POLICY RESEARCH

EU Sustainability Disclosures

We shine a lens on the myriad new disclosure requirements embedded across the EU Sustainable Finance Action Plan and what investors can expect to see.

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Executive Summary

The EU Sustainable Finance Action Plan intends to induce a variety of third parties to carry out a public aim in an effort to actively steer investments as part of meeting sustainability goals.

The plan relies heavily on the traditional financial-regulatory approach of compelling disclosure and places new requirements upon companies, financial-services providers, and financial products. The plans' success will depend to a large extent on how effective the disclosures are, particularly the extent to which they are comparable, useful, and complete.

The centrepiece of the new disclosures is the Sustainability-Related Disclosures Regulation. The SDR is intertwined with disclosure requirements spread across multiple other pieces of new and amended regulation. Unfortunately, while there has been increasing synchronicity across these regulations, they are not seamless either in their timing or content.

The SDR itself will concentrate firms' reporting on three main aspects: how they manage sustainability risks; the adverse impacts that their investments have on sustainability; and the substantiation of the claims that they make in promoting their ESG products.

In marked contrast to many other pieces of EU legislation, the SDR introduces a strong move toward mandating the format and detailed content of many of the disclosures. It forms a critical part of operationalizing the Action Plan and will more clearly distinguish between different kinds of sustainable investing. Quantitative measurements will: increase the chance of objectives being achieved; identify winners and losers; and ameliorate a tendency that voluntary reporting has toward focusing on text that shows a firm or product in the best light.

The European Supervisory Authorities have thus far only proposed the format and content of one set of disclosures in their joint consultation paper on draft technical standards. These standards focus on the principal adverse impacts on sustainability factors identified by a firm, which they must report at an aggregated enterprise level. The value of these to investors is unclear, given they will mask a lot of disparate individual strategies and that investors tend to buy a product rather than a firm. More interesting will be the product-level disclosures and the outcome of the ESA continuing deliberations about level of detail, granularity, and balance between optional and mandatory metrics, which will be key in determining how beneficial they will be to investors.

In this paper we analyse the disclosure requirements that fall upon different types of firms and the consequent interdependencies thereof. Our research explores what, when, and where investors can expect to see improved ESG disclosures based on the latest available information, including the text of the SDR, and expected amendments to that text by virtue of the latest draft regulation on the establishment of a framework to facilitate sustainable investment (taxonomy) and the joint consultation paper.

Key Takeaways

- The Sustainability-Related Disclosures Regulation, more than any other, raises the bar for financial products to promote genuine ESG credentials, setting strict minimum disclosure standards to prevent greenwashing.
- These increased disclosure demands can reasonably be expected to see a range of products either amend the ESG objectives to which they currently allude, or to double down on them by making them a core aim. Either outcome will give investors a clearer choice when evaluating investment decisions.
- There is a delicate balance between preventing greenwashing and making it unduly onerous to be an ESG product.
- Investors' primary focus on products may render the depth of disclosures required at firm level disproportionate.
- Firm-level aggregated disclosures will mask many different underlying strategies but likely will be more useful as macro indicators to policymakers of the societal success of the Action Plan than as useful information for investors.
- Product-disclosure requirements that differ from company-reporting obligations and benchmark disclosures will create extra overheads that would be rendered unnecessary by aligning the reporting requirements.

Background

The European Commission is further ramping up its sustainable finance efforts toward meeting its 2050 carbon-neutrality goal. The European Green Deal, published in December 2019, included an ambition to formalise that goal with a Climate Law, a draft of which was published in March. The Green Deal also announced a Renewed Sustainable Finance Strategy to build on the 10 actions laid down in its Sustainable Finance Action Plan, which aim to channel private capital toward sustainable investments.

The Commission asserts that a more comprehensive and ambitious strategy is needed, because while progress has been made, the financial system is not transitioning fast enough. The Sustainable Finance Action Plan does, however, continue apace with two major new pieces of regulation in place, a third imminent, and amendments to multiple other pieces of EU regulation.

All of them incorporate new disclosure obligations in respect to environmental, social, and governance factors. The individual pieces of regulation are itemised in Exhibit 1, indicating which types of firms and products are impacted by each and the dependencies that firms have on each other.

Exhibit 1 EU Regulations With ESG Disclosure Requirements

Directive or Regulation	Companies	Asset Managers	Insurers/ Pensions	Financial Products	Advisers	Benchmark Providers
Primary						
Taxonomy	●	●	●	●	●	
Sustainability-Related Disclosure		●	●	●	●	
Nonfinancial Reporting	●	●	●			
Benchmark						●
Secondary						
MiFID II		●		●	●	
IDD			●			
UCITS		●		●		
AIFMD		●		●		
Shareholder Rights II		●	●			
Institutions for Occupational Retirement Provision			●			
Solvency II			●			

Source: Morningstar. Data as of 10 June 2020.

In this paper we unpack the individual components of each, including what has to be done—by whom and by when—and we explain what additional information investors ultimately need to inform their investment decisions.

The Timetable and Interdependencies of EU Regulations

The Sustainable Finance Action Plan design creates a push-pull dynamic, making each type of firm in the financial-services chain dependent on information from other firms in order to fulfill their own obligations. When financial-product manufacturers report fully to their investors, they are highly reliant upon companies disclosing detailed information about their sustainability accomplishments and goals. In turn, for financial advisers to match their clients' sustainability preferences to suitable investable products, they need high quality and consistent information from product manufacturers.

The Sustainability-Related Disclosures Regulation, more than any other aspect of the Action Plan, seeks to set harmonized requirements for disclosures to end investors—on the integration of sustainability risks; on the consideration of adverse sustainability impacts upon sustainable-investment objectives; and on the promotion of environmental or social characteristics—in investment decision-making and in advisory processes.

The details of how that will be done and what they will look like will be defined by regulatory technical standards. Draft versions of those standards have been opened to public consultation between April and Sept. 1, 2020, the feedback to which must be evaluated and the drafts turned into final versions by year-end. The first tranche of disclosures then will have to be enacted by product manufacturers and advisers 10 weeks later, on March 10, 2021.

The draft proposals are both complex and extensive. Unfortunately, they do not totally align with the separate disclosure requirements imposed by the Taxonomy Regulation, or those of the Benchmark Regulation on index providers.

More encouragingly, to minimize duplication—and worse, inconsistency—some areas of EU regulation are slowly becoming more interconnected and include systemic cross-references. An example is evident in our first area of focus, which is company-reporting obligations.

Corporate Disclosures

Large EU public interest companies (with more than 500 employees), banks, and insurers will be subject to two principal sets of complementary reporting obligations, summarised in Exhibit 2.

Exhibit 2 EU Regulation Governing Company ESG Reporting

Regulation/ Framework	Effective Date	Goal
NFRD	2016	Policies, principal risks, and outcomes relating to environmental, social, and employee matters, respect for human rights, board diversity, anti-corruption and bribery matters.
Taxonomy	2022	The proportions of turnover and capital expenditure aligned with activities defined in the taxonomy as making substantial contributions toward meeting EU environmental goals.
EU Green Bond Standard	TBA	Voluntary code that, for bonds issued where the proceeds will be EU-taxonomy aligned, requires reporting about the use of proceeds and impacts made.

Source: Morningstar. Data as of 10 June 2020.

Non-Financial Reporting Directive

The Non-Financial Reporting Directive is a comply-or-explain[1] piece of regulation and comes with two separate sets of nonbinding guidance for companies: the original 2017 Guidelines[2] and a 2019 supplement on Reporting Climate-Related Information.[3]

The information may be found in either company annual reports or in a separate dedicated sustainability report. Unfortunately, despite the guidelines, the requirements allow for a range of different frameworks to report the information, including UN Global compact; ISO 26000; OECD guidelines for multinational companies; EC guidelines for environmental and social information; and EC guidelines for climate-related reporting and TCFD.

Consequently, companies tend to mix and match which elements of which frameworks they use, resulting in long, noncomparable reports for investors to decipher. Indeed, in its first-quarter 2020 consultation paper on proposed revisions to the Directive, the European Commission asserts[4] that:

"There is inadequate publicly available information on non-financial issues as:
A. reported non-financial information is not sufficiently comparable or reliable;
B. companies do not report all non-financial information that users think is necessary, and many companies report information that users do not think is relevant;
C. some companies do not report such information; and
D. it is hard to find non-financial information even when it is reported."

As a data provider, equity researcher, and investment manager, Morningstar can attest to these statements based on firsthand experience. While we, and other information providers, can play a valuable role on behalf of investors by finding and normalizing the information, more standardisation at source will lead to more efficiencies; companies will be clearer about what they should report; the location and format of the information will be more consistent and faster for investors to find and distill; and companies will face fewer time-consuming requests from third parties seeking additional information.

On the positive side, there is at least a growing move to rally behind the recommendations of the Task Force on Climate-Related Financial Disclosures. The NFRD Climate Guidelines recommend their use, and countries including Germany and the U.K. both took further action in the early part of 2020 by requiring some listed companies to report on this basis from 2022. This is consistent with the NFRD guidelines, which already recommend the use of TCFD, and these guidelines are specifically referenced in the text of the Taxonomy Regulation.[5]

While the NFRD has set a baseline for reporting, we hope that out of the current consultation, a much greater degree of standardized reporting requirements will emerge to assist investors'

1. In contrast to binding laws, companies may either comply with a regulatory code or explain publicly why they do not.
2. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017XC0705(01)&from=EN
3. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019XC0620(01)&from=EN
4. https://ec.europa.eu/info/sites/info/files/business_economy_euro/company_reporting_and_auditing/documents/2020-non-financial-reporting-directive-consultation-document_en.pdf
5. Recital 22 of https://data.consilium.europa.eu/doc/document/ST-5639-2020-REV-2/en/pdf

analysis. As will become evident later in this paper, one of the most valuable actions would be to embed in company disclosure requirements, including NFRD, the specific metrics that financial-market participants will need in order to make their own disclosures as complete and accurate as possible for investors. In our own response[6] to the consultation, we encouraged the Commission to adopt more consistent use of existing standards. Partial use of different sets of standards is workable if everyone is using the same standards to address the same issue.

Taxonomy

The reporting requirements related to the Taxonomy Regulation will commence in 2022 and for the first year will be focused on climate adaptation and climate-mitigation activities. Specifically, companies will be reporting their degree of alignment, by both turnover and capital expenditure, with the range of activities that contribute positively to the environment as identified in the taxonomy.

The information will roll out gradually during 2022 as companies report on their 2021 financial year results. As well as their overall degree of alignment, companies are recommended to show how that breaks down across each of the six different environmental objectives of the taxonomy. The activities in the taxonomy are further broken down into whether they make a "substantial contribution" in their own right; "enable" other contributions; or help "transition" toward more contribution, and reporting this breakdown is also encouraged. The detailed reporting requirements and type of data that underly this summary are fully explained in a sister paper[7] to this.

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Financial-product manufacturers, including banks, insurers, or public-interest companies with over 500 employees, will need to disclose in their own right under both the NFRD and Taxonomy. These disclosures will be from the perspective of their overall business and largely independent of their reporting obligations to investors in the products that they manufacture.

These firms, and their many smaller or private counterparts that are not subject to the terms of NFRD, will be highly dependent on company reporting in order to discharge their specific investment-reporting requirements to their own clients. It is these aspects that we concentrate on in the next section.

EU Green Bond Standard

At this time, the standards drafted by the Technical Expert Group remain in draft form and effectively serve as a best-practice guide. Transposing the TEG work into legislation is being evaluated by the commission and, if formalized, will have firms that wish to gain green-bond accreditation for a bond issuance ensure that the proceeds of the bond are used for taxonomy-aligned activities. During the life of the bond, the firm would have to report at least annually on the allocation of the bond proceeds and would need to be taxonomically aligned. Also, they will need to report at least once on the impact of the bond and make known the key metrics they will use to ensure taxonomy alignment.

6. https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation
7. Pettit, Walton: EU Taxonomy of Sustainable Activities, May 2020.

Sustainability-Related Disclosures Regulation

The Sustainability-Related Disclosures Regulation forms the core of new ESG reporting requirements for the manufacturers of, and advisers on, financial products. It will, above anything else, raise the bar for products seeking to promote ESG credentials by setting strict minimum-disclosure standards to prevent greenwashing.

Broadly, the SDR will focus firms' disclosures on their assessment and management of sustainability risks and adverse impacts, as well as their substantiation of the objectives of those products they promote as ESG or sustainable. As a result, investors can expect to see more standardized information and more quantification of textual claims.

The SDR disclosure obligations are broadly split into information that must be provided at a firm level and information that must be provided for each individual financial product, including those products that do not have an ESG or sustainable focus. What follows is based upon the text of the regulation and the joint consultation paper issued by the European Supervisory Authorities. In Exhibit 3 we lay out the timetable of deliverables between now and the effective dates of the various requirements.

Exhibit 3 SDR Timetable

Deliverable	Date
Consultation on ESG Disclosures Closes	Sept. 1, 2020
ESA proposals on the nature of product precontractual and periodic disclosures	Pending
ESA submits RTS to EC on content, methodologies, and presentation of: ► Sustainability indicators on adverse impacts to climate and environment ► Precontractual disclosures in respect to how Article 8 products aim to achieve their environmental and social objectives ► Precontractual disclosures in respect to how Article 9 products aim to achieve their sustainability objectives ► Website disclosures of Article 8 and 9 products ► Periodic disclosures of Article 8 and 9 products	Dec. 30, 2020
SDR website and precontractual disclosures required	March 10, 2021
Website entity-level PAI textual disclosures required for NFRD firms	June 30, 2021
ESA submits RTS to EC on sustainability indicators on adverse impacts to Social factors	Dec. 30, 2021
Product-level periodic reporting of extent to which Article 8 and 9 products have met their goals	Jan. 1, 2022
Website entity-level PAI quantitative measures required	June 30, 2022
Precontractual product-level PAI disclosures required	Dec. 30, 2022
EC review of effectiveness of SDR, including the definition of firms required to report and the quality of data available to them	Dec. 30, 2022

Source: Morningstar. Data as of 10 June 2020.

As is evident, there is a very compressed timeframe between closing the consultation, drafting the final rules, and those rules taking effect. This is exacerbated by the supervisory authorities still, at the time of writing, evaluating how prescriptive they should be regarding the range of product-level disclosures.

We are encouraged by the preferences they have expressed to find a balance between prescriptive metrics, provided in standardized formats with some freedom to add additional product-specific information. We support this approach because standardisation puts products on a level playing field; provides investors with comparable information; and shifts the weight of disclosures away from a bias to showing a firm or product in the best light that voluntary reporting leads to. However, the task is not easy, and the likelihood of success is difficult to judge until more proposals are forthcoming.

In the following sections, we look first at the firm-level requirements on those entities managing investment products. Subsequent sections look at the required product disclosures, including multi-option products, as well as implications for financial advisers, and lastly, the interaction with benchmark requirements.

Disclosures by Financial Product Manufacturers

In Exhibit 4 we collate the primary firm-level requirements, not only from the SDR but also from those arising from other pieces of regulation that are being adapted to address sustainability issues.

Exhibit 4 Firm-Level Reporting Requirements

Directive or Regulation	Effective	Principal Reporting Requirements
Sustainability-Related Disclosures	Statement-based disclosures: March 10, 2021 (June 30, 2021 for NFRD firms) Statistics (relating to a reference period) June 30, 2022	Website disclosures, in an easy place to find, of ▸ policies to identify, assess and address **principal adverse sustainability** impacts **OR** a statement that such impacts are not considered and why ▸ policies on integrating sustainability risks into the investment decision process ▸ **engagement** policy and **voting** behaviour ▸ any **international standards** the firm adheres to ▸ **remuneration** policies, and how they are consistent with sustainability risk integration ▸ which products promote E or S characteristics and sustainable investments
Shareholder Rights II	Sept. 3, 2020	Website disclosure of engagement and voting policy, including how they monitor companies, and an annual statement including how the policy has been implemented and their voting behavior over the prior year, including an explanation of key or material votes.
Taxonomy	Dec. 30, 2021	Those financial-market participant firms that are required to make disclosures under the terms of the NFRD are also required to make disclosures in respect to their alignment with, and their management of, products to align with the taxonomy.
MiFID II, IDD, UCITS and AIFMD (ESG amendments)	Likely to be Q3 2021	Various amendments related to ▸ target-market considerations and the types of clients whose ESG preferences the product is compatible with and any groups of clients that the product is not compatible with ▸ documenting how sustainability risks are considered as part of risk-management policies

Source: Morningstar. Data as of 10 June 2020.

With regard to principal adverse impacts, large public interest firms with more than 500 employees will be required to disclose aggregated information on the emissions, policies, and processes of their investments. Other firms have an option instead to publish a prominent notice on their website that they do not consider principal adverse impacts and why that is the case.

In addition, an equivalent statement must be made in each products' precontractual disclosure document. Therefore, if a firm has any ESG products then they will need to comply with the firm-level disclosures or face the contradictory situation of having to include a warning that they do not consider adverse impacts of their investment decisions in their ESG products prospectus (or other precontractual documents).

Regulators have proposed a detailed reporting template[8] that firms should use to report both their textual policies and quantitative metrics on an extensive range of issues that include:

Climate and Other Environment-Related Indicators

- Carbon emissions, footprint, intensity, and solid fossil fuel exposure
- Energy usage, broken down into sectors and into shares of renewable energy
- Biodiversity polices including deforestation policies, operations in or near protected areas, or areas of high biodiversity value
- Water emissions, exposure to areas of high-water stress, untreated water discharge
- Hazardous waste and nonrecycled wastewater generated

Social Indicators

- Policies on international labour convention, gender pay gap, CEO to median employee pay ratio, board gender diversity, whistleblower-protection policies, workplace accident-prevention polices
- Human rights policies, due-diligence processes, antihuman trafficking policies, supply chain risk of child labour or forced labour (including number and nature of any severe human rights issues)
- Controversial weapons exposure
- Anti-corruption and anti-bribery policies, including cases of insufficient action to address breaches, and number of convictions and value of fines incurred for any breaches

The full list of adverse impacts and requisite metrics is provided in Appendix 1. Two further sets of proposed indicators are provided, from which firms must elect and report on at least one other relevant climate or environmental-factor indicator and one other relevant social indicator.

The metrics must be disclosed for discrete reference periods, commencing from June 30, 2022, and covering the period from when the firm began considering adverse impacts, through to Dec. 31, 2021. Thereafter the information must be updated in respect of each calendar year annually by June 30.

8. Tables 1, 2, and 3 in Annex 1 of the Joint Consultation Paper on ESG Disclosures, April 23, 2020.

Establishing the metrics will often involve the manufacturer having to estimate their aggregated share of the emissions of each of their underlying investee companies, in absolute terms or per-million euro invested; the proportion of investee companies that are without a relevant policy or are affected by an adverse impact on an area; and/or the weighted percentage invested in companies without a policy or are affected by an adverse impact.

The carbon-emission data requirements are extensive, including scope 1, 2, and 3 carbon emissions. Scope 1 encompass the direct emissions of the company; scope 2, the emissions from electricity purchased and used by the company; and scope 3 includes all the emissions from a company's value or supply chain. Scope 3 emissions in particular are hard to calculate, and most companies do not disclose, or calculate, this information and so there may be a wide information gap for this at the beginning. The disclosures require both calculated data, such as energy-consumption intensity broken down by NACE[9] sector, as well as explanatory text for that calculated data.

The provisions of the 2019 updated Shareholder Rights (Long Term Shareholder Engagement) Directive take effect independently on Sept. 30, 2020. Those obligations to disclose an engagement policy and annual updates on its implementation and how material votes were cast will be emphasized via direct reference in the SDR.

While the firm-level disclosures are extensive, we question the need for them to be so. Whilst they can indicate a firm's commitment and intent, those principles are likely to be adopted to different degrees in different products. Plus, firms that are commissioned to run institutional mandates that conform to the investment philosophy of the delegating company could potentially skew a firm's statements and metrics.

On balance, we think that end investors are more likely to be interested in the credentials of individual products than the holistic firm-level information, and it's these disclosures that we look at next.

Disclosures by Financial Products

The wide range of financial products affected by SDR requirements are shown in Exhibit 5. The regulation creates two self-assigning and self-policing subsets of the entire product universe. These so-called Article 8 and Article 9 products take their name from the respective sections of the SDR. Although it is these subsets that are subject to the bulk of the reporting obligations, the regulation imposes a level of new reporting requirements onto all products.

9. NACE is a statistical classification schema of economic activities in the European Community.

Exhibit 5 SDR and Financial Products

Investment funds
- Undertakings for Collective Investment in Transferable Securities management companies
- Alternative Investment Fund Managers
- Venture capital and private equity funds

Insurance undertakings making available Insurance-Based Investment Products

Pension funds
- Institutions for Occupational Retirement Provision
- Manufacturers of pension products
- Pan-European Personal Pension Product providers

Investment firms or credit institutions providing portfolio management and investment advice

Article 8: Products promoting environmental or social characteristics

Article 9: Products with sustainable investment as their objective

Source: Morningstar. Data as of 10 June 2020.

All products promoting any ESG characteristics will be defined as either Article 8 or Article 9 products. The SDR consultation paper describes Article 8 products as a "catch-all category to cover all financial products with different environmental or social ambitions that do not qualify as sustainable investments according to Article 9." The recitals do indicate that Article 8 products would encompass those that exclude certain companies based on involvement in certain sectors or activities, but points out that simply "taking into account" sustainability risks or "ESG integration" (as will be required for all products under MiFID, UCITS, and IDD) would not be enough in itself for a product to be classified as an Article 8 product. Article 8 products will also need to include a statement in their predisclosure document that states: This product does not have as its objective sustainable investment.

In contrast, Article 9 products must have a "sustainable investment" objective aligned to the EU taxonomy in that "sustainable investment" is defined in the SDR as: "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."

The SDR definition goes on to also include social goals "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."

To address greenwashing concerns, the proposed disclosures will require those products wishing to market or promote green credentials to substantiate how they plan to do so and how successful they have been. Indeed, the consultation paper envisions that the product would need to disclose the extent to which the investment object was attained, using relevant indicators to show how that compares historically—up to 10 years or to when the product first started to consider that indicator. These increased disclosure demands can be reasonably expected to see a range of products either amend the ESG objectives to which they currently allude or to double down on them by making them a core aim. Either outcome will give investors a clearer choice when evaluating investment decisions.

Whether a hidden consequence of a higher European standard turns out to penalize EU funds compared with those domiciled in other jurisdictions, or, conversely and more optimistically, raise the bar in other jurisdictions, remains to be seen.

The reporting requirements for Article 8 and 9 products are summarised in Exhibit 6. The format of those disclosures is not yet defined in the ESA consultation, but they do outline the options that they are considering. Their stated preferences all lean toward a level of mandated formats and measures, supplemented with product-specific information. We are supportive of this move toward more prescriptive disclosures assuming the required information is meaningful to investors; practical to obtain; relevant to each type of product or objective; and kept relevant by being regularly updated to reflect market evolution.

Defining the precontractual disclosures is paticularly challenging for the supervisory authorities due to the differing nature of those documents across different product types. UCITS and alternative investment funds, for example, will make these disclosures in their prospectus while for many insurance and pension products the precontractual document will usually be a much shorter, retail investor-facing document.

To overcome this challenge, a significant amount of information must also be displayed on the website in a section titled “Sustainability-Related Disclosures,” located in the same part of the website as other product information, including marketing communications. The summary should not extend to more than two pages of A4 in printed form and should include all the substantial information required in the precontractual documents.

Additional information that needs to be included is: information about how sustainability indicators are monitored and the methodologies used to measure the attainment of the characteristics promoted by the product, including the data sources used and how the data is processed and quality assured, plus the proportion of data that is estimated and any limitations to the data and methodologies; how due diligence is carried out on underlying assets; and engagement policies.

Products citing a reference benchmark must also describe the index, including its input data, methodologies, rebalancing methodologies, underlying components, calculation methods, and effects of leverage. This may be fulfilled by signposting to the index administrator’s website.

Exhibit 6 SDR-Proposed Reporting Requirements for Article 8 and 9 Financial Products

Precontractual Documents	Periodic Reports
Description of the E, S, or sustainable characteristics being promoted.	Description of the actions taken to attain the E, S, or sustainable characteristics.
Narrative and graphic of planned proportion of sustainable investment broken down into those that are E and S. Further distinguishing between direct and indirect holdings, plus explanation of the purpose of remaining investments; use of derivatives and proportion in different subsectors, including fossil fuels.	Graphical representation of the actual proportion of the E, S, and sustainability-related investments, plus narrative distinguishing between direct and indirect holdings; the purpose of the remainder of investments and the proportion in different subsectors, including fossil fuels.
A "No Sustainable Investment Objective" statement for Article 8 products or an explanation of "How investments do not harm the sustainable investment objectives" for Article 9 products.	Explanation of how the sustainable-investment objectives have not been harmed, plus how the adverse indicators were considered, and if any investments were excluded due to significant harm to the fund's objective.
"Investment strategy" description, including policies used to assess good governance practices and any binding criteria used for selecting investments.	A list of the top 25 investments of the financial product, based on average proportion of investment during the period, with sector and location.
List of the sustainability indicators used to monitor attainment of E and S characteristics.	"Attainment of the 'E', 'S', or sustainable characteristics" description of the extent to which they were achieved, including shareholder engagement, voting behaviour, and performance of the indicators with historic comparisons.
Reference benchmark—if an index has been designated, description of how it aligns with E and S or sustainability goals and how it differs from broad market index.	For the sustainable indicators deemed relevant, a tabular or graphical comparison between the fund, the index, and a broad market index.
If carbon reduction is the objective, indicate if the index is an EU Climate-Transition or Paris-aligned benchmark.	Description of the products contribution to the Paris Agreement global-warming objectives.

Source: Morningstar. Data as of 10 June 2020.

Many of the above disclosures will be narrative in nature, describing a product's ESG ambitions and how it seeks to achieve them. Some will be more quantative—such as the planned and actual proportions—to be invested in sustainable securities and/or those that support environmental or social goals.

The more standardised the qualitative disclosures of environmental or social characteristics or sustainable objectives are, the more useful they will be to investors when it comes to making decisions. Developing some common terminology guidelines would help ensure that similar language, when used by different products to describe progress toward goals, is, in fact, comparable. Without this there is a chance of investor confusion surrounding what the characteristic or objectives actually mean.

While more standardised qualitative information is better, the real substantiation will come from quantatitive metrics. In this regard the consultation paper has some interesting examples about how products might assess, measure, and monitor the criteria and the extent to which goals have been met, acknowledging that there are likely to be numerous criteria and ways to measure and monitor them. An example is the binding tests for underlying investments—these would include any exclusion tests, such as the number of companies with revenue exposure greater than a given percentage to fossil fuel production, as well as any postive tests (for example, the minimum level of EU taxonomy alignment or renewable energy usage). These tests will potentially be different for each product but will allow investors the opportunity to compare the binding criteria used, in addition to the strategy the product will employ, to attain its goals.

Similarly, the indicators used to assess, measure, or monitor the attainment of the stated goals, such as the level of carbon emissions to demonstrate reduction in those emissions, are likely to be different across different products but can be used to determine if goals have been achieved. Less clear is how manufacturers will express the potential impact on a product's returns, which may be narrative-based or quantitative, such as a ranges of values or estimated values.

Multi-Option Products
Products, such as insurance or pension policies, that offer a range of underlying investment options must provide a list of the investment options that qualify as either Article 8 or Article 9 products, together with a summary of those underlying products' SDR disclosures.

Benchmarks
The SDR introduces additional disclosures in respect of benchmarks for those Article 8 and 9 products that cite a sustainable benchmark. Alongside the product's own sustainability measures, they must also publish relevant sustainability indicator(s) for their chosen benchmark and performance comparisions against a broad market index.

Benchmark providers themselves are subject to their own disclosure requirements as laid out in the Benchmark Regulation, which was amended regarding climate benchmarks and sustainability disclosures. The extent to which the SDR product disclosures will be correlated will be better known when the ESA publishes the proposed reporting templates.

Providers are required to include in all of their benchmark statements, except interest rate and foreign exchange, if and how ESG factors are reflected. A template will be provided for the disclosures and each benchmark will have a Yes/No indication of whether ESG factors are considered in the construction methodology of the benchmark.

For those where the answer is Yes, the ESG factors used, as well as the data inputs, standards, and verification processes need to be disclosed. The template[10] proscribes a range of other measures applicable to different benchmark types and cover a wider spectrum, such as greenhouse-gas intensity, exposure to physical climate risks, exposure to controversial weapons (and how defined), number of constituents subject to social violations, weighted average percentage of independent board members and female board members, or in the case of sovereign debt, benchmark income inequality and rule of law measures.

10. https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12019-References-to-ESG-factors-enabling-market-participants-to-make-well-informed-choices

There is a degree of ambiguity in the consultation as to whether every measure must be calculated for every ESG benchmark or just for those that the benchmark administrator considers relevant. Benchmark administrators are under no obligation to disclose equivalent ESG-related statistics for their broad market indexes.

Additional information is required for climate benchmarks. Paris-Aligned Benchmarks must disclose the temperature scenario used, the provider of temperature scenario, and a link to the methodology used for the temperature scenario. Climate Transition Benchmarks must disclose the forward-looking decarbonization trajectory, the degree to which the Intergovernmental Panel on Climate Change decarbonization trajectory on limiting global warming to 1.5 degrees Celsius has been attained on average per year, and the benchmarks' active share to the investable universe.

Consequently, firms may not fulfill their SDR obligations by using off-the-shelf public information from benchmark providers. They either have to calculate it themselves in respect to their chosen indexes; alternatively, benchmark providers may provide the information as an additional service. Both routes will create extra overheads that would be rendered unnecessary by aligning the reporting requirements between benchmarks and financial products.

Financial Product Disclosures and the EU Taxonomy

Article 8 and Article 9 products that have an environmental characteristic or objective must, from Dec. 31, 2021, disclose in their annual report the proportion of their investment portfolio that is aligned with the EU taxonomy. In doing so, firms may rely on company disclosures directly without verifying them, although they should remain mindful of general obligations regarding the accuracy of their precontractual and periodic reporting. Products may also elect to independently evaluate an investee company's degree of alignment in the case of companies that are not required to make taxonomy disclosures.

The products' overall proportion of taxonomy alignment is required, together with a supporting break down across climate-change mitigation, adaptation activities in 2022, and across all six taxonomy objectives from 2023.

Additionally, it is recommended to report the proportion that is potentially aligned, where a product has good reason to believe that portion of its investments would be aligned but could not verify it. In these cases, the product should explain which criteria could not be verified and why; the due diligence undertaken; any engagement with the company; and how any estimates used have been calculated.

The full regulatory technical standards on the presentation and content of financial products' taxonomy-alignment disclosures are due to be submitted by the ESA by June 1, 2021, for climate-related objectives, and a year later for the other four taxonomy objectives.

Those financial products that define their sustainable goals with reference to taxonomy alignment, or any of its underlying objectives, will therefore have a more unified disclosure process. If the product is to be measured on different criteria, then it must also disclose its EU taxonomy alignment in addition to its self-selected criteria.

Disclosures by Financial Advisers

Many of the disclosure requirements on product manufacturers apply equally to financial advisers who give investment advice, including insurance advice. These requirements explain how they integrate sustainability risks in their investment advice and whether they consider the principal adverse impacts on sustainability factors. The information should be published on their websites in a separate section titled, "Adverse sustainability impacts statement" with details on the process to select the financial products on which they advise.

The statement should include how the information published by financial-market participants is used; whether the financial adviser ranks and selects financial products based on principal adverse impacts, and, if so, a description of the ranking and selection methodology used; and any criteria or thresholds used to select financial products and advise on them based on those impacts.
Advisers must also explain how their remuneration policies are consistent with the integration of sustainability risks, as well as the likely impact of sustainability factors on returns of the financial products on which they advise. In most cases this will be a pass-through of information taken from the financial-product disclosures.

Conclusion

The evolving ESG disclosure requirements will make a meaningful difference to the quality and consistency of information available to investors. The additional measures will add substance to both the stated ambitions of firms and their products and the degree to which those ambitions are achieved over time.

As a result, the scope for greenwashing will diminish, and, if implemented in the full spirit of the proposals and policed effectively, financial-product disclosures will contain only relevant and targeted information that is useful. The moves to make the information more fact-based, quantitative, and standardised across products will make information more comparable and consumable to investors.

Consequently, the higher standards of disclosure are likely to see products whose ESG claims are at the margin, either remove those references from their mandates and avoid many of the reporting requirements, or, strengthen their focus upon those aims. Either outcome is beneficial to investors and advisers when making product-selection decisions.

Coupled with the prevalence of EU fund availability, particularly UCITS, in other parts of the world, and the increasing propensity for asset managers to run or emulate strategies internationally, these standards have the potential to set a benchmark in markets beyond Europe.

Some detailed proposals are still to emerge, and timelines are tight between them needing to be finalised and put into effect. The staggered implementation dates of different parts of each regulation pose further challenges. With this backdrop we encourage regulators to focus on aligning company disclosures with financial product-reporting requirements. It is positive to see this awareness evident in the ESMA's--the European Securities and Markets Authority--response to the recent consultation of the NFRD by the European Commission.[11] In those areas where financial product-disclosure requirements are more detailed, the same level of disclosure should be required at the company level. Publishing draft technical standards as early as possible will at least enable manufacturers to consider them in their first rounds of reporting next March.

11. https://www.esma.europa.eu/sites/default/files/library/esma32-334-245_response_to_ec_consultation_on_revision_of_nfrd.pdf

Appendix

Exhibit 7 Adverse Sustainability Indicators and Metrics (as proposed in the joint consultation paper)

	Adverse sustainability indicator	Metric (expressed in market value)
	Climate and Other Environment-Related Indicators	
	Greenhouse-Gas Emissions	
1.	Carbon emissions (broken down by scope 1, 2, and 3 carbon emissions—including agriculture, forestry and other land use (AFOLU) emissions—and in total)	Current value of investment in each investee company divided by investee companies' enterprise value and multiplied by the investee companies' carbon emissions
2.	Carbon footprint	Carbon emissions divided by current value of all investments
3.	Weighted average carbon intensity	Current value of each investment divided by the current value of all investments and multiplied by investee company's scope 1, 2, and 3 carbon emissions divided by investee companies' revenue
4.	Solid fossil fuel sector exposure	Share of investments in solid fossil fuel sectors
	Energy performance	
5.	Total energy consumption from nonrenewable sources and share of nonrenewable energy consumption	1. Total energy consumption of investee companies from nonrenewable energy sources (in GWh), expressed as a weighted average
		2. Share of nonrenewable energy consumption of investee companies from nonrenewable energy sources compared with renewable energy sources, expressed as a percentage
6.	Breakdown of energy consumption by type of non-renewable sources of energy	Share of energy from nonrenewable sources used by investee companies broken down by each non-renewable energy source
7.	Energy-consumption intensity	Energy consumption of investee companies per million EUR of revenue of those companies (in GWh), expressed as a weighted average
8.	Energy-consumption intensity per sector	Energy-consumption intensity per million EUR of revenue of investee companies, per NACE sector (in GWh), expressed as a weighted average
	Biodiversity	
9.	Biodiversity and ecosystem-preservation practices	1. Share of all investments in investee companies that do not assess, monitor, or control the pressures corresponding to the indirect and direct drivers of biodiversity and ecosystem change
		2. Share of all investee companies that do not assess, monitor, or control the pressures corresponding to the indirect and direct drivers of biodiversity and ecosystem change

Exhibit 7 Adverse Sustainability Indicators and Metrics (as proposed in the joint consultation paper) (Continued)

Adverse sustainability indicator	Metric (expressed in market value)
10. Natural species and protected areas	1. Share of investments invested in investee companies whose operations affect IUCN Red List species and/or national conservation list species
	2. Share of investments in investee companies with operational sites owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected areas
11. Deforestation	1. Share of investments in entities without a deforestation policy
	2. Share of investee companies without a deforestation policy
Water	
12. Water emissions	Weight in metric ton of water emissions generated by investee companies per million EUR invested, expressed as a weighted average
13. Exposure to areas of high-water stress	1. Share of investments in investee companies with sites located in areas of high-water stress
	2. Share of investee companies with sites located in areas of high-water stress
14. Untreated discharged wastewater	Weight in metric ton of hazardous waste generated by investee companies per million EUR invested, expressed as a weighted average
Water	
15. Hazardous waste ratio	Weight in metric ton of hazardous waste generated by investee companies per million EUR invested, expressed as a weighted average
16. Nonrecycled waste ratio	Weight in metric ton of nonrecycled waste generated by investee companies per million EUR invested, expressed as a weighted average
Social and Employee, Respect for Human Rights, Anti-corruption and Anti-bribery indicators	
Social and employee matters	
17. Implementation of fundamental ILO Conventions	1. Share of investments in entities without due-diligence policies on issues addressed by the fundamental ILO Conventions 1 to 8
	2. Share of investee companies without due-diligence policies on issues addressed by the fundamental ILO Conventions 1 to 8
18. Gender pay gap	Average gender pay gap of investee companies
19. Excessive CEO pay ratio	Average ratio within investee companies of the annual total compensation for the highest-compensated individual to the median annual total compensation for all employees (excluding the highest-compensated individual)
20. Board gender diversity	Average ratio of female-to-male board members in investee companies

Exhibit 7 Adverse Sustainability Indicators and Metrics (as proposed in the joint consultation paper) (Continued)

Adverse sustainability indicator	Metric (expressed in market value)
21. Insufficient whistleblower protection	1. Share of investments in entities without policies on the protection of whistleblowers
	2. Share of investee companies without policies on the protection of whistleblowers
22. Investment in investee companies without workplace accident-prevention policies	1. Share of investments in investee companies without a workplace accident-prevention policy
	2. Share of investee companies without a workplace accident-prevention policy
Human rights	
23. Human rights policy	1. Share of investments in entities without a human rights policy
	2. Share of investee companies without a human rights policy
24. Due diligence	1. Share of investments in entities without a due-diligence process to identify, prevent, mitigate, and address adverse human rights impacts
	2. Share of investee companies without a due-diligence process to identify, prevent, mitigate, and address adverse human rights impacts
25. Processes and measures for preventing human trafficking	1. Share of investments in investee companies without policies against human trafficking
	2. Share of all investments exposed to entities without international framework agreements combating human trafficking
26. Operations and suppliers at significant risk of incidents of child labour	1. Share of the investments in investee companies exposed to operations and suppliers at significant risk of incidents of child labour exposed to hazardous work in terms of geographic areas or type of operation
	2. Share of investee companies exposed to operations and suppliers at significant risk for incidents of child labour exposed to hazardous work in terms of geographic areas or type of operation
27. Operations and suppliers at significant risk of incidents of forced or compulsory labour	1. Share of the investments in investee companies exposed to operations and suppliers at significant risk of incidents of forced or compulsory labour in terms of geographic areas and/or the type of operation
	2. Share of investee companies exposed to operations and suppliers at significant risk of incidents of forced or compulsory labour in terms in terms of geographic areas and/or the type of operation
28. Number and nature of identified cases of severe human rights issues and incidents	Number and nature of cases of severe human rights issues and incidents connected to investee companies
29. Exposure to controversial weapons (land mines and cluster bombs)	Any investment in entities involved in the manufacture or selling of controversial weapons (land mines and cluster bombs)

Exhibit 7 Adverse Sustainability Indicators and Metrics (as proposed in the joint consultation paper) (Continued)

Adverse sustainability indicator	Metric (expressed in market value)
Anti-corruption and anti-bribery	
30. Anti-corruption and anti-bribery policies	1. Share of investments in entities without policies on anti-corruption and anti-bribery consistent with the United Nations Convention Against Corruption
	2. Share of investee companies without policies on anti-corruption and anti-bribery consistent with the United Nations Convention Against Corruption
31. Cases of insufficient action taken to address breaches of standards of anti-corruption and anti-bribery	1. Share of investments in investee companies with identified insufficiencies in actions taken to address breaches in procedures and standards of anti-corruption and anti-bribery
	2. Share of investee companies with insufficiencies in actions taken to address breaches in procedures and standards of anti-corruption and anti-bribery
32. Number of convictions and number of fines for violation of anti-corruption and anti-bribery laws	Numbers of convictions and number of fines for violations of anti-corruption and anti-bribery laws by investee companies

Source: Joint Committee of European Supervisory Authorities. Data as of 23 April 2020.

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