

Pre-contractual disclosures and information on the integration of sustainability risks

Preliminary remarks

Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (hereinafter “**SFDR**”) aims to provide transparency on sustainability within the financial markets in a standardised way by ensuring comparability and impeding greenwashing.

SFDR requires financial market participants (the “**FMPs**” or a “**FMP**”) and financial advisers to consider sustainability from a number of perspectives taking into account both internal (by development and update of internal policies, integration of sustainability into investment decisions) and external considerations (assessment on how investments impact on sustainability factors). The definition of FMPs under Article 2 of SFDR is rather broad and includes *inter alia* all alternative investment fund managers, management companies of undertakings for collective investment in transferable securities, investment firms which provide portfolio management services, insurance undertakings which make available an insurance-based investment product and institutions for occupational retirement provision¹. SFDR also applies to financial advisers², which include different firms providing investment advice.

SFDR maintains the requirements for FMPs and financial advisers to act in the best interest of end investors, including, among others, the requirements to conduct adequate due diligence prior to making investments as provided for in various pieces of sectoral legislation³. In order to comply with their duties under such

¹ Under Article 2 (1) of SFDR a “financial market participant” means “*an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management*”.

² Under Article 2 (11) of SFDR a “financial adviser” means “*an insurance intermediary which provides insurance advice with regard to IBIPs; (b) an insurance undertaking which provides insurance advice with regard to IBIPs; (c) a credit institution which provides investment advice; (d) an investment firm which provides investment advice; (e) an AIFM which provides investment advice in accordance with point (b)(i) of Article 6(4) of Directive 2011/61/EU; or (f) a UCITS management company which provides investment advice in accordance with point (b)(i) of Article 6(3) of Directive 2009/65/EC*”.

³ Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2013/36/EU, 2014/65/EU, (EU) 2016/97, (EU) 2016/2341, and Regulations (EU) No 345/2013 and (EU) No 346/2013.

rules, FMPs and financial advisers are expected to integrate into their processes (including their due diligence processes), and assess on a continuous basis, not only financial risks but also relevant sustainability risks that might have a material negative impact on the financial return of an investment or advice. Under Article 2 of SFDR, a “sustainability risk” is defined as an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment. The reference in the definition to *an actual or potential material impact* leaves the task to each FMP/investment adviser to assess those risks which may have a material impact on the financial performance of an investment product.

SFDR contains various transparency requirements on sustainability to be disclosed to investors at different levels – both at the FMPs/financial advisers’ level, as well as at the financial product-level. At the product level, pre-contractual information for investors must be implemented as of March 10, 2021.

Depending on the category an FMP or financial adviser is part of and the product itself, pre-contractual disclosures as referred to in Article 6 (3) of SFDR could mean, for example, a prospectus, an offering document, a placement memorandum (or another document or instrument as referred to in Article 23 (1) of Directive 2011/61/EU on alternative investment fund managers) or the information provided to clients by investment firms under Directive 2014/65/EU of 15 May 2014 on markets in financial instruments.

In the early days of SFDR, one critical question was how to design adequate wording addressing the requirements of the European legislator, which meets the expectations of investors while maintaining flexibility in terms of procedures and investment policy. A few months have elapsed since the entry into force of the main provisions of SFDR and this is still an ongoing issue. The purpose of this article is to present the disclosure requirements under SFDR under Articles 6, 8 and 9 and summarise the few lessons we have learnt so far.

Disclosure requirements under Article 6

According to Article 6 (1) and Article 6 (2) of SFDR, FMPs and financial advisers must include certain specific descriptions in the pre-contractual disclosures.

As a first step to comply with the obligation laid down in Article 6 of SFDR, all FMPs and investment advisers must proceed to an assessment on whether sustainability risks are relevant at the level of each financial product, be it an alternative investment fund, an undertaking for collective investment in transferable securities, an insurance-based investment product or a pension product. It must be noted that

Article 6 of SFDR applies to all types of products and not only to those promoting environmental or social characteristics or to those with a sustainable objective.

Further to such assessment, if the FMP or the investment adviser reaches the conclusion that sustainability risks are indeed relevant in respect of a specific product, according to Article 6 of SFDR, it must include in the product's pre-contractual disclosures (i) a description on the manner in which sustainability risks are integrated into the investment decision, or as applicable, into the investment or insurance advice, together with (ii) an assessment on the likely impact of sustainability risks on the return of the product made available or advised on. A simple declaration that sustainability risks are integrated into the investment decision or investment or insurance advice is not sufficient and FMPs/financial advisers are expected to describe how such integration is achieved in practice. In respect of the likely impact of sustainability risks on a product's return, pre-contractual documents must clearly disclose a qualitative or quantitative description of the specific material likely impacts⁴.

Should the outcome of such assessment be negative, FMPs/financial advisers are expected to provide a brief and clear explanation on the reasons why the sustainability risks are not relevant. Unless pertinent reasons can be given for such an outcome (e.g. a specific asset class for which sustainability factors are not relevant), not considering sustainability risks could be regarded as a breach of the applicable fiduciary duties towards investors.

Neither SFDR nor the draft level 2 regulatory technical standards (the “**RTS**”)⁵ issued by the European Supervisory Authorities (the “**ESAs**”)⁶ on 2 February 2021 provide practical indications on the exact form that the pre-contractual disclosures under Article 6 of SFDR must be made or any template wording thereof. Consequently, each FMP/financial adviser should assess and determine the most appropriate way to implement Article 6 required statements in the investors' pre-contractual disclosures on a case-by-case basis⁷.

Lastly, no specific provisions on the timing of updates to the pre-contractual disclosures are included in SFDR or the RTS. However, following the rules applicable in relation to the pre-contractual documents in

⁴ Recital 15 of SFDR.

⁵ As of the date of the drafting of this article, draft RTS have been submitted to the European Commission for review and approval and the European Commission has not adopted the RTS. Accordingly the content of the disclosure requirements may be subject to changes.

⁶ The ESAs are the European Banking Authority (“**EBA**”), the European Insurance and Occupational Pensions Authority (“**EIOPA**”) and the European Securities and Markets Authority (“**ESMA**”).

⁷ For the fund industry, useful practical guidelines can be found in “ALFI Guidelines on Sustainability –Related Pre-Contractual Disclosures”, issue 1, January 2021.

general under the relevant sectoral legislation, the pre-contractual disclosures made under Article 6 will have to be updated once any material changes to the SFDR disclosure information occur.

Disclosure requirements for Article 8 and Article 9 financial products

There are some financial products where sustainability is not only a matter of risk assessment, but rather a criterion for investment or an investment objective *per se*. Under the terms of SFDR, those are “Article 8” and “Article 9” financial products. What differentiates them from so-called Article 6 (1) financial products is the fact that sustainability becomes a binding commitment and can justify a “no-go” for investment opportunities or even trigger a divestment. If the financial product performs well in terms of sustainability or, on the contrary, if it fails to attain the objectives initially set, it may enhance or impede relationships with investors.

A few months ago, many FMPs and sponsors had the ambition that their financial products would qualify as “light green” or even “dark green” products in terms of sustainability. As discussions proceeded, the grey area with respect to the requirements under SFDR grew and the necessity to provide transparency to end-investors with respect to the integration of sustainability and procedures in place prevailed.

Article 8 (or “light green”) financial products are those products promoting environmental or social characteristics among the full set of criteria that are assessed when considering an investment opportunity or managing assets in the portfolio. This “sustainable” facet aside, financial products will target and invest in companies that follow “good governance practices”. SFDR does not elaborate much on what “good governance practices” are but indicates that investee companies must follow good governance practices in particular with respect to sound management structure, employee relations, remuneration of staff and tax compliance in order for the financial product to qualify as a “light green financial product”. The main difference with Article 9 financial products lies in the fact that if sustainability is an investment criterion, it is not an objective *per se*.

Similar to the disclosures to be made pursuant to Article 6 of SFDR, it is up to FMPs and sponsors⁸ (with the input of existing investors usually) to identify and determine which environmental or social characteristics they wish to pursue as part of the investment policy. In the case of umbrella

⁸ Sponsors or promoters are those individuals or legal persons seeking to raise money from investors for some type of investment activity through an investment vehicle such as regulated and unregulated alternative investment funds

funds, chosen characteristics may change from one compartment to another depending on the particularities of the investment policy, geography and nature of the assets, as well as the sensitivity of the FMP, the sponsor and the investors to certain factors rather than others. They may wish to disclose that only certain environmental vs. social factors are promoted or make a combination of both, depending on the particular investment objective of the financial product. As the list of sustainable factors is infinite, most FMPs and financial products rely on concepts and principles that are familiar to end-investors, such as the United Nations 17 Sustainable Development Goals⁹ or more recently the concepts developed in Taxonomy Regulation¹⁰ (e.g. climate change mitigation, climate change adaptation, transition to a circular economy, pollution prevention and control, etc.) or other objectives related to (S)ocial (e.g. reduction of poverty, gender diversity, quality education, peace, justice, etc.) or related to (G)overnance (e.g. strong institutions, corruption, bribery, etc.) .

As regards the disclosure requirements, the pre-contractual disclosures of Article 8 financial products shall provide (a) information on how those characteristics are met and (b) if an index is designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. Article 8 further reads that the indication of where the methodology used for the calculation of the index referred to in (b) above is to be found in the pre-contractual disclosures. The choice of an index is not required by SFDR and shall be decided on a case-by-case basis by the FMP and the sponsor in light of the availability of data with respect to the particular environmental or social objective and the wish to provide qualitative and quantitative information to investors on the performance of the financial product in this respect. The choice of index is a critical question for FMPs as there might be cases where the measurement of the impact is not possible due to the particularities of the factor especially in the social sphere. Another aspect to bear in mind is that where an index is designated, it is important to ensure that it is adequate to the features of the financial product (in addition to those of the environmental and/or social characteristics promoted) and that it provides concise and valuable information to investors on the performance of the financial product.

⁹ <https://sdgs.un.org/goals>

¹⁰ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, *O.J.*, L 198, 22 June 2020.

Luckily, further guidance on the presentation and content of the information to be disclosed pursuant to this Article was provided by the ESAs in the RTS.

FMPs are required to complete and append a document to the pre-contractual disclosures of financial products using the template prepared by the ESAs and to include a prominent statement in the main body of the pre-contractual disclosures whereby information related to environmental or social characteristics is available in that annex¹¹.

Below is a list of the main questions to be answered by FMPs in the annex for each financial product:

- Does the financial product invest partially in sustainable investments?
- What environmental and/or social characteristics are promoted and what indicators are used to measure the attainment of objectives?
- What investment strategy does the financial product follow, comprising the investment procedure implemented by the portfolio management function with respect to sustainability and outcomes?
- What is the asset allocation planned for the financial product between assets aligned with the sustainable objectives and others?
- Does the financial product take into account principal adverse impact on sustainability factors?
- Where may more specific information on the financial product be found online?
- Where an index is designated, how does it differ from a relevant broad market index and in which way is it aligned with the environmental and/or social characteristics promoted and the investment strategy of the financial product?

Providing a standard template to FMPs for all Article 8 financial products proves to be a handy tool for prospective investors interested in having an in-depth view on the sustainable profile of a given financial product without going through hundreds of pages of documentation. It also enables

¹¹ Article 13 of the RTS.

the performance of comparative analysis between financial products on their commitment with respect to sustainability, how sophisticated their procedures and tools are and the identification of the best candidates.

Disclosure requirements for Article 9 financial products

Article 9 (or “dark green”) financial products are products that have either (i) sustainable investment or (ii) reduction in carbon emissions as their objective. SFDR defines “sustainable investment” as “ *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*”¹².

In a nutshell, a financial product may opt for Article 9 if (i) it targets investments contributing to one of the sustainable objectives (including reduction in carbon emissions), (ii) such investments do not significantly harm any other sustainable objective and (iii) good governance practices are followed by invested companies. The section above relating to the choice of adequate sustainable objectives in respect of a particular financial product applies in a similar vein under Article 9 of SFDR.

Under Article 9, FMPs are required to provide statements in the pre-contractual disclosures on (i) how the designated index is aligned with that objective, (ii) an explanation as to why and how the designated index aligned with that objective differs from a broad market index and (iii) where the

¹² Article 2 (17) of the Regulation.

methodology used for the calculation of the indices may be found. Where no index has been designated, the documentation shall include an explanation on how that objective is to be attained.

It shall be noted that for financial products with reduction in carbon emissions as its objective, the information to be disclosed shall include (i) the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement and (ii) where the methodology used for the calculation of the benchmarks are to be found. The Article further reads that where no EU Paris-aligned benchmark or EU Climate Transition Benchmark is available, the documentation shall provide a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

Practically speaking, the above information is to be provided in a document appended to the pre-contractual disclosures with a prominent statement in the main body of the pre-contractual disclosures that information on sustainable investment is available in that annex.

In particular, the following questions shall be addressed by FMPs in the annex for financial products opting for Article 9:

- Does the financial product have sustainable investment as its objective with the definition of sustainable investment as per Article 2 (17) of SFDR?
- What environmental and/or social characteristics are promoted and what indicators are used to measure the attainment of objectives?
- What investment strategy does the financial product follow, comprising the investment procedure implemented by the portfolio management function with respect to sustainability and outcomes?
- What is the asset allocation planned for the financial product between assets qualifying as sustainable investments and other investments that do not qualify as sustainable investments with the related minimum environmental or social safeguards for those investments?
- Does the financial product take into account principal adverse impact on sustainability factors?
- Where may more specific information on the financial product may be found online?

- Where an index is designated, how does it differ from a relevant broad market index and in which way is it aligned with the environmental and/or social characteristics promoted and the investment strategy of the financial product?
- Does the financial product have the objective of a reduction in carbon emissions?

What key takeaways from the implementation of Articles 6, 8 and 9 can be captured?

Who chooses Articles 8 or 9? A generally accepted position among the market is that Article 8 and Article 9 are reserved for those financial products which already have sound “ESG” procedures in place and a team of people dedicated to the implementation and monitoring of the performance of each investment in the portfolio of the financial product from a qualitative and quantitative perspective.

There is no “one-fits-all approach”: Standard disclosure requirements do not exist. The option for Article 8 or 9 is a function of many factors, such as the industry in which FMPs and financial products operate, existing and prospective investors targeted, the geographical location and nature of assets invested by the financial product (e.g. venture capital, start-ups where it can be difficult to collect data and measure the impact considering the stage of development vs. real estate assets where the performance is easier to monitor and there are more tools to assist FMPs).

This is a matter of transparency: FMPs are required to disclose what they have effectively in place in respect of a given financial product, i.e. a picture of the financial product and not a presentation of what they plan to achieve in a certain period of time. There might be cases where sustainability is disregarded for certain reasons that relate to the particular specificities of the financial product, in which case they are to be concisely explained in the pre-contractual disclosures. For some other products, the strategy is to go further in the integration of sustainability by translating into investment criteria (i.e. Article 8) or moving this topic to the heart of the investment objective of the financial product (i.e. Article 9). In such a case, the pre-contractual disclosures shall satisfy the requirements set forth in Article 8 or 9, in addition to those under Article 6 of SFDR.

This is a multiparty discussion: The choice of Article 6, 8 or 9 and the design of adequate statements are the result of multiparty discussions between the sponsor, the FMP (usually the alternative investment fund manager), the investment adviser and — most importantly — existing

investors in the financial product. Another critical question is, based on the specific features of the financial product and investors targeted, what level of commitment in terms of sustainability the sponsor and the FMP want to have for a particular financial product and what could be the appetite/sensitivity of prospective investors to sustainability? This question is not driven by the FMP only but rather the result of a common understanding of these actors.

Pay particular attention to the wording of disclosures: Disclosures provided pursuant to Articles 6, 8 and 9 shall be clear and concise for investors. General, misleading, confusing and forward-looking statements shall be avoided notably with respect to the name of the product and procedures implemented. Clear references to the articles of SFDR are preferred as they provide transparency to investors. Finding the right balance between providing poor disclosures that do not address the requirements of SFDR and too detailed statements, which reduce flexibility for FMPs to deviate from procedures disclosed in the documentation even though they are aligned with the spirit of SFDR and for the benefit of a good management of the financial product.

Better to upgrade than downgrade: avoid overpromising: Disclosure statements shall provide accurate information about the integration of sustainability at the level of FMPs and financial products even though they are less ambitious for the time being than what is targeted. Sustainability has had a growing place in the financial sector leading to the proliferation of a “greenwash” phenomenon. How sustainability is implemented in respect of a financial product may evolve with time with the identification of achievable sustainable goals and development of the procedure to assess and monitor the performance of the financial product in compliance with the requirements under SFDR. It is preferable to start with lesser commitments in terms of sustainability that are more realistic and achievable as per the reality of the assets of the financial product, industry, actors and wishes of investors and to upgrade its status later on. Sometimes the question is even whether it is worth it or not because of the grey areas within SFDR itself, the burden of additional reporting to investors for Article 8 or 9 financial products, and difficulties to implementing procedures disclosed to investors with the risk of breaching the commitments and impacting relationships with investors.

Regulation in motion: The main purpose of SFDR was to reduce asymmetries in principal-agent relationships through the European Union member states, especially where environmental and/or social characteristics are promoted by investment funds (so-called “Article 8” products) or sustainable

investments are the objective of such funds (so-called “Article 9” products). Instead, it is known as a matter of great controversy and uncertainty, with each participant in the financial sector having its own interpretation of SFDR and things to say about the implementation of the requirements. In two years, SFDR has already been amended once by the Taxonomy Regulation and clarification is still being sought from the European Commission and the ESAs. It is very likely that SFDR as it is known today will change in the future, as will the required disclosures. The issuance of the RTS by the ESAs was a great challenge with regard to the goals targeted by SFDR, i.e. encompassing the size and variety of FMPs and financial products in the European Union and abroad, coping with a complex but booming matter and the *desideratum* to ensure the protection of end-investors. The result was the issuance of a 195-page long paper, numerous queries raised to the European Commission and a large call for clarification. This is one of the first milestones to building a European sustainable investment environment and there is no express sanction for the time being on choice or implementation aside the reputational risk and the risk relating to the non-compliance by a regulated financial product with respect to its legal and regulatory duties. The integration of sustainability will undoubtedly shift from a good governance principle to a mandatory rule with adverse financial consequences for financial products and FMPs.

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