providing the advice, regardless of the sustainability preferences of the end investors.

For these purposes, financial market participants shall include descriptions of the following in pre-contractual disclosures: (a) the manner in which sustainability risks are integrated into their investment decisions; and (b) the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available. Furthermore, if they deem the sustainability risks not to be relevant, the aforementioned descriptions should include a clear and concise explanation of the reasons for this.

Financial advisers shall include descriptions of the following in pre-contractual disclosures: (a) the manner in which sustainability risks are integrated into their investment or insurance advice, and (b) the result of the assessment of the likely impacts of sustainability risks on the returns of the financial products they advise on. In turn, if they deem the sustainability risks not to be relevant, the aforementioned description should include a clear and concise explanation of the reasons for this.

2. Regarding the consideration of adverse impacts, whether material or likely to be material, of investment decisions on sustainability factors:

- A. Where financial market participants, taking due account of their size, the nature and scale of their activities and the types of financial products they make available, consider the principal adverse impacts, whether material or likely to be material, of investment decisions on sustainability factors, they should integrate in their processes, including in their due diligence processes, the procedures for considering the principal adverse impacts alongside the relevant financial risks and relevant sustainability risks.

The information on such procedures may describe how financial market participants discharge their sustainability-related administrative responsibilities or other commitments vis-à-vis the shareholders.

- B. Financial market participants should include on their websites information on those procedures and descriptions of the principal adverse impacts.

In this respect, financial market participants shall publish and maintain on their websites, in the terms provided for in the Regulation: (a) where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available; or (b) if, on the contrary, they do not consider adverse impacts of investment decisions on sustainability factors, clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts. As of 30 June 2021, the obligation indicated in the aforementioned section (a) will be mandatory, among others, for financial market participants who, on their balance sheet

closing date exceed the criterion of the average number of 500 employees during the financial year.

The foregoing also applies to financial advisers, who should publish and maintain on their websites, in the terms provided for in the Regulation: (a) information as to whether, taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider in their investment or insurance advice the principal adverse impacts on sustainability factors; or (b) information as to why they do not consider adverse impacts of investment decisions on sustainability factors in their investment or insurance advice, and, where relevant, including information as to whether and when they intend to consider such adverse impacts.

- C. Financial market participants that consider the principal adverse impacts of investment decisions on sustainability factors should disclose in the pre-contractual information for each financial product, concisely and in qualitative or quantitative terms, how such impacts are considered as well as a statement that information on the principal adverse impacts on sustainability factors is available in the ongoing reporting.

In this regard, by 30 December 2022, for each financial product, the aforementioned pre-contractual information shall include the following: (i) a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors and (ii) a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed in the periodic reports (including but not limited to the annual report) in accordance with the Regulation.

If, on the contrary, the financial market participant does not consider the adverse impacts of investment decisions on sustainability factors, the disclosure of pre-contractual information shall include for each financial product a statement that the financial market participant does not consider the adverse impacts of investment decisions on sustainability factors and a reasoned explanation for not doing so.

It should be noted that in the scope of the transparency obligations regarding sustainability-related issues, the Regulation calls on the European supervisory authorities to develop draft regulatory technical standards to further specify and govern the content, methodologies and presentation of information to which the aforementioned transparency obligations apply, in relation to sustainability indicators with regard to climate and other environment-related adverse impacts, to social and employee matters, to respect for human rights, and to anti-corruption and anti-bribery matters.

3. Regarding financial products that promote environmental or social characteristics or those that have as an objective a positive impact on the environment and society:

The overall sustainability-related impact of financial products should be reported regularly by means of indicators relevant for measuring the chosen sustainable investment objective. Where an appropriate index has been designated as a reference benchmark, that information should also be provided with regard to the designated index as well as for a broad market index for comparison purposes. In particular, and in relation to European social entrepreneurship funds (EuSEF), the Regulation allows these managers, when they make available information on the positive social impact that is the objective of a given fund, on the overall social outcome achieved and on the related methods used in accordance with Regulation (EU) No 346/2013, to use such information, where appropriate, for the purposes of the disclosures under this Regulation.

- A. 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 pursuant to the Regulation, should include the following: (i) information on how these characteristics are met; and (ii) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.

The aforementioned pre-contractual information shall indicate where the methodology used for the calculation of the index can be found.

The Regulation calls on European supervisory authorities to develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed.

- B. 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 on the website pursuant to the Regulation, shall be accompanied by the following: (i) information on how the designated index is aligned with that objective; and (ii) an explanation as to why and how the designated index differs from a broad market index.
- C. Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be included in the precontractual information regarding the integration of sustainability risks, pursuant to the Regulation shall include an explanation on how that objective is to be attained.

- D. Where a financial product has a reduction in carbon emissions as its objective, the precontractual information shall include a detailed explanation of how the objective of low carbon emission is guaranteed in view of achieving the long-term goals regarding global warming of the Paris Agreement adopted under the United Nations Framework Convention on Climate Change that entered into force on 4 November 2016.
- E. For each financial product that either (i) promotes environmental or social characteristics, provided that the companies in which the investments are made follow good governance practices, or (ii) have sustainable investments as their objective, the financial market participants shall publish the following information on their websites:
- a) a description of the environmental or social characteristics or the sustainable investment objective;
 - b) information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, selection criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product;
 - c) in the case of a financial product that promotes environmental or social characteristics, (i) the extent to which the environmental or social characteristics have been met; (ii) information on how these characteristics are met; (iii) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.
 - d) in the case of a financial product whose objective is sustainable investments: (i) the overall sustainability-related impact of the financial product by means of relevant sustainability indicators; or (ii) where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators; (iii) if an index has been designated as a reference benchmark, information on how the designated index is aligned with that sustainable investment objective and an explanation as to why and how said designated index differs from a broad market index.
 - e) Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, an explanation on how that objective is to be attained.

This information shall be clear, succinct and understandable to investors and published on a prominent and easily accessible area of the website.

4. Regarding remuneration policies:

Notwithstanding applicable EU and national provisions regarding remuneration policies of financial market participants and financial advisers, the Regulation promotes greater transparency, in qualitative or quantitative terms, on the remuneration policies of financial market participants and financial advisers with respect to their investment or insurance advice.

The aim is therefore to promote sound and effective risk management with respect to sustainability risks while the structure of remuneration does not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance. For these purposes, financial market participants and financial advisers shall include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and shall publish that information on their websites.

5. Regarding periodic reports:

- A. Since annual reports in principle summarise business results for complete calendar years, the provisions of this Regulation regarding the transparency requirements for such reports should not apply until 1 January 2022 (therefore, in relation to fiscal year 2021).
- B. Where financial market participants offer a financial product that promotes environmental or social characteristics, or has sustainable investment as its objective, the periodic reports shall include a description of the following:
 - a) in the case of a financial product that promotes environmental or social characteristics, the extent to which the environmental or social characteristics have been met;
 - b) in the case of a financial product whose objective is sustainable investments: (i) the overall sustainability-related impact of the financial product by means of relevant sustainability indicators; or (ii) where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.

For these purposes, the Regulation allows financial market participants to use the information in management reports in accordance with Article 19 of Directive 2013/34/EU or the information in non-financial statements in accordance with Article 19 bis of that Directive, where appropriate.

V. Implementation of the Regulation

For the purposes of implementing the Regulation, the European supervisory authorities (EBA, ESMA and EIOPA), through the Joint Committee, are expected to develop draft regulatory technical standards to (i) further specify the content, methodologies and presentation of information in relation to sustainability indicators with regard to climate and other environment-related adverse impacts, to social and employee matters, to respect for human rights, and to anti-corruption and anti-bribery matters, and specify the presentation and content of the information with regard to the promotion of environmental or social characteristics and sustainable investment objectives to be disclosed in pre-contractual documents, annual reports and on websites of financial market participants; and (ii) to determine the standard presentation of information on the promotion of environmental or social characteristics and sustainable investments in marketing communications.