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"Technological change raised humans out of Stone Age living standards. Climate change threatens, in the most extreme scenarios, to return us economically whence we came."

William D. Nordhaus

DEDICATION

I dedicate this thesis to my deceased grandfather who left this world in the beginning of the year. I am extremely grateful for his unconditional love surrounded me from the moment I was born. This endeavour would not have been possible without my family. Special thanks to my mom who always believed in me and supported throughout my life path. I would like to extend my sincere thanks to my partner and his family, their substantial support helped me to keep my spirits and motivation high during my studying in Italy, far from home. Additionally, thanks should also go to my friends for all the encouragement and emotional support they generously provided me during last years.

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ABBREVIATIONS

AIFMD	Alternative Investment Fund Managers Directive
EBA	European Banking Authority
EC	European Commission
EIOPA	European Insurance and Occupational Pensions Authority
EFRAG	European Financial Reporting Advisory Group
ESA	European Supervisory Authorities
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
ESS	European Standard Setter
EU	European Union
Eurosif	European Sustainable Investment Forum
FMP	Financial Market Participants
GHG	Greenhouse Gas
HLEG	High-Level Expert Group
IPCC	Intergovernmental Panel on Climate Change
MiFID II	Markets in Financial Instruments Directive
NDC	Nationally Determined Contributions
NFRD	Non-Financial Reporting Directive
OECD	Organisation for Economic Co-operation and Development
PAI	Principal Adverse Impacts
PRI	Principles for Responsible Investments
PTF	Project Task Force
RTS	Regulatory Technical Standards
SFDR	Sustainable Finance Disclosure Regulation
SRI	Sustainable and Responsible Investment
TSC	Technical Screening Criteria
UN	United Nations

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INTRODUCTION

Nowadays one of the biggest concerns is an ecological crisis and human actions impact on the planet. Every year the problem is becoming increasingly acute, provoking natural disasters in various parts of the globe. National authorities around the world have reacted to this emergency by issuing new regulations which could help to control and stimulate corporations and institutions to be more responsible and transparent on its adverse impact on sustainable development.

In 2015 the United Nations made a major step in global response to climate change by the Sustainable Development Goals and the Paris Agreement adoption. The Paris Agreement is a legally binding international treaty on climate change entered into force on 4 November 2016. The treaty's main objectives are the limitation of the global temperature rising, reporting on countries' commitment on its reduction of greenhouse gas emission and providing finance aimed to mitigate climate change to the developing countries.

In 2018 the European Union in line with the Paris Agreement has developed the Action Plan on Sustainable Finance which is part of a wider Sustainable Finance Framework consisting of new and improved regulations focused on creation of a sustainable economy. These include a new Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 aimed to improve transparency in the financial market and to redirect capital to sustainable product investments.

One of the main goals of the SFDR is to prevent greenwashing and provide final investors with clear and sufficient information concerning sustainability risks. Nevertheless, application of level 1 of the Regulation has created a misunderstanding between financial market participants due to its broad formulation. Particularly the Articles 6, 8

and 9 were criticized because of creation so called “label system” which divide funds in three groups: funds which do not integrate any kind of sustainability into investment process (Article 6), funds which promote environmental or social characteristics or its combination (Article 8) and funds which specifically have sustainable goals as their objective (Article 9). Different interpretations of the Regulation led to distinct approaches used by managers in fund classification. The problem solution should appear when the level 2 of the SFDR will come into force and financial market participants must comply with Regulatory Technical Standards (RTS) issued by the European Supervisory Authorities (ESAs).

This thesis discusses development of the Regulation and presents an analysis of the RTS pre-contractual and periodic disclosures concerning Articles 8 and 9 funds. The first part of the analysis refers to sustainable finance and SFDR background providing an understanding of its premise. Second chapter explains disclosure requirements and defines the Articles 8 and 9 problematics. While the last part of analysis focuses on the RTS and legislation level 2. The research's main goal is to explore legislation’s work at second level and clarifications provided by the RTS on the SFDR regarding Articles 8 and 9 funds.

CHAPTER 1 SFDR BACKGROUND

1.1 GREENWASHING ISSUE

As one of the main goals of the SFDR is to prevent "greenwashing" it is necessary to investigate the origins and significance of this concept, its patterns, drivers, and possible ways to reduce its harm.

The term "greenwashing" was used first in the 1980s by American environmentalists and it implies any false practices used by businesses to improve impression of its performance concerning environmental care and providing consumers with misleading information on sustainability of its products or services. However, due to its multidisciplinary nature it is problematic to achieve a general definition for the term "greenwashing".[1] In the Oxford Dictionaries, the term "greenwashing" is described as "the creation or propagation of an unfounded or misleading environmentalist image"[2] or "activities by a company or an organization that are intended to make people think that it is concerned about the environment, even if its real business actually harms the environment".[3]

Lyon and Maxwell define "greenwash" as "the selective disclosure of positive information about a company's environmental or social performance, without full disclosure of negative information on these dimensions, so as to create an overly positive corporate image".[4] Looking at the different definitions it is interesting that the "greenwashing" problem is not only about disinformation in classical

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[1] Netto, Sebastião & Sobral, Marcos & Ribeiro, Ana & Soares, Gleibson. "Concepts and forms of greenwashing: a systematic review" (2020). Environmental Sciences Europe

[2] Oxford English Dictionary. "Art, n. 1." OED Online. Oxford University Press (December 2022)

[3] Hornby, Albert Sydney. Oxford Advanced Learner's Dictionary of Current English / [by] A.S. Hornby; Editor Jonathan Crowther. Oxford, England: Oxford University Press (1995)

[4] Lyon, Thomas P. and Maxwell, John W., "Greenwash: Corporate Environmental Disclosure Under Threat of Audit" (February 24, 2011), p. 7. Journal of Economics & Management Strategy, Vol. 20, Issue 1, pp. 3-41

comprehension but more about the way companies choose to disclose positive information and to hide negative one.

That was possible because of the regulation gap, companies and organizations had a choice which information they want to disclose and which not. According to Delmas and Burbano one of the main drivers of greenwashing is a weak and uncertain regulation.[5] Therefore, creation of the system which could provide a classification of environmental and social disclosures and oblige companies to communicate accordingly can improve transparency and prevent greenwashing. On the other hand, if the criteria of this system are vague and uncertain it could increase the greenwashing effect due to different interpretation and create a labelling system in which products or companies with different impact on sustainable development will fall in the same "green" category.

In the paper "An international empirical study of greenwashing and voluntary carbon disclosure" authors demonstrated with a sample of 444 firms from 12 countries operated in different sectors a negative correlation between number of climate-related regulations in the country and firm's likelihood to engage in greenwashing activities.[6] The study shows that the number of regulations and high level of stringency of climate change-related laws reduce temptation for the companies to greenwash.

It should be noted that there is not a generally applicable and binding definition of greenwashing in the EU regulatory framework. Nevertheless, some EU regulations including the SFDR refer to greenwashing. One of the non-binding definitions is presented in

[5] Delmas, Magali & Burbano, Vanessa. "The Drivers of Greenwashing" (2011). California Management Review, Vol. 54, No. 1, pp. 64–87

[6] Antonio J. Mateo-Márquez, José M. González-González, Constancio Zamora-Ramírez. "An international empirical study of greenwashing and voluntary carbon disclosure" (2022). Journal of Cleaner Production, Volume 363

Sustainable Finance Roadmap 2022-2024 issued by European Securities and Markets Authority (ESMA):

"The term greenwashing may be defined in a number of ways, but it intuitively refers to market practices, both intentional and unintentional, whereby the publicly disclosed sustainability profile of an issuer and the characteristics and / or objectives of a financial instrument or a financial product either by action or omission do not properly reflect the underlying sustainability risks and impacts associated to that issuer, financial instrument or financial product."[7]

Lately in Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 which sets out the RTS to be used by financial market participants (FMP) when disclosing sustainability-related information under SFDR level 2 which will apply from 1 January 2023 the term "greenwashing" is defined as "the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards".[8]

In the light of the variety of interpretations, it is fair to conclude that greenwashing is a very multifaceted subject, and its definition depends on the approach used and the field where that definition aims to apply. Given the fact that this thesis presents an analysis in the legal and financial areas and mainly focused on the information disclosures under the SFDR it is reasonable to take into consideration the EC interpretation.

In addition, Delmas and Burbano emphasized that greenwashing could appear at two different levels which are firm or entity level and product or service level.[9] Entity-level greenwashing is focused on the green

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[7] ESMA. Sustainable Finance Roadmap 2022-2024 (10 February 2022), p. 8

[8] Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022, p. 4. Official Journal of the European Union (25 July 2022)

[9] Delmas & Burbano, op. cit., p. 66

performance of the company and implemented ecological or social policies, while greenwashing at the product-level represents an improvement of the offering product sustainability image. Later in the second chapter will be discussed which information should be disclosed under the SFDR on each of these levels.

In the study "Doing Good or Feeling Good? Detecting Greenwashing in Climate Investing" researchers distinguish two types of greenwashing:

"The first, which is better known, is corporate greenwashing, whereby firms advertise environmental credentials for their products and practices (or otherwise seek to shape perceptions) that are materially inflated or even in contradiction to their performance. This type of greenwashing receives considerable attention from all stakeholders (investors, NGOs, regulators) and is widely criticised.

The second is portfolio greenwashing by the finance industry. Investment managers may claim that their funds produce a positive impact on the environment when in fact they are not managed in a manner that is consistent with promoting such an impact."[10]

In reference to the drivers of greenwashing we can differentiate them in three main categories: external drivers, organizational drivers, and individual drivers.[11] External drivers are divided into non-market external drivers which are regulatory framework and attention from activists and non-government organizations while market external drivers represent consumer and investor demand and competition. External drivers create an environment which could incite the companies to greenwash. Organizational drivers appear inside the company including an ethical climate, company's characteristics, effectiveness of internal communication, thus the factors influencing a

[10] Noël Amenc, Felix Goltz and Victor Liu. "Doing Good or Feeling Good? Detecting Greenwashing in Climate Investing" (August 2021), p. 5. An EDHEC - Scientific Beta "Advanced ESG and Climate Investing" Research Chair Publication

[11] Delmas & Burbano, op. cit., p. 68

company's response to external drivers. Finally, individual drivers are psychological and cognitive factors which could influence definite managers in their decision-making process and affect the manner of the company's response to the external drivers.

Furthermore, Delmas and Burbano provide a list of recommendations for policymakers, non-government organizations and companies' management on how to reduce greenwashing through increasing the transparency of company environmental performance, through facilitating and improving knowledge about greenwashing, and through efficient cooperation processes inside the company.[12] In particular, to increase the transparency policymakers should introduce mandate annual disclosures and standardize eco characteristics of the product, whereas companies managers should make voluntary disclosures on environmental performance of the company and share the best practices collaborating with other companies, policymakers and non-government organizations. After all, coming back to the European Sustainable Finance Framework which includes the SFDR with one of the main goals to prevent greenwashing through improving transparency, the recommendations discussed above now are part of the new European regulation.

1.2 ESG FACTORS

In order to understand better the importance and essential development of the SFDR disclosure requirements it is needed to explore what are the ESG factors.

[12] Delmas & Burbano, op. cit., p. 77

The abbreviation ESG stands for Environmental, Social and Governance. It is a framework which was popularly mentioned first in a 2004 report "Who Cares Wins" thanks to the United Nations initiative, it was possible to bring together financial institutions around the world and to increase awareness of the ESG risks and opportunities.[13] Almost 20 years ago this initiative has already pointed out an importance of integration of the ESG issues into investment decision-making process, transparency increase in the financial markets, need of specific legislation on information disclosures and more precise distinction in what exactly could be called "sustainable".[14]

According to Principles for Responsible Investments (PRI) a definitive and complete list of the ESG issues does not and cannot exist, but some examples could be the following:

- Environmental (E) issues concern the quality and behaviour of the natural environment and natural systems, such as greenhouse gas emissions, loss of biodiversity, climate change, energy efficiency, water, air, or resource pollution.
- Social (S) issues relate to the welfare, rights and interests of the people and community like labour standards, workplace safety, human rights and freedoms, health, and access to medicine, diversity, human capital management and consumer protection.
- Governance (G) issues respond to corporate governance or management of the company including board of directors, its structure, diversity, size, competence and independence, remuneration policy, shareholder rights, business ethics,

[13] UN The Global Compact. "Who Cares Wins – Connecting Financial Markets to a Changing World" (June 2004)
[14] ibid

information disclosure, bribery and corruption, business strategy, risk management and fund governance.[15]

The EBA in the Report on Management and Supervision of ESG Risks for Credit Institutions and Investments Firms declares that there are many international frameworks and standards addressing the ESG factors, such as one above by the PRI, on which credit institutions and investment firms rely on and moreover in some cases the institutions use its own definitions.[16]

In the context of this report EBA defines ESG factors and ESG risk in the following way:

"'ESG factors are environmental, social or governance matters that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual."[17]

"ESG risks are the risks of any negative financial impact on the institution stemming from the current or prospective impacts of ESG factors on its counterparties or invested assets."[18]

The concept of the ESG is closely related to sustainable investment. Over the past decade, an interest to sustainable investments has grown rapidly, investors are actively seeking for sustainable investment opportunities which could allow them to consider the ESG factors along with the economic performance of investing.[19]

On the other hand, in light of increasing demand, the financial market fills up with new products and services related to the ESG ratings and indices. All this variety creates disorientating conditions for the

[15] Principles for Responsible Investments Association. "PRI Reporting Framework" (November 2018)
[16] EBA. Report on Management and Supervision of ESG Risks for Credit Institutions and Investments Firms (2021),
[17] Ibid, p.31
[18] Ibid, p.33
[19] Bernow Sara, Klempner Bryce, Magnin Clarisse. "From "Why" to "Why Not": Sustainable Investing as The New Normal" (October 2017). Private Equity & Principal Investors Practice, McKinsey & Company

investors and complicates the decision-making process. Moreover, the lack of transparency and standardized ESG reporting creates an obstacle to appropriate integration of sustainability factors into investment decision-making process.[20]

The European Sustainable Investment Forum (Eurosif) defines Sustainable and Responsible Investment (SRI) as:

"a long-term oriented investment approach that integrates Environmental, Social & Governance (ESG) factors in the research, analysis, and selection process of securities within an investment portfolio. It combines fundamental analysis and engagement with an evaluation of ESG factors in order to better capture long term returns for investors, and to benefit society by influencing the behaviour of companies".[21]

There are at least three key elements that led to high interest on ESG criteria and sustainable investing in recent years. Firstly, recent academic studies show that ESG investing could improve risk management performance and not always lead to inferior returns compared with traditional financial investments. Secondly, growing society's attention to climate change risks, standards of responsible business conduct, diversity and inclusion in the workplace indicate that social values will increasingly influence investor and consumer choices and will impact corporation performance. Thirdly, there is a tendency between corporations and financial institutions to move away from short-term risks and returns and focus on long-term sustainable performance.[22]

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[20] Boffo, R., and R. Patalano. "ESG Investing: Practices, Progress and Challenges" (2020). OECD Paris
[21] Kyoko Sakuma-Keck, Eurosif Team. "Fostering Investor Impact" (2021). Eurosif Report, p. 11
[22] Boffo, R., and R. Patalano, op. cit.

1.3 PARIS AGREEMENT

The Paris Agreement is a legally binding international treaty which was signed by 196 Parties at the United Nations Climate Change Conference on 12 December 2015. It is a milestone in the climate change fight, for the first time, was adopted the legally binding agreement and all nations unanimously agreed to confront climate change challenge together.[23]

The Paris Agreement put down three long-term goals:

"(a) Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change;

(b) Increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production; and

(c) Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."[24]

According to the Intergovernmental Panel on Climate Change (IPCC) report, human activity, especially greenhouse gas (GHG) emissions is the main reason of climate change and global warming.[25] Therefore, reduction of GHG emissions is a fundamental approach used in the Paris Agreement to fight climate change and to limit temperature raise to 1.5°C by the end of this century.

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[23] The United Nations Framework Convention on Climate Change website, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

[24] UN. Paris Agreement (2015), Article 2

[25] Intergovernmental Panel on Climate Change. Climate Change 2013: The Physical Science Basis. Contribution of Working Group I to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change

As part of the Paris Agreement, countries agreed to take increasingly ambitious climate actions every five years. These national climate plans are known as Nationally Determined Contributions (NDC).[26] It is mandatory for the countries to communicate in their NDC how they plan to reduce their GHG emissions and mitigate climate change impact to meet the goals of the Paris Agreement. In addition, countries are encouraged to develop a long-term strategy which will provide a vision and direction for future development but unlike NDC it is not obligatory.[27]

Moreover, under the Paris Agreement developed countries are expected to lead transformation process and to provide financial assistance to more vulnerable and less endowed parties.[28]

Undoubtedly, the Paris Agreement goals require a major effort from all participants of the treaty. Anyway, over the years since 4 November 2016, the date when the treaty came into force, there are already new markets and low-carbon solutions which are competitive and perspective.[29] Zero-carbon solutions and alternative energy sources are opening a variety of new business and investment opportunities which could drive the world towards more sustainable economy.

According to The Climate Action Tracker's analysis of real-world action, 5 years after adoption of the Paris Agreement an estimation of global warming by the end of the century dropped on 0.7°C.[30] In 2015, the model showed a global temperature increase of 3.6°C, while in 2020 considering the policies and goals introduced by governments after the Paris Agreement the assessment is 2.9°C. For sure it is a good result but still far from ambitious goal of 1.5°C, to achieve it countries should strengthen its 2030 goals and keep moving to net-zero GHG emissions.

[26] The United Nations website, https://www.un.org/en/climatechange/paris-agreement
[27] ibid
[28] The United Nations Framework Convention on Climate Change website, op. cit.
[29] ibid
[30] Climate Action Tracker. Warming Projections Global Update (December 2020)

1.4 EC ACTION PLAN ON SUSTAINABLE FINANCE

At the end of 2016, the European Commission assigned a High-Level Expert Group (HLEG) on sustainable finance destined to develop a sustainable finance strategy for the European Union.[31] Subsequently in 2017 President of the European Commission Jean-Claude Juncker communicated the ambition for Europe to lead the fight against climate change and the reduction of carbon emissions.[32]

At the beginning of 2018 the expert group presented its final report according to which the sustainable finance has two crucial aspects.[33] The first is an improvement of financial contribution to sustainable growth and climate change mitigation, the second is a reinforcement of financial stability through integration of environmental, social and governance factors into investment decision-making.[34] Moreover, sustainable finance is a core for the EU strategy and it is crucial to fulfil sustainable development financing gap, the report states:

"In the climate and energy space alone, the Commission estimates that at least €170 billion of additional investments is needed each year for priorities such as renewable energy generation and efficient buildings. Achieving a sustainable financial system can help to deliver these investments."[35]

Later, in March 2018 basing on recommendations from the final report by HLEG the EC published the "Action Plan: Financing Sustainable Growth". It was a response to the milestone signing of the Paris Agreement and UN 2030 Agenda for Sustainable Development.[36]

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[31] EC. Action Plan: Financing Sustainable Growth (March 2018)
[32] EC website, https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_17_3165
[33] EU High-Level Expert Group on Sustainable Finance. "Financing a sustainable European economy" (2018). Final report
[34] ibid
[35] ibid
[36] EC website, https://finance.ec.europa.eu/publications/renewed-sustainable-finance-strategy-and-implementation-action-plan-financing-sustainable-growth_en

Hereby the EU took a leading role in a transformation process towards sustainable economy setting a benchmark which could become a blueprint for global community in its sustainable development path.[37]

The EC Action Plan sets the EU sustainable finance strategy and guideline for financial system change. According to the EBA the EC Action Plan has three main objectives:

"a. reorienting capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;

b. managing financial risks stemming from climate change, resource depletion, environmental degradation and social issues;

c. fostering transparency and long-termism in financial and economic activity."[38]

The EC Action Plan states that the financial sector plays a key role in transition to a more sustainable economy. Increasing private capital flows in sustainable investment requires significant change in regular financial system work. The Plan aims to set sustainability benchmarks which could be inserted in investing strategies along with common indices and to clarify responsibility of asset managers and institutional investors towards sustainability.[39]

The EC Action Plan presents an inclusive strategy of finance and sustainability unification. The implementation strategy includes new legislative and non-legislative measures as well as amendments to existing rules.[40] One of the key actions of the EC Action Plan is the establishment of an EU classification system for sustainable activities or EU taxonomy, which aims to provide unified definitions, reliable and

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[37] ibid

[38] EBA. Report on Management and Supervision of ESG Risks for Credit Institutions and Investments Firms (2021), p. 15

[39] EC. Action Plan: Financing Sustainable Growth, op. cit.

[40] ibid

comparable information on sustainable investments.[41] Development of the EU taxonomy is necessary and important because it would build a fundament for the other actions presented in the strategy such as standards, labels, prudential requirements, sustainability benchmarks, corporate and finance disclosures, or provision of financial advice.

On 22 June 2020, the Taxonomy Regulation was published in the Official Journal of the European Union, and it came into force on 12 July 2020.[42] An Article 9 of the Regulation states:

"For the purposes of this Regulation, the following shall be environmental objectives:

(a) climate change mitigation;

(b) climate change adaptation;

(c) the sustainable use and protection of water and marine resources;

(d) the transition to a circular economy;

(e) pollution prevention and control;

(f) the protection and restoration of biodiversity and ecosystems."[43]

The Taxonomy communicates that only activities which substantially contribute to one or more of six environmental objectives and at the same time do no significant harm to any of these objectives and comply with minimum safeguards[44] can be identified as environmentally sustainable or "Taxonomy-aligned" activities.[45]

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[41] ibid

[42] EC website, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

[43] Regulation EU 2022/852 of 18 June 2020. Official Journal of the European Union (22 June 2020), p.29

[44] "[…] alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights."

[45] Regulation EU 2022/852 of 18 June 2020, op. cit.

The Taxonomy Regulation and the SFDR are results of the European sustainable development course, these are two separate regulations that are closely related, more in detail about its connection discussed in a Chapter 3 of the thesis.

In the context of sustainability-related transparency it is important to notice amendments to the Markets in Financial Instruments Directive (MiFID II) and the Alternative Investment Fund Managers Directive (AIFMD) which came into force in 2022. Firms within scope of the MiFID II providing portfolio management and financial advice must perform a mandatory assessment of sustainability preferences of clients, consider sustainability risk, and integrate that risk into risk management policies, as well as consider sustainability factors in product approval process and product governance arrangements.[46] Similarly, firms within scope of the AIFMD must take into consideration sustainability risk in due diligence policies and internal conflicts of interest and risk management policies.[47]

"Investment decisions are typically based on several factors, but those related to environmental and social considerations are often not sufficiently taken into account, since such risks are likely to materialise over a longer time horizon. It is important to recognise that taking longer-term sustainability interests into account makes economic sense and does not necessarily lead to lower returns for investors."[48]

In conclusion, according to the EC Action Plan, sustainability and the transition to a low-carbon economy are crucial in a long-term horizon and following sustainable development path the EU economy would be competitive and prosperous in the future.[49]

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[46] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021. Official Journal of the European Union (2 August 2021)
[47] Commission Delegated Regulation (EU) 2021/1255 of 21 April 2021. Official Journal of the European Union (2 August 2021)
[48] EC. Action Plan: Financing Sustainable Growth, op. cit., p.1
[49] ibid

1.5 EFRAG TECHNICAL ADVICE ON REPORTING STANDARDS

The European Financial Reporting Advisory Group (EFRAG) is a private association formed in 2001 with the incentive of the European Commission to serve the public interest.[50]

"EFRAG's mission is to serve the European public interest in both financial reporting and sustainability reporting by developing and promoting European views in the field of corporate reporting and by developing draft EU Sustainability Reporting Standards."[51]

On 25 June 2020 the EC published a request for technical advice mandating the EFRAG to take in charge preparatory work for the elaboration of possible EU non-financial reporting standards in a revised Non-Financial Reporting Directive (NFRD).[52] In the request the EC emphasises an importance to consider international initiatives with specific attention to a climate-related disclosures, in the developing of a European non-financial reporting standards.[53]

Moreover, in the request the Commission asks the EFRAG "(…) ensuring to the greatest extent possible the compatibility of future EU non-financial reporting standards with the key private sector standards and frameworks used in the market."[54]

In particular, the EC in its request invites the EFRAG to establish a task force, specifically focused on preparation of technical advice, which should include a balanced representation of stakeholders from the public and private sectors along with civil society from across the EU.

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[50] EFRAG website, https://www.efrag.org/About/Facts
[51] ibid
[52] EFRAG website, https://www.efrag.org/Activities/2010051123028442/Sustainability-reporting-standards-roadmap#
[53] EC. Request for technical advice on preparatory work for the elaboration of EU non-financial reporting Standards (25 June 2020)
[54] EC. Request for technical advice on preparatory work for the elaboration of EU non-financial reporting Standards, op. cit., p. 6

As well as ESAs should be closely involved in development of potential EU non-financial reporting standards with respect to its key role in setting standards for sustainable finance disclosures and transparency.[55]

Under the EC mandate the Task Force should:

"Assess whether sectoral non-financial reporting standards should be developed for financial institutions, in particular credit institutions and insurance undertakings, taking into account the specific role they play as investors. For example, many of the impacts of financial institutions on the environment and society are indirect, arising via their lending portfolios, financial products and investment decisions, rather than directly via their own operations."[56]

In addition, the Task Force should ensure that any recommendations applicable to financial entities should be compatible to the disclosure requirements placed by relevant EU legislation such as the SFDR or the Taxonomy Regulation.[57]

The preparatory work was conducted by a multi-stakeholder Project Task Force (PTF-NFRS) which submitted its final report to the Commission on 28 February 2021, presenting a roadmap for the development of a comprehensive set of EU sustainability reporting standards.[58]

The final report reflects an exceptionally large consensus and consists of 54 detailed proposals.[59] One of the blocks of the huge report is dedicated to addressing the specific challenges of financial institutions.

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[55] EC. Request for technical advice on preparatory work for the elaboration of EU non-financial reporting Standards, op. cit.
[56] EC. Request for technical advice on preparatory work for the elaboration of EU non-financial reporting Standards, op. cit., p. 3
[57] EC. Request for technical advice on preparatory work for the elaboration of EU non-financial reporting Standards, op. cit.
[58] EFRAG website, op. cit.
[59] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting (February 2021)

In the Appendix 4.5 of the report is presented a full analysis of existing and upcoming non-financial reporting disclosures applicable to financial institutions to identify critical issues which could be addressed by the regulator in further development of the reporting standards.[60]

One of the challenges for financial institutions is its indirect impact on sustainability deriving from its investing and financing activities.[61] Therefore, in order to report on its indirect impacts financial institutions, need relevant, high-quality and easily accessible information about the clients and projects they finance.[62]

On the other hand, financial institutions are not a uniform group. The terms "financial institutions" or "financial market participants" covers at least three main sectors: banking, asset management and insurance.[63] Each of these sectors uses distinct business models, manages risks, and creates value in different ways using divergent levers and cannot be assessed equally.[64]

With respect to the specific role and needs of financial institutions as users and preparers of the sustainability-related information, the PTF propose to the European Standard Setter (ESS) following:

"Proposal #07

The ESS should recognise financial institutions' dual role and specific challenges in reporting their indirect sustainability impacts and design standards addressing these challenges for each of the three categories of financial institutions. In doing so and to the extent possible at its level, the ESS should aim at defining as simplified and unified as

[60] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting (February 2021). Appendix 4.5 Focus on financial institutions
[61] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit.
[62] ibid
[63] ibid
[64] ibid

possible a set of sustainability information fit to meet the multiple sustainability reporting requirements imposed on financial institutions."[65]

In addition, in the context of fast changing world, financial institutions should respond to new demand from savers asking for financial products which could create financial and sustainability performance at the same time.[66] The integration of ESG factors is a first step towards impact investing but this approach does not allow to measure the corresponding monetary value in terms of costs / benefits of the impact.[67] Monetisation translates impact currently measured in physical (e.g. tonnes, M3, etc.) or relative ratio format (carbon / environmental intensities) into estimation of monetary value creation or destruction.[68] Monetisation allows to identify a net positive or negative value to the sum of the financial risks taken by the investors and of the positive and negative effects of the activities invested in enabling investors to select companies meeting their investment criteria.[69]

The PTF second proposal to the Regulator regarding financial institutions specific challenges sounds as following:

"Proposal #08

When determining a first set of mandatory sustainability information for all reporting entities (and then when further developing sustainability information requirements), the ESS should consider financial institutions' specific needs as users of sustainability

[65] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit., p. 49
[66] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit.
[67] ibid
[68] ibid
[69] ibid

information, in order for them to appropriately direct investment flows to relevant projects and meet their own specific sustainability reporting obligations regarding indirect impacts. In particular, the ESS should consider the following:

a) it should cover all sustainability topics, not just climate-related;

b) to be investment decision-useful, sustainability information needs to include in particular quantitative forward-looking information; and

c) sustainability information data needs to be collected in a timely manner and easily accessible.

The possible development of indicators based on monetised impacts remains a growing need in order to foster performance and goal alignment measurement and should be considered at a later stage."[70]

Finally, the PTF recommend to the ESS to base on three layers of reporting, three reporting areas and three topics, in order to build more coherent and comprehensive overall target architecture of standards (Figure 1).[71]

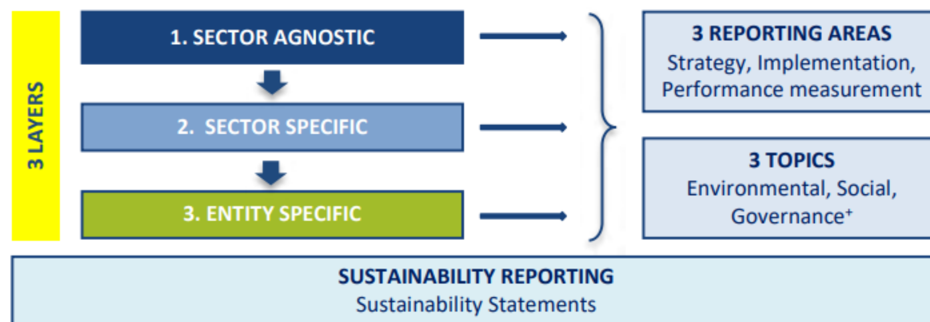

Figure 1. Target architecture. Source: EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, February 2021

[70] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit., p. 52
[71] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit., p. 9

In the EU there is a unique sustainable development landscape with an ambitious strategy at the heart. Hence, sustainability reporting should be improved and progress together with rapidly developing EU policies in the context of sustainable finance.[72]

The EU non-financial disclosure system environment becomes more comprehensive but at the same time more complex.[73] Potential inconsistencies emerging from divergent information requirements for data preparers and data users creating challenges for both.[74]

Therefore, quality, and consistent sustainability information is a key for reaching the EU sustainable finance objectives. Poor data quality could lead to confusion between investors and misguiding investment decisions along with inadequate quality reporting on indirect sustainability impact of financial institutions.[75]

In the context of relevant EU legislation, according to the PTF, clarifications through robust definitions, standards, and principles could mitigate and address potential inconsistencies of disclosure requirements:

"Robust Level 2 standards could address some of the identified gaps and potential vertical and horizontal misalignments and enhance data comparability, relevance and reliability. In any case, it appears that Level 2 measures will play a decisive role in successfully implementing the objectives and principles of ambitious EU disclosure requirements contained in Level 1 legislation."[76]

[72] EFRAG. Proposals for a relevant and dynamic EU sustainability reporting standard-setting, op. cit.
[73] ibid
[74] ibid
[75] ibid
[76] EFRAG. Progress report of the Project Task Force on preparatory work for the elaboration of possible EU non-financial reporting standards (6 November 2020), p. 5

1.6 SFDR OVERVIEW

On 9 December 2019 in the Official Journal of the European Commission was published the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR)[77] deriving from the Action 9 of the EC Action Plan on Sustainable Finance which is defined as "strengthening sustainability disclosure and accounting rule-making".[78]

The Regulation aims to information requirements harmonization and lays down sustainability disclosure obligations for producers of financial products and financial advisers towards end-investors:

"This Regulation aims to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment, by requiring financial market participants and financial advisers to make pre-contractual and ongoing disclosures to end investors when they act as agents of those end investors (principals)."[79]

According to the Eurosif the SFDR seek to enhance transparency in the market for sustainable investment products, to prevent greenwashing and to improve transparency of sustainability claims made by financial market participants.[80]

J.P. Morgan in its guide for investors describes the SFDR as the regulation which aimed to help investors in comparison and distinguishment between lots of sustainability strategies and products available within the EU.[81]

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[77] Regulation (EU) 2019/2088 of 27 November 2019. Official Journal of the European Union (9 December 2019)

[78] EC website, op. cit.

[79] Regulation (EU) 2019/2088, op. cit., p.3

[80] Eurosif website, https://www.eurosif.org/policies/sfdr/

[81] J.P. Morgan. "EU SFDR Explained: A guide to the EU Sustainable Finance Disclosure Regulation for investors" (28 July 2022)

The SFDR was adopted by co-legislators in spring 2019 and expected the ESAs to develop most of the draft regulatory technical standards (level 2) which should provide detailed explanations on disclosure requirements by 30 December 2020.[82] Initially, it was supposed that level 2 should be applicable simultaneously with level 1 in March 2021. Due to the Covid-19 crisis, necessary scrutiny procedures carried out by ESAs and complexity of the new regulation it was not possible to achieve this ambitious timeframe.[83] Therefore, the Commission had to delay the application of the RTS twice, while level 1 entered into force on 10 March 2021 as it was expected, whereas eventually the date of the application of level 2 is 1 January 2023.[84] Moreover, in its previous communication the Commission declared that 13 regulatory technical standards is planned to bundle in a single delegated act facilitating the smooth implementation of the standards by product manufacturers, financial advisers and supervisors.[85]

Asset managers and advisers in order to achieve the SFDR compliance must disclose the manner of how they consider the two key factors: "sustainability risks" and "principal adverse impacts". While sustainability risk is more related to value of the investment, principal adverse impact is a broader concept regarding impact of the investment on sustainability factors.[86]

Under the Regulation financial market participants expected to make disclosures concerning principal adverse impact on sustainability at the entity level along with disclosures at the product level, i.e. whether financial market participants and financial advisers consider negative externalities on environmental and social factors of the investment

[82] Regulation (EU) 2019/2088, op. cit.

[83] EC. Letter to the ESAs on SFDR of 20 October 2020

[84] EC. Letter to the Chair of the European Parliament's Committee on Economic and Monetary Affairs (ECON) and the President of the Ecofin Council at the European Council of 25 November 2021

[85] EC. Letter to the Chair of the European Parliament's Committee on Economic and Monetary Affairs (ECON) and the President of the Ecofin Council at the European Council of 8 July 2021

[86] J.P. Morgan. "EU SFDR Explained: A guide to the EU Sustainable Finance Disclosure Regulation for investors", op. cit.

decision/advice and, if so, how it is reflected at the product level.[87] The rationale behind is that despite sustainable investment strategy, some investment decisions and financial advice might cause or be directly linked to negative material effect on environment or society, like for example investments in assets that destroy biodiversity or contribute in water pollution or carbon dioxide emissions.[88]

According to EC communication, financial market participants are expected to comply with level 2 of the SFDR and disclose information regarding principal adverse impact on sustainability factors by the first time on 30 June 2023 where the first reference period is from 1 January 2022 to 31 December 2022.[89]

Another important point under the SFDR is a creation of product categorisation which distinguish between:

- Article 6 products which integrate environmental, social and governance risk considerations into the investment decision-making process or explain why such risk is not relevant but do not meet the supplementary criteria of Articles 8 and 9.
- Article 8 products promote social and/or environmental characteristics and could make sustainable investments but do not have sustainable investing as a core objective.
- Article 9 products have a sustainable investment objective.[90]

Onwards in the Chapter 2 of the thesis the classification and in particular Article 8 and Article 9 characteristics are explained in more detail.

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[87] Regulation (EU) 2019/2088, op. cit.
[88] EC website, op. cit.
[89] EC. Letter to the Chair of the European Parliament's Committee on Economic and Monetary Affairs (ECON) and the President of the Ecofin Council at the European Council of 25 November 2021, op. cit.
[90] Regulation (EU) 2019/2088, op. cit.

Furthermore, the SFDR aims to provide investors with necessary information by setting an increasing level of disclosures according to the degree of which sustainability is considered.[91]

Figure 2. Level of detail in disclosure increases according to the category of the product. Source: Morningstar research, December 2020

In the end of the day, considering rapidly-changing modern context, and all issues discussed in the Chapter 1, such as greenwashing threat, growing demand from the investors towards sustainable investments, high-level attention to the ESG factors, dual role of financial institutions as users and preparers of sustainability-related information, indirect impact of investments on sustainability, climate change emergency and as consequence the necessity of economic transformation, the SFDR introduction was essential and inevitable.

[91] J.P. Morgan. "EU SFDR Explained: A guide to the EU Sustainable Finance Disclosure Regulation for investors", op. cit.

CHAPTER 2 SFDR COMPLIANCE

2.1 SUSTAINABILITY RISK

Sustainability risk is a recently emerging risk dimension and one of the most critical challenges of the current century. Consideration of sustainability risk by companies could help them to generate business strategy aligning profit goals of the company with green policies and strategies. These policies aim to reduce negative impact on environment and society by decreasing GHG emissions, contamination, usage of natural resources, respecting human rights and labour standards, providing employee safety and gender equality.

Sustainability risk was first defined in 2006 by Anderson as risks related to environmental or social justice issues affecting the business, examples of which might be taxes on emissions, regulations of manufacturing process, negative attention from media, boycotts, fines, and lawsuits.[92]

Sustainability risk-management is a key for sustainable development and aims to support business growth and at the same time protecting the environment.[93] A general definition of sustainability risks according to Schulte and Hallstedt is following: "risks that are due to an organisation's contribution or counteraction to society's transition towards strategic sustainable development".[94]

According to Steve Lydenberg, the Founder and CEO at The Investment Integration Project, over the past century, the investment risk-management passed through two stages and now seems like it is

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[92] Anderson, Dan R. "The Critical Importance of Sustainability Risk Management", (2006). Risk Management 53, no. 4: 66-72.

[93] Zu Liangrong. "Sustainability Risk Management" (2013). Encyclopedia of Corporate Social Responsibility. Springer, Berlin, Heidelberg

[94] Schulte Jesko and Hallstedt Sophie I. "Company Risk Management in Light of the Sustainability Transition" (2018). Sustainability 10, no. 11: 4137

entering in a third.[95] Through first half of 20th century, best practice in investment was just an avoidance of risky securities and risk was managed at a single-security level.[96] In the second half of the century started the new stage due to development of financial theory and tools allowing to manage the risk at portfolio level. Diversification permitted adding in portfolio risky securities till the overall risk of the portfolio was not increased so the risk management was conducted at the security and portfolio levels.[97] Nowadays, investment risk-management is tending to further transformation. Investors are increasingly aware of an investment decision-making impact on the sustainability of the environmental, social, and financial systems within which they operate. That investors can impact these systems and in turn these systems can impact their portfolio returns has been made clear by the 2008 financial crisis and the ongoing issue of sustainable investment in the climate change emerge.[98] The investors started to address risks and rewards at the systems level, that means managing sustainability of these systems and at the same time continuing to monitor risks at portfolio and security levels. Thereby, incorporation of sustainability risk into the investment decision-making process is the third stage of risk-management development and one of the most complex challenges of the new era in the context of a powerful but at the same time resource-constrained modern world.

In the field of financial industry as was discussed earlier, in Chapter 1 there is a close nexus between ESG factors and sustainable investment. Actually, the definitions of sustainability factors and sustainable investment under the SFDR sounds as following:

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[95] World Business Council for Sustainable Development. "Sustainability and Enterprise Risk management: The First Step Towards Integration" (2017)
[96] ibid
[97] ibid
[98] ibid

"… 'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."[99]

"… 'sustainable investment' means 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".[100]

Eurosif in its report declares that sustainability risk cannot be defined as a new risk category but as a factor of existing risk classes, such as market risk, credit risk, reputational risk, operational risk, or strategic risk.[101] This is because sustainability nature which was already considered in the past by taking into account material risks during evaluation of potential investment. Sustainability risks if they occur could have a significant impact on existing risk types. In addition, sustainability risks can be divided into two categories: physical risks and transition risks.[102] Physical risks could be a direct consequence of environmental conditions or climate change, for example, floods, storms, heatwaves, or other extreme weather events that can affect

[99] Regulation (EU) 2019/2088, op. cit., Art. 2
[100] ibid
[101] Kyoko Sakuma-Keck, Eurosif Team, op. cit.
[102] ibid

business operations. While under transition risks intend the risks arriving from the transition to a low-carbon economy. [103] Transition to a lower-carbon economy may lead to market, legal, policy and technology changes to tackle climate change mitigation and adaptation requirements, depending on the speed, focus and nature of these changes, transition risks could affect financial and reputational risks of the company.[104]

However, despite the fact that the majority of sustainability practitioners agreed with importance of sustainability risks, a survey conducted by the World Business Council for Sustainable Development showed that 70% of respondents consider that current risk management practices do not adequately addressing sustainability risks. [105] According to the same survey 72% of sustainability professionals agreed that in general companies are not adequately disclosing sustainability risks to shareholders and 74% conquered that management tends to view sustainability risks as less likely and less impactful on a company's performance then financial risk.[106]

Among the obstacles on the way of appropriate sustainability risk management could be different factors such as lack of knowledge, data and general definitions, difficulties in the evaluation of the risks, longer time horizons, limited guidance for implementing risk management framework and pure cross-functional collaboration.[107]

Under the SFDR the sustainability risk defined as:

"… 'sustainability risk' means 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."[108]

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[103] ibid

[104] Task Force on Climate-related Financial Disclosures. "Recommendations of the Task Force on Climate-related Financial Disclosures" (June 2017)

[105] World Business Council for Sustainable Development, op. cit.

[106] ibid

[107] ibid

[108] Regulation (EU) 2019/2088, op. cit., Art. 2

Previously, before the SFDR introduction, disclosures to end investors on the integration of sustainability risks, on the consideration of principal adverse impacts, on sustainable investment objectives, or on the promotion of environmental or social characteristics in investment advisory and in investment decision-making processes were developed deficiently due to the absence of harmonised requirements at the EU level.[109] In addition, without regulation at the EU level there was a risk of the development of the divergent national measures by Member States which could obstacle the smooth functioning of the internal market.[110] Therefore, the SFDR should facilitate the comparability of financial products helping end investors in their decision-making process addressing divergent disclosure standards and market-based practices, usually based on commercial interests, and confront market fragmentation which could aggravate financial market functioning in the future.[111]

Under the SFDR financial market participants and financial advisers are required to disclose specific information concerning their approaches to the integration of sustainability risks and make pre-contractual and ongoing disclosures to end investors.[112] Moreover, they should integrate in their due diligence processes and should assess in continuous basis all relevant sustainability risks along with financial risks and publish the policies where is explained how they integrate those risks.[113]

The Regulation aims to achieve transparency concerning how financial market participants and financial advisers integrate sustainability risk into their investment decisions and investment or insurance advice. If sustainability risk assessment concludes that there are no relevant sustainability risks impacting the financial product, the reasons

[109] Regulation (EU) 2019/2088, op. cit.
[110] ibid
[111] ibid
[112] ibid
[113] ibid

therefore should be explained.[114] In the case when those sustainability risks are assessed as relevant, the extent to which they might impact the performance of the financial product should be disclosed in qualitative or quantitative terms. [115] The sustainability risk assessments and related pre-contractual disclosures by financial market participants should be considered in pre-contractual disclosures by financial advisers. Financial advisers should disclose how they consider sustainability risks in their financial product selection process and present this information to the end investors before providing the advice despite the end investors sustainability preferences.[116]

Furthermore, to achieve better transparency of remuneration policies of financial market participants and financial advisers that promote sound and effective risk management with respect to sustainability risks, which means that structure of remuneration does not contribute in excessive risk-taking regarding sustainability risks, Article 5 of the SFDR states:

"Financial market participants and financial advisers shall include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and shall publish that information on their websites."[117]

In addition, financial market participants and financial advisers should provide access to information on how they integrate relevant sustainability risks in their decision making processes, including the governance, risk management and organisational sides of such processes, and in their advisory processes, respectively, by maintaining concise information about these policies on their websites.[118]

[114] Regulation (EU) 2019/2088, op. cit., Art. 6
[115] Regulation (EU) 2019/2088, op. cit.
[116] ibid
[117] Regulation (EU) 2019/2088, op. cit., Art. 5
[118] Regulation (EU) 2019/2088, op. cit., Art. 3

2.2 PRINCIPAL ADVERSE IMPACTS

Any business can create positive and negative impacts on the environment, society, and development of a more sustainable economy. Positive impacts, for instance could be the job creation, stimulation of innovation, human capital development and sustainable investing, while negative impacts could directly or indirectly harm the environment, human rights, workers conditions, disclosures and consumers through company's operations, supply chains or business relationships.[119]

These negative impacts in the OECD Guidelines are called adverse impacts and defined as following:

"Adverse impacts refer to negative impacts (harm) to individuals, workers, communities and the environment in relation to matters covered by relevant chapters in the OECD Guidelines: disclosure; human rights; employment and industrial relations; environment; combatting bribery, bribe solicitation and extortion; and consumer interests."[120]

In the recitals of the SFDR is mentioned that in relation to principal adverse impacts of investment decisions on sustainability factors ESAs, financial market participants and financial advisers "… should consider the due diligence guidance for responsible business conduct developed by the Organisation for Economic Co-operation and Development (OECD) and the United Nations-supported Principles for Responsible Investment".[121] Moreover, financial market participants "… should integrate in their processes, including in their due diligence processes, the procedures for considering the principal adverse impacts alongside the relevant financial risks and relevant sustainability risks. The

[119] OECD. OECD Due Diligence Guidance for Responsible Business Conduct (Draft 2.1) (2016)
[120] OECD, op. cit., p. 3
[121] Regulation (EU) 2019/2088, op. cit., recital 18

information on such procedures might describe how financial market participants discharge their sustainability-related stewardship responsibilities or other shareholder engagements. Financial market participants should include on their websites, information on those procedures and descriptions of the principal adverse impacts."[122]

According to the OECD, companies should expand positive impacts and avoid adverse impacts and in doing so companies are expected to carry out due diligence processes. Due diligence defined by the OECD in a following way:

"Due diligence is the processes through which enterprises can identify, prevent, mitigate and account for how they address their actual and potential adverse impacts. (Guidelines, Chapter II – General Policies, para. 10). Due diligence can be included within broader enterprise risk management systems, provided that it goes beyond simply identifying and managing material risks to the enterprise itself to include the risks of harm related to matters covered by the Guidelines. (Guidelines, Chapter II – General Policies, Commentary para. 14)"[123]

In other words, due diligence is a process which aims to help companies to meet its responsibility and to identify, prevent and address its adverse impacts. Actually, due diligence process could be divided in four main stages.[124] First of all companies should in a regular basis identify and assess adverse impacts through special tools and approaches, including benchmarking against relevant laws and regulations, which could help to prioritise adverse impacts and to assess company's relationship to those impacts.[125] Secondly, companies should prevent and mitigate adverse impacts through development of response plans fitting for purpose of the potential or actual adverse impacts and use leverage with business relationship to

[122] ibid

[123] OECD, op. cit., p. 3

[124] OECD, op. cit.

[125] ibid

respond efficiently to potential or actual adverse impacts.[126] In third place companies should track performance by creation and adoption of appropriate systems aimed to monitor management plan implementation against settled goals, objectives and timelines.[127] Moreover, companies should seek to recognise trends and patterns of continuously repeating problems and use feedback lessons to improve due diligence process and its outcomes in the future.[128] Last but not least, companies should communicate with stakeholders and provide the information on how the company has addressed actual and potential adverse impacts by disclosing in a timely and accurate manner the data on all material matters regarding company's financial situation, structure, performance and governance.[129]

In addition, under the OECD Guidelines there are three ways in which a company can be involved to the actual or potential adverse impact, it means that company can "cause", "contribute to" or be "directly linked" to adverse impact.[130] A company "causes" an adverse impact if there is direct connection between the action or inaction of the company and the adverse impact, for instance if the company discriminates against racial or gender minorities in its hiring processes.[131] The term "contribute to" means a substantial contribution or activity which causes, facilitates or stimulates another entity to cause an adverse impact, for example consider a retailer who sets a very short timeframes for delivery of the product despite knowing that it will cause an excessive overtime at the manufacturing level.[132] Finally, a company's operations, products or services can be directly linked to an adverse impact through a business relationship.[133] For

[126] ibid
[127] ibid
[128] ibid
[129] ibid
[130] OECD. OECD Due Diligence Guidance for Responsible Business Conduct (2018)
[131] ibid
[132] ibid
[133] ibid

example, investors could be directly linked to adverse impacts caused or contributed to by investee companies by reason of the ownership in, or management of, shares in the company which causes or contributes to certain environmental or social impacts.[134]

The relationship of the company to adverse impact is important because it determines the company's response to such impact. How company can address adverse impacts considering its nature is showed in the table below.[135]

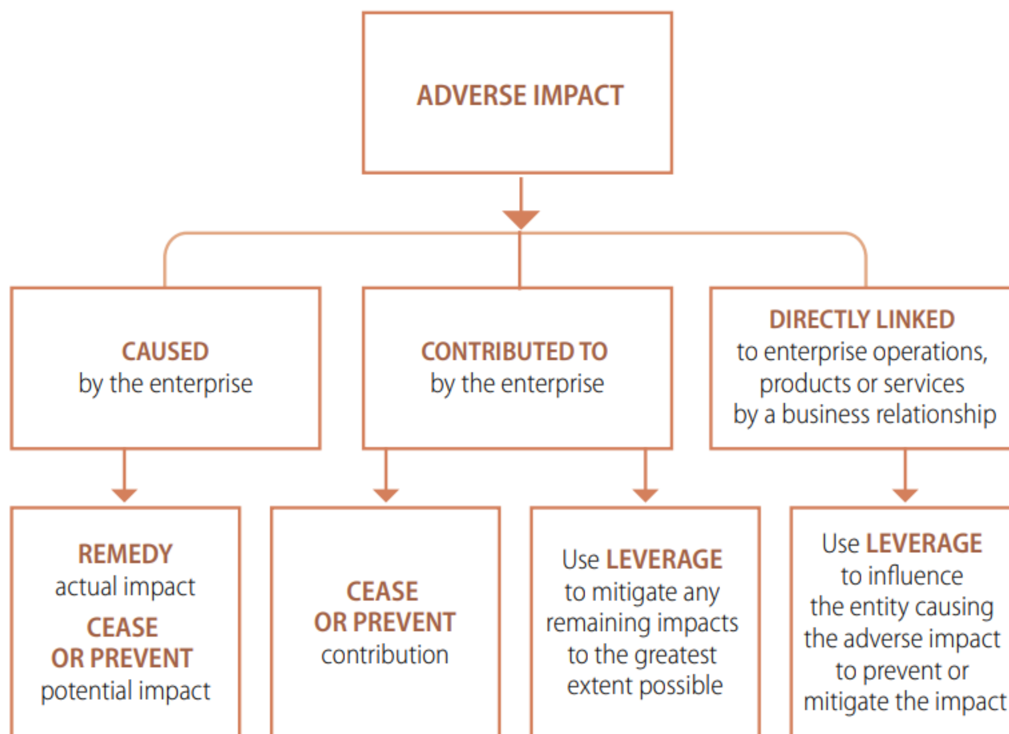

Figure 3. Addressing adverse impacts. Source: OECD, OECD Due Diligence Guidance for Responsible Business Conduct, 2018

[134] OECD. Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises (2017)
[135] OECD (2018), op. cit.

For better understanding of the Figure 3, OECD provides following definitions of recommended actions to address adverse impacts:

"Remediation and remedy refer to both the processes of providing remedy for an adverse impact and to the substantive outcomes that can counteract, or make good, the adverse impact, including: apologies, restitution or rehabilitation, financial or non-financial compensation (including establishing compensation funds for victims, or for future outreach and educational programs), punitive sanctions (whether criminal or administrative, such as fines), as well as prevention of harm through, for example, injunctions or guarantees of non-repetition."[136]

"Prevention are actions taken to avoid an impact happening. 'Prevention' of the kinds of adverse impacts set out in the Guidelines is the priority and may also be required under national law. These steps can range from the simple (installing a smoke detector) to complex (testing protocols on health products to protect consumer safety or engineering solutions to eliminate emissions). Prevention can also include decisions not to conduct activities where the risk of adverse impacts is considered too high."[137]

"Leverage is considered to exist where the enterprise has the ability to effect change in the wrongful practices of the entity that has caused the harm. (OECD Guidelines, II, Commentary, 19)"[138]

Following the OECD Guidelines framework, in the recitals of the SFDR concerning adverse impacts there are two important statements:

"Investment decisions and advice might cause, contribute to or be directly linked to effects on sustainability factors that are negative, material or likely to be material."[139]

[136] OECD (2016), op. cit., p. 4
[137] OECD (2016), op. cit., p. 3
[138] ibid
[139] Regulation (EU) 2019/2088, op. cit., recital 16

"Principal adverse impacts should be understood as those impacts of investment decisions and advice that result in negative effects on sustainability factors."[140]

Therefore, principal adverse impacts could be defined as negative, material, or likely to be material effects on sustainability factors that are caused, compounded by, or directly linked to investment decisions and advice performed by the entity.

In addition, in the Joint ESAs Final Report on RTS under SFDR is mentioned that the EU objectives concerning sustainability, in particular carbon neutrality, increasing the share of renewable energy, the protection of biodiversity and water mean that it is essential to consider any adverse impacts in these areas as a principal adverse impacts, as well as in the social areas like human rights, anti-corruption and anti-bribery.[141]

Under the Article 4 of the SFDR financial market participants and financial advisers should disclose and maintain on their websites the information of adverse sustainability impacts at entity level.[142] If company is small and has less than 500 employees applies "comply or explain" principle which means that the company has a choice either consider or not the principal adverse impacts (PAI), however in the case it chooses to do not consider the PAI, the company should publish a statement on its website with a clear reasons behind this decision and whether they will consider the adverse impacts in the future.[143] Financial market participants if they consider the PAI of investment decisions on sustainability factors should publish on their websites a statement on due diligence policies regarding those impacts. Also, in

[140] Regulation (EU) 2019/2088, op. cit., recital 20
[141] Joint Committee of the European Supervisory Authorities. Final Report on draft Regulatory Technical Standards (2 February 2021)
[142] Regulation (EU) 2019/2088, op. cit., Art. 4
[143] ibid

the Article 4 there is a list of the minimal required information which should be provided by the FMP:

"(a) information about their policies on the identification and prioritisation of principal adverse sustainability impacts and indicators;

(b) a description of the principal adverse sustainability impacts and of any actions in relation thereto taken or, where relevant, planned;

(c) brief summaries of engagement policies in accordance with Article 3g of Directive 2007/36/EC, where applicable;

(d) a reference to their adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement."[144]

In addition, the EC mandates the ESAs to develop draft regulatory technical standards to the paragraphs 1 to 5 of the Article 4, on the contents, methodology and presentation of information regarding PAI indicators in the field of climate, environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery.[145]

From 1 January 2023 when the Level 2 RTS comes into force, this information must be provided by FMP in the form of the template "Statement on principal adverse impacts of investment decisions on sustainability factors".[146] The template includes a summary section which should be written in English, an official language of the home Member State of the company, if it is different, and an official language of each Member State where a product is available.[147] In the Table 1 of the template are presented 14 mandatory environmental and social adverse sustainability indicators and defines the metric which companies should apply obtaining information about the indicators.[148]

[144] Regulation (EU) 2019/2088, op. cit., Art. 4 (2)
[145] Regulation (EU) 2019/2088, op. cit.
[146] Commission Delegated Regulation (EU) 2022/1288, op. cit.
[147] ibid
[148] ibid

Companies should report on the impact every year and describe any actions taken or planned, and set the targets for the next period in respect of each indicator.[149] Tables 2 and 3 of the template provide additional environmental, social and governance indicators from which companies should choose at least one additional factor from each of the two tables and potentially more if those indicators considered material.[150] However, the indicators defined in the RTS may change in the future due to the Commission request to the ESAs for further development of the regulatory framework, the indicator list extension and the refining of the indicators contents and definitions, applicable methodologies, presentations and metrics.[151]

2.3 ENTITY-LEVEL DISCLOSURE

As it was discussed in the Chapter 1, under the SFDR financial market participants and financial advisers are required to disclose information at entity and product levels. Disclosures provided at entity-level cover sustainability considerations and practices that a company as a whole has adopted with respect to the manner in which environmental and social factors are integrated in the investing and internal processes of the company. These disclosures are regulated in the SFDR Articles 3, 4 and 5, each of which required financial market participants and financial advisers to publish and maintain relevant information on their websites.[152]

[149] ibid
[150] ibid
[151] EC. Letter to the ESAs on amendments to regulatory technical standards under the Sustainable Finance Disclosure Regulation 2019/2088 of 11 April 2022
[152] Regulation (EU) 2019/2088, op. cit.

According to the Article 3 of the SFDR, financial market participants should disclose an information about their policies on the integration of sustainability risks in their investment decision-making process and respectively, financial advisers should disclose an information about their policies on the integration of sustainability risks in their investment advice or insurance advice.[153]

The Article 4 is dedicated to a transparency of adverse sustainability impacts, according to which financial market participants and financial advisers should publish an information regarding their investment decisions or investment advises principal adverse impacts (PAI) on sustainability factors.[154] In more detail the Article 4 requirements and PAI were discussed in a previous paragraph 2.2.

The Article 5 aims to achieve a transparency of remuneration policies in relation to the integration of sustainability risks. According to the Article 5, as was already mentioned in the paragraph 2.1, financial market participants and financial advisers are invited to disclose how the integration of sustainability risks is considered in their remuneration policies.[155]

Information provided at entity-level is not influenced by the classification of financial product and should be disclosed on the company's website. Therefore, entity-related disclosures should be published regardless of company's decision to classify its products as Article 6, 8 or 9.

In addition, "To ensure the reliability of information published on the websites of financial market participants and financial advisers, such information should be kept up to date, and any revisions or changes to such information should be clearly explained."[156]

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[153] ibid
[154] ibid
[155] ibid
[156] Regulation (EU) 2019/2088, op. cit., recital 26

2.4 PRODUCT-LEVEL DISCLOSURE

Product-level disclosures aim to provide stakeholders better insight into the sustainable reality of the funds and other financial products with which they engage. Disclosures at product level should ensure that investors receive consistent fund-related information on sustainability, in particular about the products which promote environmental or social characteristics or have a sustainable investment as its objective.

The recitals 20 and 21 of the SFDR state:

"Financial market participants which consider the principal adverse impacts of investment decisions on sustainability factors should disclose in the pre-contractual information for each financial product, concisely in qualitative or quantitative terms, how such impacts are considered as well as a statement that information on the principal adverse impacts on sustainability factors is available in the ongoing reporting."[157]

"Sustainable products with various degrees of ambition have been developed to date. Therefore, for the purposes of pre-contractual disclosures and disclosures in periodical reports, it is necessary to distinguish between the requirements for financial products which promote environmental or social characteristics and those for financial products which have as an objective a positive impact on the environment and society. As a consequence, as regards the financial products with environmental or social characteristics, financial market participants should disclose whether and how the designated index, sustainability index or mainstream index, is aligned with those characteristics and where no benchmark is used, information on how the sustainability characteristics of the financial products are met. As

[157] Regulation (EU) 2019/2088, op. cit., recital 20

regards financial products which have as an objective a positive impact on the environment and society, financial market participants should disclose which sustainable benchmark they use to measure the sustainable performance and where no benchmark is used, explain how the sustainable objective is met. Those disclosures by means of periodic reports should be carried out annually."[158]

Therefore, a product-level and entity-level disclosures should be published through different channels, while entity-level disclosures should be published on the company's website, product-level disclosures should be provided in pre-contractual documentation, periodic reports and/or on the company's website.[159]

As it was mentioned in the Chapter 1 (Figure 2), there are different levels of the required disclosures according to the involvement degree of the product to the sustainability factors. The greener the fund's objectives, the more detailed disclosures it is expected to make. The disclosure obligations at the financial product level are divided into the three categories under Articles 6, 8 and 9 and are so called "grey", "light green" and "dark green" funds respectively.

The Article 6 represents a default classification for funds and corresponds to financial products which do not take into consideration sustainability criteria in the investment process.[160] It is dedicated to a transparency of the integration of sustainability risks and states:

"Financial market participants shall include descriptions of the following in pre-contractual disclosures:

(a) the manner in which sustainability risks are integrated into their investment decisions; and

(b) the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.

[158] Regulation (EU) 2019/2088, op. cit., recital 21
[159] Regulation (EU) 2019/2088, op. cit.
[160] ibid

Where financial market participants deem sustainability risks not to be relevant, the descriptions referred to in the first subparagraph shall include a clear and concise explanation of the reasons therefor."[161]

Hence, funds should make provisions for the required information in the fund's prospectus. If the fund deems sustainability risks not to be relevant, it should clearly explain the rationale behind such conclusions. In the case the fund deems sustainability risks to be relevant, it should not just declare that it has integrated sustainability risks into its investment decision-making process, but to explain how this is reached, and to present a policy which would endorse that disclosure.

There are different criteria for assessment of how sustainability risk is integrated to the investment process such as, exclusion or avoidance screening, inclusionary screening, the best-in-class approach and active ownership and engagement.[162]

Exclusion or avoidance screening usually is a first step in ESG integration. Contentious sectors such as coal, weapons and tobacco are most-frequently subjects for exclusion and divestment. Often could be excluded by funds' investments in alcohol, gambling, gender imbalanced boards and fossil fuel exploration and production.[163]

Inclusionary screening, which is ordinarily done after exclusion decisions, takes into account ESG factors which means the assessment of the relative ESG ratings and, for instance fund managers could select only the companies with a score higher than average or only those that are on the top ratings in each of the asset classes.[164]

The best-in-class approach could be applied to different sectors and particular ESG objectives, for example the fund could choose a specific

[161] Regulation (EU) 2019/2088, op. cit., Art. 6
[162] Deloitte. Sustainable Finance Disclosure Regulation - Article 6 Funds (2021)
[163] ibid
[164] ibid

criteria and select companies with a high green agenda or low carbon print foot.[165]

Active ownership and engagement are commonly used in sustainability risks integration. Some investors could actively engage in shareholding voting and could have determined intentions to increase a companies' overall ESG performance.[166]

According to the Deloitte, once the criteria on sustainability risk integration has been agreed, the fund should put down the policy which should include the following:

"• a description of the assessment process used by the fund manager to identify and prioritise sustainability factors relevant to the fund;

• the date of approval of the policies by the board of the fund or the fund manager;

• the allocation of responsibility for the implementation of the policies within organisational structure and procedures;

• a description of the methodologies to select and identify the sustainability indicators and assess the impact of those indicators;

• an explanation of any associated margin of error within those methodologies;

• a description of the data sources used; and

• details of data obtained either directly from investee companies or from third party data providers."[167]

Funds classified under the Article 6 have much less disclosure obligations compared to the Articles 8 and 9 funds which are discussed in more detail in the next paragraph.

Regarding the product-level disclosures it is important to mention the Article 7 of the SFDR which is directed on the transparency of adverse

[165] ibid
[166] ibid
[167] Deloitte, op. cit., p. 2

sustainability impacts at financial product level.[168] The Article 7 declares:

"By 30 December 2022, for each financial product where a financial market participant applies point (a) of Article 4(1) or Article 4(3) or (4), the disclosures referred to in Article 6(3) shall include the following:

(a) a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors;

(b) a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed pursuant to Article 11(2).

Where information in Article 11(2) includes quantifications of principal adverse impacts on sustainability factors, that information may rely on the provisions of the regulatory technical standards adopted pursuant to Article 4(6) and (7)."[169]

In other words, a financial market participant must include in a pre-contractual documentation a clear explanation of how the financial product considers PAI on sustainability factors, and a statement of the information on PAI should be available in the fund's annual report.[170] To provide quantitative information on PAI in the annual report a financial market participant could rely on the RTS issued by the ESA.[171] In the case a financial market participant decides to do not consider PAI, applying the point (b) of Article 4 (1), the disclosures regarding Article 6 (3) should include a statement that financial market participant does not consider PAI of investment decisions on

[168] Regulation (EU) 2019/2088, op. cit.
[169] Regulation (EU) 2019/2088, op. cit., Art. 7
[170] ibid
[171] ibid

sustainability factors.[172] The statement should be provided for each financial product in a pre-contractual documentation.[173]

2.5 ARTICLE 8 AND ARTICLE 9 FUNDS

In the recitals of the SFDR state:

"The current disclosure requirements set out in Union law do not require the disclosure of all the information necessary to properly inform end investors about the sustainability-related impact of their investments in financial products with environmental or social characteristics or financial products which pursue sustainability objectives. Therefore, it is appropriate to set out more specific and standardised disclosure requirements with regard to such investments. For instance, the overall sustainability-related impact of financial products should be reported regularly by means of indicators relevant for measuring the chosen sustainable investment objective. Where an appropriate index has been designated as a reference benchmark, that information should also be provided for the designated index as well as for a broad market index to allow for comparison."[174]

Therefore, the SFDR aims to define more specific information requirements for the financial products with environmental and/or social characteristics and those with sustainability objective. These particular disclosures should be comparable and are mostly covered by the Articles 8, 9, 10 and 11 of the Regulation.

[172] ibid
[173] ibid
[174] Regulation (EU) 2019/2088, op. cit., recital 24

Article 8 of the SFDR is dedicated to a transparency of the promotion of environmental or social characteristics in pre-contractual disclosures. The Article 8 funds, also known as "promoting environmental and/or social characteristics", covers financial products which are characterised by environmental or social factors, and where their companies have good governance practices, but ESG investing is not the core factor of these products. Under Article 8 the company should disclose how those environmental or social characteristics are met. The Article 8 (1) states:

"Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following:

(a) information on how those characteristics are met;

(b) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics."[175]

Moreover, financial market participants should include information and indicate where the methodology used for the index calculation could be found.[176]

In addition, under the Article 8 the Commission mandates ESAs to develop draft regulatory technical standards and define the standards for the presentation and content of disclosures, taking into account the various types of financial products, their characteristics and the differences between them, along with the objective to make disclosures clear, accurate, fair, not misleading, concise and simple.[177]

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[175] Regulation (EU) 2019/2088, op. cit., Art. 8
[176] ibid
[177] ibid

The SFDR does not set out a general definition of "good governance practices", but refers to the approach in the definition of sustainable investment as "… in particular sound management structures, employee relations, remuneration of staff and tax compliance"[178], indicating the key elements of the concept. This concept sounds broad and could leave a high degree of discretion for its practical application.

The OECD Guidelines for Multinational Enterprises provide an inclusive arsenal of best business practices and responsible business conduct. For example, a company's assessment could include:

- company's management efficiency, its board composition, balance, remuneration policies and operations control;
- company's compliance with tax, antibribery, anti-money laundering and environmental standards;
- correspondence of a company's audit, risk, and compliance controls to the best practices;
- responsibility of the company towards employees and respect for human rights.[179]

Any company managing a fund within scope of Article 8 should build up a policy to assess good governance of investments, considering the type of investments, the company's access to information and its potential to influence the investment during the period of ownership.[180] It is important to notice that, companies could consider a good governance differently due to their assessments could relate to the various relevant risks for instance depending on investment's industry and jurisdiction.

[178] Regulation (EU) 2019/2088, op. cit., Art. 2
[179] OECD. OECD Guidelines for Multinational Enterprises (2011)
[180] Regulation (EU) 2019/2088, op. cit.

Article 9 of the SFDR focuses on a transparency of sustainable investments in pre-contractual disclosures. Also known as the "dark green" funds, Article 9 products specifically target sustainable investment. The Article 9 declares:

"1. Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following:

(a) information on how the designated index is aligned with that objective;

(b) an explanation as to why and how the designated index aligned with that objective differs from a broad market index.

2. Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall include an explanation on how that objective is to be attained.

3. Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include 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."[181]

[181] Regulation (EU) 2019/2088, op. cit., Art. 9

Therefore, under Article 9 a company is expected to disclose in its pre-contractual documentation further detail how its sustainable investment will be achieved. First, in the case the fund with a sustainable investment objective has an index designed as a reference benchmark it should provide information on how this index is aligned with the objective, while if such index was not designed the company should disclose how it plans to reach the sustainable objective. If the fund has as its objective a reduction of GHG emissions, it should provide information taking into consideration long-term global warming objectives of the Paris Agreement.

In addition, similarly to Article 8, financial market participants should include in its disclosures and indicate where the methodology used in calculation of the indices and benchmarks could be found.

And again, ESAs are expected to develop the draft regulatory technical standards and specify criteria for the disclosures regarding Article 9 financial products.

In the Article 9 fund all underlying assets should be classified as subjects of sustainable investment but with some limited exceptions, such as hedging or liquidity. According to the Commission Q&A:

"A financial product, in order to meet requirements in accordance with prudential, product-related sector specific rules may next to 'sustainable investments', also include investments for certain specific purposes such as hedging or liquidity which, in order to fit the overall financial product's sustainable investments' objective, have to meet minimum environmental or social safeguards, i.e. investments or techniques for specific purposes must be in line with the sustainable investment objective."[182]

[182] EC. Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088) (14 July 2021), p. 5

2.6 INVESTMENT FUNDS BEHAVIOR

Three months after the SFDR introduction, according to the Morningstar surveys there was a wide range of interpretations and practices used by asset managers in classification of their products. In total, around 23-24% of European funds considered themselves as green.[183] The overwhelming majority of the green funds were classified as Article 8 and represented a broad variety of the ESG approaches, from light ESG exclusions to more serious best-in-class strategies, some of which were very close to the Article 9 dark green policies.[184]

Companies were exposed to commercial pressure which reinforced them to have as many funds as possible to meet at least Article 8 requirements, for example, in May 2021 JPMorgan upgraded 55 funds from Article 6 to Article 8.[185] Many distributors and fund buyers across Europe expressed the intention to consider in the future only the finds in green categories.[186]

Since the SFDR came into force, asset managers upgraded their strategies and launched new ones which could meet Article 8 or 9 requirements. However, at this stage the problem of usage of differing approaches by asset managers in product classification appeared.

According to Eurosif, since the SFDR introduction financial market participants "(…) have faced a number of difficulties in interpreting and applying its provisions consistently. The interim conclusion is that the SFDR has increasingly been perceived and used as a product standard although it is ill equipped to fulfil this function currently."[187]

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[183] Morningstar website, https://www.morningstar.co.uk/uk/news/213385/will-the-sfdr-prevent-greenwashing.aspx

[184] ibid

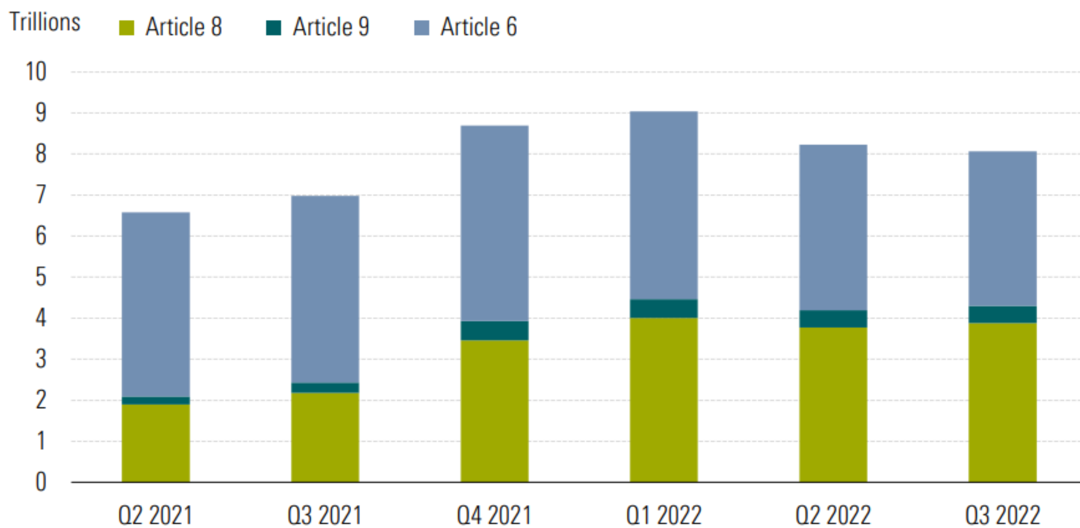
[185] Morningstar website, https://www.morningstar.co.uk/uk/news/214207/sfdr-four-months-on.aspx

[186] ibid

[187] Eurosif. EU Sustainable Finance & SFDR: making the framework fit for purpose. Eurosif Policy Recommendations for Article 8 & 9 product labels (June 2022), p. 5

In October 2022, Morningstar published a report regarding Article 6, 8 and 9 funds dynamics in the third quarter of 2022. According to the Morningstar report, in the context of inflationary pressures, increasing of interest rates, emerging global recession, and geopolitical risks related to Russia's invasion of Ukraine, Article 8 funds faced a funds outflow of 28.7 billion euros in the third quarter, but it is less than 31.6 billion euros loss in the second quarter.[188] However, Article 8 funds are not leader in outflows in the third quarter, Article 6 funds loss is equal to 62.1 billion euros.[189] On the contrary, Article 9 funds registered 12.6 billion euros of inflows.[190]

Regardless of net outflows and falling market prices, Article 8 and 9 funds grew around 3% and stood at 4.30 trillion euros at the end of September mostly driven by newly launched and upgraded funds.[191] Figure 4 demonstrates a chronology of Article 6, 8 and 9 funds volume in terms of money.



[188] Morningstar. SFDR Article 8 and Article 9 Funds: Q3 2022 in Review (October 2022)
[189] ibid
[190] ibid
[191] ibid

Figure 4. Quarterly Assets Breakdown by SFDR Classification. Source: Morningstar Direct. Data as of Oct. 13, 2022. Based on SFDR data collected from prospectuses on 96% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds

Asset managers continued reclassifying strategies and launching new products to meet Article 8 and 9 requirements. Therefore, at the end of September a market share of green funds in the EU had increased to 53.5%, split between Article 8 (48.3%) and Article 9 (5.2%).[192] Figure 5 reflects a volume correlation of Article 6, 8 and 9 funds by financial product.

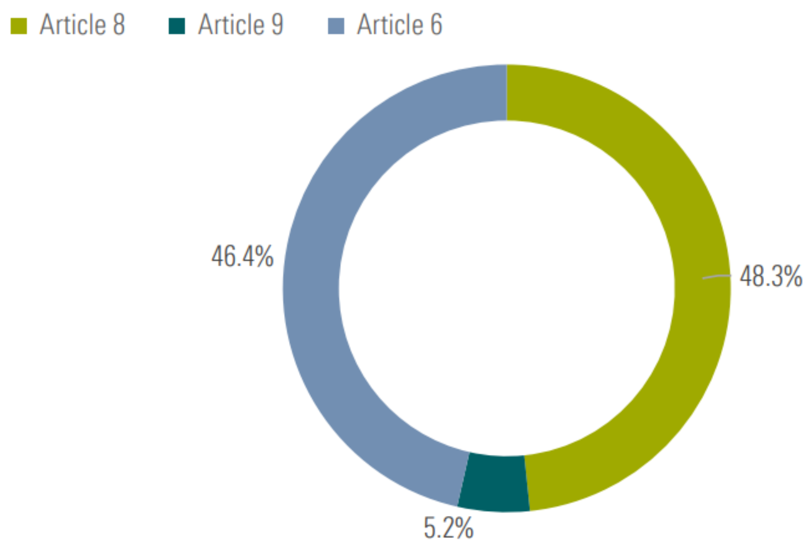


Figure 5. SFDR Fund Type Breakdown (by Assets). Source: Morningstar Direct. Data as of Sept. 30, 2022. Based on SFDR data collected from prospectuses on 97.4% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

[192] ibid

Regarding number of funds, the market share of Article 8 and Article 9 funds also increased in the third quarter, representing 37.8% of the EU fund universe with 8,459 funds (33.6%) classified as Article 8 and 1,080 funds (4.3%) classified as Article 9 at the end of September.[193] Figure 6 below shows Article 6, 8 and 9 fund proportions by number of funds.

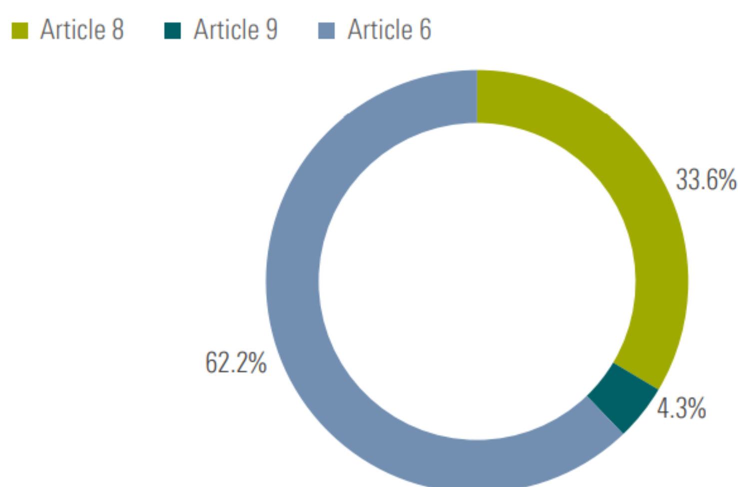


Figure 6. SFDR Fund Type Breakdown (by Number of Funds). Source: Morningstar Direct. Data as of Sept. 30, 2022. Based on SFDR data collected from prospectuses on 97.4% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

In addition, over the third quarter of 2022, Morningstar identified 383 funds changed its SFDR status.[194] 342 funds were which ones who raised its status mostly from Article 6 to Article 8.[195] While 41 funds downgraded from Article 9 to Article 8 which could probably related to the SFDR level 2 RTS coming into force from 1 January 2023.[196] Some

[193] ibid
[194] ibid
[195] ibid
[196] ibid

asset managers expressing the opinion that "sustainable investment" is still subject to numerous interpretations and therefore many of them prefer to act ahead downgrading the funds from Article 9 to 8 before the SFDR level 2 implementation bringing stricter criteria for Article 9 products.[197] Thus, Morningstar states:

"In light of all these recent developments and in expectation of further downgrades, we can expect the number of Article 9 products to decline in the next six months from its current level of 1,080 funds (representing 4.3% of funds distributed in the EU)."[198]

[197] ibid

[198] Morningstar, op. cit., p. 12

CHAPTER 3 SFDR LEVEL 2 ANALYSIS

3.1 SFDR DEVELOPMENT AND IMPLEMENTATION PROCESS

As it was discussed in the Chapter 1, actually the SFDR introduction is a consequence of the UN 2030 Agenda for Sustainable Development and the Paris Agreement adoption which aims to strengthen the global response to the climate change threat.

In the 2016 Commission Communication on the next steps for a sustainable European future, the Commission stated key actions through which it plans to deliver the UN 2030 Agenda, one of these actions sounds as:

"The Commission will mainstream the Sustainable Development Goals into EU policies and initiatives, with sustainable development as an essential guiding principle for all its policies. Existing and new policies should take into account the three pillars of sustainable development, i.e., social, environmental and economic concerns. The Commission will to this effect ensure that its policies are sustainability-assured through its better regulation tools."[199]

After the signing of the Paris Agreement, the EU expressed an intention to become a leader in the fight against climate change and in the reduction of carbon emissions. Hence, the EU developed a strategy focused on the building of a more sustainable economy.

According to the EU strategy, financial sector should play a key role in the transformation process, therefore it is crucial to redirect private capital flows towards sustainable investment. But at the moment, there was no regulatory framework at the Union level regarding sustainable finance and thus what could be defined as sustainable investment.

[199] EC. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Next steps for a sustainable European future. European action for sustainability (22 November 2016), p. 18

Thereby, the European Commission had to fill the regulatory gap by developing of the EC Action Plan on Sustainable Finance consisting of amendments to the existing rules and new regulations as the SFDR and the EU Taxonomy which are the main pillars of the EU sustainable finance strategy.

As it was mentioned in the Chapter 1, the EC Action Plan on Sustainable Finance was built on the recommendations from High-Level Expert Group (HLEG) assigned by the Commission in 2016 in order to help in shaping of the EU sustainable finance strategy. On 31 January 2018, the HLEG published its final report on Financing a Sustainable European Economy along with a feedback statement on previously presented consultation questionnaire. According to the Commission Proposal on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/234, there were a strong tendency in the responses such as:

- "the importance of a clear EU-wide strategy on sustainability;
- the importance of providing a favourable environment for sustainable investment and subsequent finance;
- the need to define institutional investors' and asset managers' duties regarding sustainability, which could be extended to embed wider environmental, social and governance considerations; that duty should also include the notion of sustainability;
- the need for improved disclosures."[200]

[200] EC. Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (24 May 2018), p. 7

In reality, the SFDR occurrence began in 2017 with the Commission initiative on the institutional investors' and asset managers' duties regarding sustainability. In the light of the Commission engagement to sustainable finance, the initiative aimed at strengthening financial stability and asset pricing through clarifying to institutional investors and investment managers on its duty to consider the materiality of sustainability factors.[201]

Moreover, at the beginning of 2018 the Commission carried out targeted interviews with stakeholders (medium and large asset managers and institutional investors), which have already integrated the ESG factors in its investment decision making process, including some of them who even have socially responsible investment products.[202] The prevailing majority of interviewed entities agreed on necessity to clarify at the EU level whether asset managers and institutional investors have a duty to assess the ESG risks and to consider them if it is relevant.[203]

In addition, the interviewed entities provide the Commission with more specific detail regarding internal processes on integration of the ESG factors, such as risk management, investment strategy, governance measures including ESG board member or specific committee on ESG, engagement with investee companies and voting policy. Some entities specified existence of separate ESG policies, mandatory report directly to ESG committee and alignment of remuneration policies with ESG factors.[204] Major part of the interviewed entities make ESG disclosures at entity-level in annual and/or periodic reports, while others have

[201] EC website, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/1185-Institutional-investors-and-asset-managers-duties-regarding-sustainability_en

[202] EC. Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, op. cit.

[203] ibid

[204] ibid

client-specific not public disclosures and a very few entities start to provide public ESG disclosures at product level.[205]

According to the Commission Proposal on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 in order to make investments more sustainable the ESG factors should be considered in the investment decision making process.[206]

Moreover, the Proposal states that transparency on the integration of sustainability risks and on pursuing sustainable investments could not be achieved only by amending existing directives and regulations as it could lead to uneven implementation.[207] Therefore, a directly applicable regulation is essential in order to reach policy objectives and to provide maximum harmonization along with avoiding divergences.[208]

In the Commission Inception Impact Assessment, the problem which should be solved by the initiative described as following:

"The duties of care, loyalty and prudence governing the obligations of institutional investors and asset managers are embedded in EU financial framework (Solvency II, IORP II, UCITS, AIFMD, MIFID II…). These duties require institutional investors and asset managers to act in the best interest of their end-investors/scheme members. The implementation of these duties implies fulfilment of various obligations for asset managers and institutional investors that include, for instance, the duty to act with due care, skill, and diligence in performing their activities.

When acting upon their obligations, institutional investors and asset managers do not necessarily consider sustainability risks within their financial decision-making. Consequently, they may disregard or

[205] ibid
[206] ibid
[207] ibid
[208] ibid

underestimate the long term effects that sustainability factors might have on the performance of their investments. (…) In addition, current rules as regards the duties of care, loyalty and prudence may be deemed to be not sufficiently explicit on how asset managers and institutional investors must consider financially material risks stemming from sustainability factors. The current rules also are not fully aligned across sectors.

Furthermore, there is a lack of transparency on how institutional investors and asset managers consider these sustainability factors in their decision-making. End-investors may thus not get the full information they need to inform their investment decisions. (…)"[209]

Thus, the initiative should increase transparency, lead to a more consistent handling of sustainability factors, provide end-investors more accessible sustainability related information, and shift private financial flows towards sustainable investment.

For the first time the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR) was published on 9 December 2019 in the Official Journal of the European Union.[210]

The SFDR level 1 came into effect on 10 March 2021 and consisted of entity-level disclosures regarding financial market participants policies on the identification and prioritisation of principal adverse sustainability impacts. Actually, the SFDR level 1 is wide and general and does not provide technical details on what exactly should be disclosed but mandate ESAs to develop the draft regulatory technical standards (level 2) specifying disclosures' content.

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[209] EC. Inception Impact Assessment of the initiative on the institutional investors' and asset managers' duties regarding sustainability (13 November 2017), p. 2

[210] Regulation (EU) 2019/2088, op. cit.

Due to different complications, the SFDR level 2 was delayed twice and at the end came into force on 1 January 2023. Financial market participants in order to comply with the SFDR level 2 must disclose information regarding principal adverse impact on sustainability factors for the first time on 30 June 2023 considering as the first reference period the period from 1 January 2022 to 31 December 2022.[211]

Figure 7 below demonstrates a timeline of application the SFDR level 1 and 2 along with EU Taxonomy Regulation, as it was mentioned in previous chapters there is a strong interconnection between two legislation pieces which is described in the following paragraphs.

Figure 7. Implementation timeline for the SFDR and EU Taxonomy Regulation. Source: Invest Europe. SFDR and the Taxonomy Regulation (July 2022)

[211] EC. Letter to the Chair of the European Parliament's Committee on Economic and Monetary Affairs (ECON) and the President of the Ecofin Council at the European Council of 25 November 2021, op. cit.

3.2 EU TAXONOMY REGULATION

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 and amending Regulation (EU) 2019/2088 or Taxonomy Regulation was published on 22 June 2020 in the Official Journal of the European Union, and it came into force on 12 July 2020.[212]

In the light of the systemic nature of global environmental threats, it is necessary to adopt a systemic and forward-looking approach to environmental sustainability which could confront growing negative tendencies, such as climate change, overconsumption of resources, the loss of biodiversity, food scarcity and ocean acidification, along with the appearance of new threat like hazardous chemicals.[213] Hence, climate change emergency is the priority for the EU Taxonomy Regulation, the recital 5 of the Taxonomy Regulation states:

"In December 2016, the Commission mandated a High-Level Expert Group to develop an overarching and comprehensive Union strategy on sustainable finance. The report of the High-Level Expert Group published on 31 January 2018 calls for the creation of a technically robust classification system at Union level to establish clarity on which activities qualify as 'green' or 'sustainable', starting with climate change mitigation."[214]

The Taxonomy Regulation covers only environmentally sustainable activities, however the EU plans to present a taxonomy regulation for social investments which will define a list of social objectives along with

[212] Regulation (EU) 2020/852 of 18 June 2020. Official Journal of the European Union (22 June 2020)
[213] ibid
[214] Regulation (EU) 2020/852, op. cit., recital 5

activities contributing to those objectives and criteria of substantial contribution.[215]

According to the Taxonomy Regulation recitals, the criteria identifying economic activity as environmentally sustainable should be harmonised at the EU level in order to do not obstacle the functioning of the internal market regarding investments in sustainability projects and to prevent further emergence of such obstacles.[216] Hence, this harmonisation should facilitate fund raising for environmentally sustainable activities across the Union through comparability against uniform criteria and ability to select underlying assets for environmentally sustainable investments.[217]

As it was mentioned in the Chapter 1, the Article 9 of the Taxonomy Regulation defines a list of six environmental objectives (climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems)[218] to one or more of which economic activity should substantially contribute to be potentially defined as environmentally sustainable.

In addition, such activity should satisfy three more conditions which are "do not significant harm" principle, complying with "minimum safeguards" and complying with technical screening criteria (TSC) established by the Commission.[219] Only in case the economic activity assures all four conditions it could be defined as environmentally sustainable activity or Taxonomy-aligned.[220]

[215] Invest Europe. SFDR and the Taxonomy Regulation (July 2022)
[216] Regulation (EU) 2020/852, op. cit.
[217] ibid
[218] Regulation (EU) 2020/852, op. cit.
[219] ibid
[220] ibid

For each of six environmental objectives the different means could be required for an activity to make a substantial contribution.[221] Under the Taxonomy Regulation, the EC had to provide the actual list of environmentally sustainable activities by defining the TSC for each of environmental objectives through delegated acts.[222]

An activity which contributes to one or more of the six objectives to be defined as sustainable implies to do not cause significant harm to any of the other Taxonomy objectives. For each activity, the TSC set out thresholds to define compliance with do no significant harm (DNSH).[223]

Moreover, an economic activity to be defined as sustainable should be aligned with the "minimum safeguards", namely the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.[224]

Due to the EU's target to achieve carbon neutrality by 2050, the Taxonomy Regulation first focuses on climate change issues, with the application of the Taxonomy Regulation on 1 January 2022 regarding the first two climate change objectives and on 1 January 2023 respectively for the other four environmental objectives (Figure 7).[225]

In July 2018, the Commission established a Technical Expert Group (TEG) on sustainable finance to assist developing of the EC Action Plan.[226] Concerning the Taxonomy Regulation, the TEG was asked to develop recommendations for technical screening criteria (TSC) for

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[221] EC website, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en
[222] Regulation (EU) 2020/852, op. cit.
[223] Invest Europe, op. cit.
[224] Regulation (EU) 2020/852, op. cit.
[225] Invest Europe, op. cit.
[226] EC website, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

economic activities on the one hand making substantial contribution to climate change mitigation and adaptation and on the other hand do not significant harm other four environmental objectives. [227]

On 9 March 2020, the TEG published its final report on EU taxonomy containing recommendations relating to the overall structure of the Taxonomy, extensive guidance on how companies and financial institutions can develop Taxonomy disclosures, moreover the report provides summary about economic activities covered by the technical screening criteria.[228]

The TEG's final report states that under the Taxonomy Regulation there are two types of substantial contributing activities to the environmental objectives which could be considered as Taxonomy-aligned:

"1. Economic activities that make a substantial contribution based on their own performance: For example, an economic activity being performed in a way that is environmentally sustainable.

2. Enabling activities: Economic activities that, by provision of their products or services, enable a substantial contribution to be made in other activities. For example, an economic activity that manufactures a component that improves the environmental performance of another activity."[229]

First type of activities also called as "transitional", is economic activities for which low-carbon alternatives are not yet accessible, its GHG emission levels correspond to the best performance in the sector or

[227] ibid

[228] EU Technical Expert Group on Sustainable Finance. Taxonomy: Final report of the Technical Expert Group on Sustainable Finance (March 2020)

[229] EU Technical Expert Group on Sustainable Finance, op. cit., p. 14

industry, and they do not lead to a carbon lock-in or obstacle the development and deployment of low-carbon alternatives.[230]

While enabling activities should not lead to a lock-in of assets that threat long-term environmental goals and should have a substantial positive environmental impact through overall activity's lifecycle.[231]

In addition, under Article 20 of the Taxonomy Regulation was established a Platform on Sustainable Finance in order to advise the Commission on the TSC, analyse the TSC impact, assist the EC in developing and revising of the TSC and regularly monitor and report to the Commission on capital flows towards sustainable investment across the Union.[232] The Platform should be composed in a balanced manner including representatives from the European Environment Agency, the ESAs, the European Investment Bank, the European Investment Fund, and the European Union Agency for Fundamental Rights along with experts from civil society, private stakeholders, academic experts and experts with knowledge and experience in the field of the Taxonomy Regulation.[233]

Dialogue and close cooperation among a wide range of stakeholders from the public and private sector is crucial to achieve the aims of the EU Taxonomy Regulation and of the European green deal. The Platform on Sustainable Finance plays a key role in allowing such cooperation by bringing together the best expertise on sustainability.[234]

[230] Regulation (EU) 2020/852, op. cit.
[231] ibid
[232] ibid
[233] ibid
[234] EC website, https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en

3.3 TAXONOMY-RELATED DISCLOSURES & SFDR

There is already evidence in the Taxonomy Regulation title on its purpose to amend the SFDR. The recitals of the Taxonomy Regulation declare:

"The disclosure obligations laid down in this Regulation supplement the rules on sustainability-related disclosures laid down in Regulation (EU) 2019/2088 of the European Parliament and of the Council (6). To enhance transparency and to provide an objective point of comparison by financial market participants to end investors on the proportion of investments that fund environmentally sustainable economic activities, this Regulation supplements the rules on transparency in pre-contractual disclosures and in periodic reports laid down in Regulation (EU) 2019/2088. The definition of 'sustainable investment' in Regulation (EU) 2019/2088 includes investments in economic activities that contribute to an environmental objective which, amongst others, should include investments into 'environmentally sustainable economic activities' within the meaning of this Regulation. Moreover, Regulation (EU) 2019/2088 only considers an investment to be a sustainable investment if it does not significantly harm any environmental or social objective as set out in that Regulation."[235]

While the Taxonomy Regulation is primarily a classification tool, it has other functions. For instance, by amending the disclosure requirements in the EU Non-Financial Reporting Directive (NFRD) and the Sustainable Finance Disclosure Regulation (SFDR), it requires certain entities to disclose information concerning the degree of alignment of their activities with the Taxonomy Regulation.[236]

[235] Regulation (EU) 2020/852, op. cit., recital 19
[236] Regulation (EU) 2020/852, op. cit.

Article 8 of the Taxonomy Regulation is dedicated to transparency of undertakings in non-financial statements, amending the NFRD it requires the companies in scope of the NFRD to disclose how, and to what extent, its activities are associated with activities that are considered as environmentally sustainable. Article 8 of the Taxonomy Regulation states:

"In particular, non-financial undertakings shall disclose the following:

(a) the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9; and

(b) the proportion of their capital expenditure and the proportion of their operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9."[237]

Whilst SFDR scoped entities should disclose information on Taxonomy-alignment of their products. The disclosure obligation under the Taxonomy Regulation covers Article 9 SFDR products that have sustainable investment as their objective, and Article 8 SFDR products for those with environmental characteristics.

The Taxonomy disclosures regarding the SFDR are regulated by Article 5 and Article 6 of the Taxonomy Regulation, they cover how and to what extent the investments underlying the financial product are in

[237] Regulation (EU) 2020/852, op. cit., Art. 8

economic activities identified as environmentally sustainable under the Taxonomy Regulation.

Article 5 of the Taxonomy Regulation is dedicated to transparency of environmentally sustainable investments in pre-contractual disclosures and in periodic reports, and it declares:

"Where a financial product as referred to in Article 9(1), (2) or (3) of Regulation (EU) 2019/2088 invests in an economic activity that contributes to an environmental objective within the meaning of point (17) of Article 2 of that Regulation, the information to be disclosed in accordance with Articles 6(3) and 11(2) of that Regulation shall include the following:

(a) the information on the environmental objective or environmental objectives set out in Article 9 of this Regulation to which the investment underlying the financial product contributes; and

(b) a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 of this Regulation.

The description referred to in point (b) of the first subparagraph of this Article shall specify the proportion of investments in environmentally sustainable economic activities selected for the financial product, including details on the proportions of enabling and transitional

activities referred to in Article 16 and Article 10(2), respectively, as a percentage of all investments selected for the financial product."[238]

Article 6 of the Taxonomy Regulation is dedicated to transparency of financial products that promote environmental characteristics in pre-contractual disclosures and in periodic reports, therefore regarding Article 8 SFDR products, and it states:

"Where a financial product as referred to in Article 8(1) of Regulation (EU) 2019/2088 promotes environmental characteristics, Article 5 of this Regulation shall apply mutatis mutandis.

The information to be disclosed in accordance with Articles 6(3) and 11(2) of Regulation (EU) 2019/2088 shall be accompanied by the following statement:

'The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities.

The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.'."[239]

For other financial products (Article 6 SFDR) which do not consider the EU criteria for environmentally sustainable economic activities, the entity should make a standard disclaimer. Article 7 of the Taxonomy Regulation is dedicated to transparency of other financial products in pre-contractual disclosures and in periodic reports, and it states:

[238] Regulation (EU) 2020/852, op. cit., Art. 5
[239] Regulation (EU) 2020/852, op. cit., Art. 6

“Where a financial product is not subject to Article 8(1) or to Article 9(1), (2) or (3) of Regulation (EU) 2019/2088, the information to be disclosed in accordance with the provisions of sectoral legislation referred to in Articles 6(3) and 11(2) of that Regulation shall be accompanied by the following statement:

‘The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’.”[240]

Therefore, the Taxonomy Regulation requires financial market participants to provide the Taxonomy-related disclosures as part of existing pre-contractual and periodic disclosure obligations, and subsequently on their websites, within the broader requirement arising from Article 10 of the SFDR.[241]

According to the TEG’s recommendations, the Taxonomy-related disclosures is better to distinguish by the channel through which information is provided:

“Pre-contractual disclosures should focus on ex-ante information, including, but not limited to:

• the environmental objectives of the fund,46 including any Taxonomy-related targets (e.g., 20% of the fund invested in companies with >50% Taxonomy-aligned turnover, or with substantial Taxonomy-related capex);

[240] Regulation (EU) 2020/852, op. cit., Art. 7
[241] EU Technical Expert Group on Sustainable Finance, op. cit.

• how the Taxonomy will be used to achieve these objectives (e.g., portfolio construction or as the basis of engagement with companies).

Periodic reporting should focus on ex-post information, including, but not limited to:

• how the strategies have been implemented in practice; and

• a point-in-time calculation of the Taxonomy percentage."[242]

In addition, relating to the steps which a fund should take in order to evaluate Taxonomy alignment of the portfolio, the Commission confirmed in the Q&A that funds should disclose information on Taxonomy alignment only in the case they have reliable data.[243] In the light of the variety investment opportunities, it is not a precondition that the underlying investment itself is under an obligation to report Taxonomy-aligned information for the fund to report on Taxonomy alignment of that investment.[244] Therefore, in the case a financial market participant fails to collect reliable data regarding underlying investment contribution to environmental objective under the Taxonomy Regulation, it should indicate zero in the pre-contractual and periodic product related disclosures.[245]

[242] EU Technical Expert Group on Sustainable Finance, op. cit., p. 43

[243] ESMA. Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR) and 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 (EU Taxonomy Regulation (EU) 2020/852)

[244] ibid

[245] ibid

3.4 PRE-CONTRACTUAL PRODUCT DISCLOSURE

As it was previously mentioned in the Chapter 1, the SFDR level 2 RTS is presented by the Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports. According to the Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022:

"It is necessary to ensure comparability of the principal adverse impacts statement, the pre-contractual disclosures and the periodic disclosures required by Regulation (EU) 2019/2088, and to ensure that such information is easily comprehensible to end investors. It is therefore appropriate to set out standard templates for the presentation of that information. For the same reason, the templates should contain summary explanations of key terms used in those templates."[246]

Therefore, financial market participants should present pre-contractual disclosure information in the format of the template set out in Annex

[246] Commission Delegated Regulation (EU) 2022/1288, op. cit., recital 29

II and Annex III of the Commission Delegated Regulation (EU) 2022/1288.[247]

Pre-contractual disclosure requirements for products that promote environmental or social characteristics (Article 8 SFDR) are covered by Article 14 to Article 17 of the Commission Delegated Regulation (EU) 2022/1288 and should be disclosed through Annex II template.[248]

The template (Annex II) consists of the questions to which financial market participants should answer in order to comply with disclosure requirements settled by the Commission Delegated Regulation.

According to the template (Annex II), financial market participants are expected to disclose following:

- define the environmental and social characteristics promoted by the product and the sustainability indicators used to measure the attainment of those characteristics;
- confirm whether and how the principal adverse impacts (PAI) on sustainability indicators is considered;
- specify the investment strategy followed by the product, including the binding elements of the strategy to attain the environmental or social characteristics promoted by the product;
- indicate the policy used to assess good governance practices of the investee companies;
- define the asset allocation planned for the financial product, including the minimum proportion of investments to attain the promoted environmental or social characteristics, the purpose of the remaining proportion of the investments and information of any minimum environmental or social safeguards.[249]

[247] Commission Delegated Regulation (EU) 2022/1288, op. cit.
[248] ibid
[249] ibid

For financial products that promote environmental characteristics (Article 8 SFDR), sustainable investment information in the asset allocation section should provide:

“(…) in the section ‘To what minimum extent are sustainable investments with an environmental objective aligned with the EU Taxonomy?’ in the template set out in Annex II, all of the following:

(a) a graphical representation in the form of a pie chart of:

(i) the degree to which the aggregated investments are investments in environmentally sustainable economic activities, as calculated in accordance with Article 17(1) to (4) of this Regulation;

(ii) the degree to which the aggregated investments, excluding sovereign exposures, are investments in environmentally sustainable economic activities, as calculated in accordance with Article 17(5) of this Regulation;

(b) a description of the investments underlying the financial products that are in environmentally sustainable economic activities, including whether the compliance of those investments with the requirements laid down in Article 3 of Regulation (EU) 2020/852 will be subject to an assurance provided by one or more auditors or a review by one or more third parties and, if so, the name or the names of the auditor or third party;

(c) where the financial products invest in economic activities other than environmentally sustainable economic activities, a clear explanation of the reasons for doing so;

(d) where the financial products have sovereign exposures and the financial market participant cannot assess the extent to which those exposures contribute to environmentally sustainable economic

activities, a narrative explanation of the proportion in total investments of investments that consist of those exposures."[250]

Under Article 16 financial products that include a commitment in sustainable investments with a social objective should include in the asset allocation section information on the minimum share of those sustainable investments.[251]

Finally, Article 17 set out how to calculate the degree to which investments are in environmentally sustainable economic activities:

"The degree to which investments are in environmentally sustainable economic activities shall be calculated in accordance with the following formula:

$$\frac{market\ value\ of\ all\ investments\ of\ the\ financial\ product\ in\ environmentally\ sustainable\ economic\ activitie}{market\ value\ of\ all\ investments\ of\ the\ financial\ product}$$

where 'investments of the financial product in environmentally sustainable economic activities' shall be the sum of the market values of the following investments of the financial product (…)"[252]

Regarding the numerator calculation, distinct types of investments are considered in different ways. For instance, debt securities and equities of investee companies in which a proportion of activities of the investee company are Taxonomy-aligned should include in the numerator only the market value of that proportion of those debt securities or equities.[253] While for green bonds, the full market value of those bonds

[250] Commission Delegated Regulation (EU) 2022/1288, op. cit., Art. 15
[251] Commission Delegated Regulation (EU) 2022/1288, op. cit.
[252] Commission Delegated Regulation (EU) 2022/1288, op. cit., Art. 17
[253] ibid

should be included, as the proceeds must be used to finance Taxonomy-compliant projects or economic activities.

Pre-contractual disclosure requirements for products that have sustainable investment as objective (Article 9 SFDR) are covered by Article 18 and Article 19 of the Commission Delegated Regulation (EU) 2022/1288.[254]

Financial market participants should provide disclosure information in the format of the template (Annex III) of the Commission Delegated Regulation (EU) 2022/1288.[255]

Under the Annex III template, Article 9 SFDR products should disclose a similar information to that is mentioned above for Article 8 SFDR products, only with difference that Article 9 covers only the products with sustainable objective. Therefore, in the pre-contractual disclosures for Article 9 products should be defined the sustainable investment objective and if it is possible provide alignment of the objective with the list of six environmental objectives of the Taxonomy Regulation and any social objectives.[256]

3.5 PERIODIC PRODUCT DISCLOSURE

According to the Commission Delegated Regulation (EU) 2022/1288 recitals:

"With respect to the content of the periodic disclosures required by Article 11 of Regulation (EU) 2019/2088, financial market participants

[254] Commission Delegated Regulation (EU) 2022/1288, op. cit.
[255] ibid
[256] ibid

should disclose a minimum set of standardised and comparable quantitative and qualitative indicators that demonstrate how each financial product meets the environmental or social characteristics that it promotes or the sustainable investment objective that it aims to attain. Those indicators should be relevant to the design and investment strategy of the financial product as described in the pre-contractual information of the financial product. In particular, to ensure consistency between pre-contractual disclosures and periodic disclosures, financial market participants should report in their periodic disclosures on the specific sustainability indicators mentioned in the pre-contractual information and that are used to measure how the environmental or social characteristics are met or the sustainable investment objective is attained."[257]

Disclosure requirements for periodic reports regarding financial products that promote environmental or social characteristics are regulated by Article 50 to Article 57 of the Commission Delegated Regulation (EU) 2022/1288.[258]

Information should be presented in accordance with the template (Annex IV) settled by the Commission Delegated Regulation (EU) 2022/1288.[259]

Hence, according to the template (Annex IV), financial market participants should include in their annual reports following information:

- a representation of the extent to which environmental or social characteristics were attained, including information about the

[257] Commission Delegated Regulation (EU) 2022/1288, op. cit., recital 25
[258] Commission Delegated Regulation (EU) 2022/1288, op. cit.
[259] ibid

performance of the sustainability indicators and comparison to previous periods;

- a way in which sustainable investment was aligned with the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights;
- a way in which PAI on sustainability factors was considered;
- a list of the top investments of the financial product, i. e. the greatest proportion of the financial product investments during the reference period;
- an information on the asset allocation, demonstrating the proportion of investments that attained the environmental or social characteristics and proportion of other investments, including any related minimum environmental or social safeguards, and proportion of investments made in different sectors and sub-sectors, including fossil fuel sectors;
- a representation in the form of a bar chart of the extent to which sustainable investment with environmental objective aligned with the Taxonomy Regulation, including comparison to the previous periods, and share of investments in enabling and transitional activities;
- a share of sustainable investments with environmental objective but not in alignment with the Taxonomy Regulation and explanations why it is so;
- a share of sustainable investment with social characteristics;
- an information on actions taken to meet the environmental or social characteristics;
- a comparison the financial product performance to the reference benchmark.[260]

[260] ibid

Periodic disclosures for the products with sustainable investment objective (Article 9 SFDR) are presented in Article 58 to Article 63 of the Commission Delegated Regulation (EU) 2022/1288.[261]

The required information should be provided in the form of the template (Annex V) of the Commission Delegated Regulation (EU) 2022/1288. [262]

The Article 9 SFDR products in the Annex V template should disclose all the information mentioned above for Article 8 SFDR products, respecting the difference that Article 9 covers only the products with sustainable objective. Hence, in the periodic reports for Article 9 products should be defined the extent achieved by investment to achieve its sustainable objective and information on sustainability indicators used in order to measure it.

In addition, under Article 64 financial market participants should:

"(…) compare the period covered by the periodic report with periods covered by previous periodic reports and, subsequently, with every previous period covered by a periodic report up to at least the last five previous periods."[263]

Article 64 states that financial market participants should provide historical comparison for periodic reports either for Article 8 and Article 9 financial products concerning attainment of the environmental or social characteristics or of the sustainable investment objective promoted by the financial products along with description and share of Taxonomy-aligned investments.

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[261] ibid
[262] ibid
[263] Commission Delegated Regulation (EU) 2022/1288, op. cit., Art. 64

Regarding the extent achieved by financial product that promote environmental or social characteristics or has as objective sustainable investment according to Article 64, financial market participants should:

"(…) report on the performance of the sustainability indicators consistently over time, and shall provide all of the following information:

a) where quantitative disclosures are made, figures with a relative measure such as impact per euro invested;

(b) which indicators are subject to an assurance provided by an auditor or a review by a third party;

(c) the proportion of underlying assets of the financial product referred to in the section 'What was the proportion of sustainability-related investments?' in the template set out in Annex IV to this Regulation and in the section 'What was the proportion of sustainability-related investments?' in the template set out in Annex V."[264]

[264] Commission Delegated Regulation (EU) 2022/1288, op. cit., Art. 64

CHAPTER 4 CONCLUSION

The Paris Agreement is a milestone in humanity history which could change entire human being and bring society to the better economic models of resource usage permitting to reduce human adverse impact on the environment and to mitigate climate change threat.

Regardless some criticism of too ambitious goals set out by the Paris Agreement in human history there were already examples of successful achievements derived from international cooperations such as the Montreal Protocol on Substances that Deplete the Ozone Layer which was adopted in 1987 to protect the Earth's ozone layer from destroying chemicals. Due to countries' joint efforts on incremental and stable implementation of the Montreal Protocol, nowadays the ozone layer is projected to recover by the middle of the century.

After the adoption of the Paris Agreement the European Union declared an ambition to become a leader in the development of a more sustainable economy and to establish a benchmark for a global community presenting the EU Action Plan on Sustainable Finance.

The European sustainable finance strategy is a very comprehensive framework which includes a myriad initiatives, legislative acts and research conducted by the best experts in sustainability and finance fields.

According to the European Commission, the financial sector is crucial in achievement of the Paris Agreement goals and therefore to deliver that goals it is necessary to reorient private capitals towards sustainable investment. In doing so it is vital to define at legislative level what is sustainable investment, thereby the EC presented the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation.

The SFDR and the EU Taxonomy Regulation are important parts of that strategy, these two legislative pieces aim to prevent greenwashing, increase transparency for the end-investors, reduce information asymmetric in financial sector and harmonise rules across the Union.

Under the SFDR financial market participants are expected to disclose how they consider sustainability risks in their investment decision making process and how are evaluated principal adverse impacts of the investment. The disclosures should be provided at both, entity and product levels via information on the website, in pre-contractual documents and in periodic reports.

This thesis discussed fundamental premises of the SFDR introduction, an importance of the ESG factors, the SFDR level 1 and 2 disclosures, investment funds reaction to the new regulation and role of distinct expert groups helping the EC in development of the disclosure requirements.

In addition, in the Chapter 3 represented an analysis of a close interconnection between the SFDR and the EU Taxonomy Regulation and an analysis of key articles of the SFDR RTS with a stricter qualitative and quantitative information requirements for financial market participants.

At the end of the day, the SFDR and the Taxonomy Regulation represent just the EU first steps towards a more sustainable financial sector composition and obviously these regulations will be a subject for further amendments and development in the future basing on its practical application and effectiveness. However, the first steps mean that we are already on the path towards a more sustainable future.

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