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The New ESG Playbook – EU Sustainable Finance Rules Start to Take Shape

- **The European Union kick-started the first phase of Sustainable Finance Disclosure Regulations in March 2021, requiring asset managers and financial advisors to reveal ESG information to encourage more private money into green investing.**
- **Key parts of the rules classify strategies as Light Green and Dark Green depending on how embedded they are in sustainability. Some large asset managers are already actively using SFDR for most existing products, while also developing new ones with the framework in mind.**
- **The second phase of SFDR with more onerous obligations will be rolled out in 2022.**

WHAT IS SFDR?

The Sustainable Finance Disclosure Regulations (SFDR) are a set of rules designed to shine a light on ESG informaton in the fund management industry to help inform investors about the types of green assets they are putting their money into. The EU's policy objective is to divert a greater amount of private wealth towards sustainable investing. The regulation should create a more level playing field to compare how asset managers are approaching major issues like climate change.

It also requires asset managers to publish the adverse effects of their investments on the environment and society, which will help to prevent 'greenwashing', the act of dressing up a product to be more environmentally-friendly than it actually is.

The EU began applying SFDR to asset managers doing business in Europe on March 10 but more detailed dislcosures won't be mandated until 2022. Europe's money managers have been practising ESG integration to the tune of €3.8 trillion, or 16% of investment funds and discretionary investments as of the end of 2019, according to the European Fund and Asset Management Association. The rules are being introduced just as funds for ESG management are increasing.

SFDR OVERVIEW AND CHALLENGES

SFDR requires asset managers and financial advisors such as brokers, to disclose ESG-related information on an entity basis and by financial instrument (fig. 1).

DISCLOSURE CHALLENGES

1. Entity level

Money managers and advisers are required to publish their policies on their websites. An important area of disclosure is called Principal Adverse Impacts, which deals with the negative effects of investment decisions and advice on sustainability factors. This is designed to prevent 'greenwashing' and allow investors to weigh the positive and negative activities of the firm.

2. Financial Instrument

This is divided according to the nature of the product. First, market participants assess and reveal sustainability risks that may affect returns. They also need to disclose financial products that promote environmental and social characteristics (Article 8), also called Light Green; and financial products that aim at sustainable investment (Article 9), known as Dark Green.

However, it is unclear which products fall under Light and Dark green because the definitions are ambiguous. Article 8 does not define what constitutes "promotion" of environmental and social characteristics. In other words, it is not clear which actions constitute advertising, yet at the same time SFDR requires disclosure of sustainability risks that may affect returns for all financial instruments.

Details of disclosure	Subject to disclosure	Disclosure method	Means of disclosure	Start date	Status of bylaws
(Article 3) Policy for Reflecting Sustainability Risk in Investment Decisions/Investment Advice	Financial market participant Financial advisor (Entity Units)	Contents Disclose	Website	2021/3/10	–
(Article 4) Principal adverse impacts of investment decisions/investment advice on environmental, social, and other sustainability factors and measures to be taken		Compliance or explain			Not yet formulated
(Article 5) Compensation policies consistent with the reflection of sustainability risks		Contents Disclose			–
(Article 6) Method of reflecting sustainability risk in investment decisions/investment advice and evaluation of the impact on returns	Financial market participant Financial advisor (Financial product unit)	Compliance or explain	Pre-contract Disclosures		
(Article 7) Principal adverse impacts of individual financial products on environmental, social, and other sustainability factors	Financial market participant (Financial product unit)			2022/12/30	
(Article 8) Standards and reference indicators for environmental and social characteristics of financial products that promote such characteristics (light green financial products);		Contents Disclose		2021/3/10	Not yet formulated
(Article 9) Consistency of reference indicators for financial products targeting sustainable investment (**dark-green financial products**)					
(Article 10) Description of the financial products falling Article 8 and 9 on the website;		Disclosure of Article 8.9.11 information	Website	2021/3/10	
(Article 11) Status of achievement of characteristics/targets of financial products falling under Article 8 and 9		Contents Disclose	Continuous Disclosure	2022/1/1	

Source: Nomura Institute of Capital Markets Research from ESAs.

Fig. 1: Outline of SFDR

Article 9 covers impact investment funds but it is unclear how much sustainable investment should be targeted. It defines sustainable investment as conditional upon (1) investing in economic activities that contribute to environmental or social goals, (2) not having a material adverse effect on either environmental or social goals, and (3) having good governance practices in terms of sound management structure, employment relationships, employee compensation, tax and compliance.

Article 8
(Light Green Products)

1. Intention to make partial sustainable investments (If yes, whether there is investment in companies that conduct activities in accordance with the EU taxonomy)
2. Content of environmental and social characteristics being advertised
3. Investment strategy
4. Asset allocation planning
5. **When (1) is Yes:** Percentage of investments meeting EU taxonomy and methods to meet sustainable investment equirements (Contribution to environmental and social goals and “do not significantly harm”)
6. Are principal adverse impacts on sustainability factors such as the environment and society considered?
7. (When there is a reference indicator) Whether the indicators are in line with the environmental and social characteristics being advertised

Article 9
(Dark Green Products)

1. Indicators used to measure the achievement of sustainable investment targets and whether there is investment in companies that conduct activities in line with EU taxonomy
2. Investment strategy
3. Asset allocation planning
4. Percentage of investment meeting EU taxonomy and how to meet sustainable investment requirements (Contribution to environmental and social goals and “do not significantly harm”)
5. Are principal adverse impacts on sustainability factors such as the environment and society considered?
6. (When there is a reference indicator) Whether the indicator is in line with the sustainable investment target
7. (If you're aiming to reduce carbon emissions,) Is the EU Climate Benchmark a reference indicator?

Source: Nomura Institute of Capital Markets Research from ESAs.

Fig. 2: Pre-contract disclosure required by the PDR of ESAs for individual financial products

Under these circumstances, market participants are required to make their own judgement about whether products fall under Article 8 or Article 9 until detailed regulations are finalized.

ASSET MANAGERS' APPROACH

French Asset Manager

- As of February, with an AUM of 452 billion euros, it has 656 products falling under Light and Dark Green
- For investment trusts in Europe, 328 billion euros, or 60% of AUM falls under these two categories
- The company has integrated all elements of ESG into its active open-end funds under a plan announced in 2018

Swiss Asset Manager

- As of March, 303 funds, 11.2% of the total, were classified as Light Green and 6 funds, 0.2% of the total, were classified as Dark Green
- It has identified and prioritized key adverse impacts of sustainability, and is working to strengthen its internal procedures framework consistent with SFDR

Dutch Asset Manager

- As of March, it has 83% of funds classified as Light Green and 12% Dark Green while other funds constitutes 5%
- It introduced a classification system* divided into three categories: (1) Sustainability Inside, (2) Sustainability Focus, and (3) Impact Investment, to help customers assess green investments

US Asset Manager

- 63% of funds established or revised in Europe in 2020 fall under Light or Dark Green
- It plans to expand the suite of sustainable investments for its European customers to accelerate the transition to a greener economy
- It expects that 70% of new or revised funds in 2021 will be Light or Dark green

* Sustainability Inside integrates ESG based on independent research, investment exclusion, voting and engagement. Sustainability Focus sets clear sustainability policies, targets for ESG characteristics, and targets for an environmental footprint that exceeds benchmarks. Impact Investments are strategies that aim to contribute to specific sustainability themes, such as the United Nations Sustainable Development Goals.

Source: Nomura Institute of Capital Markets Research from ESAs.

Fig. 3: Asset Managers' Approach

LOOKING AHEAD

While the SFDR regime is in its infancy and detailed regulations have yet to be finalized, asset managers that sell to EU investors already have a number of Light Green and Dark Green financial products. However, depending on how the European Commission establishes the bylaws, detailed ESG disclosures will not be available to investors until 2022. The incoming EU taxonomy may also affect SFDR by pushing companies to reveal more sustainability information. This is a transitional period that promises to greatly increase transparency and prevent greenwashing.

DISCLAIMER

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