European sustainable
investment regulation

A basic guide to understanding the new framework

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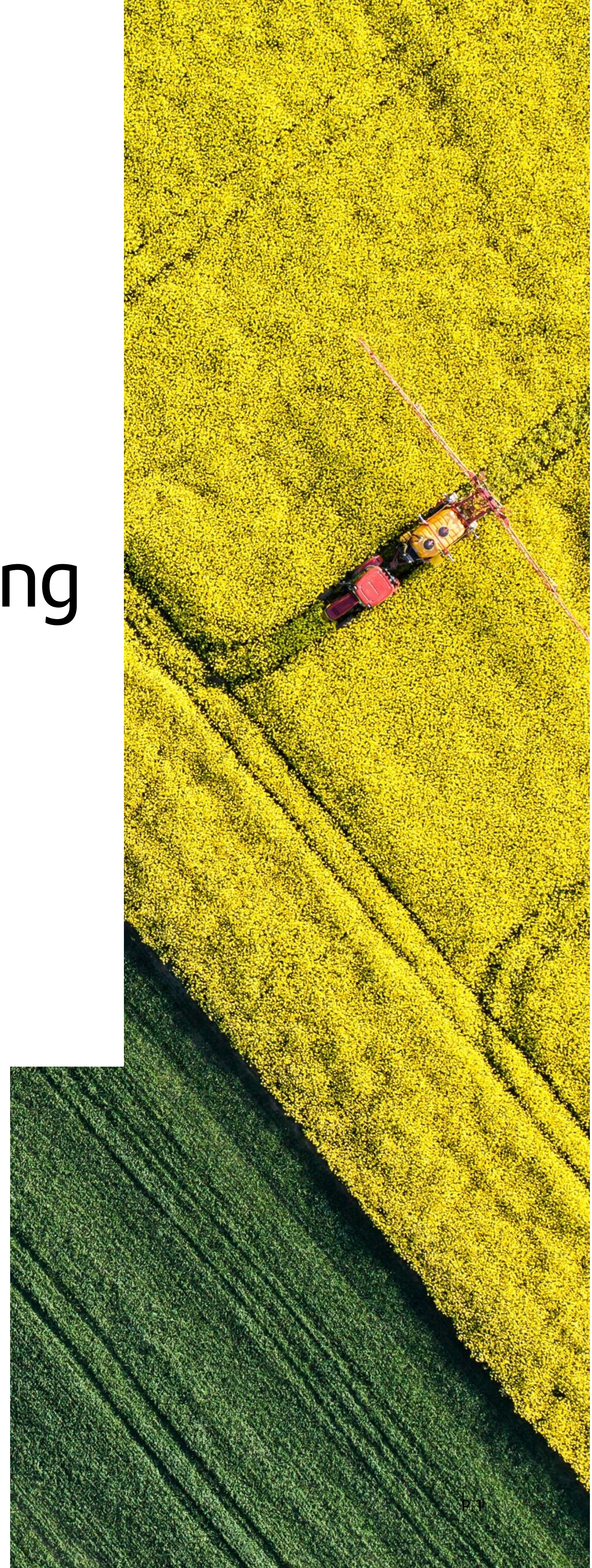

Content

1. Why the new regulation

The global sustainability agenda defined in the Sustainable Development Goals and the Paris Agreement aimed at tackling the problem of climate change have led the European Union to recognize the role of the financial sector as key to meeting these challenges.

Thus, the European Commission launched in 2018 its Sustainable Finance Action Plan, with the aim of:

- redirecting capital towards sustainable investment
- integrate sustainability into risk management
- promote transparency and long-term vision.

This plan has 10 lines of action, which are implying major transformations in the financial sector. Some of these lines of action have already been transformed into new regulations in force and others are still being developed, so that in the short and medium term we will continue to see progress in this sustainable regulatory framework.

2. What is SFDR?

The Sustainable Finance Disclosure Regulation (SFDR) stipulates for financial market participants[1] operating in Europe minimum disclosure requirements at entity level, in addition to other more specific requirements for products.

The first milestone in the implementation of this regulation was March 10, 2021, at which time entities have had to comply with level 1 disclosure requirements by publishing entity-level and product-level information, both on the web and in pre-contractual documentation.

The proposed implementation date for the level 2 text that develops this regulation (the Regulatory Technical Standards or RTS) is planned for January 2022, depending on the speed of the adoption process of this text. This level 2 will require providing more detail on principal adverse events, and additional information in the pre-contractual and periodic documentation for products listed as Article 8 or 9. This level of detail is defined in the templates developed in these RTS.

[1] Asset managers, financial advisors, investment companies and credit institutions that provide portfolio management, as well as some asset owners, are considered to be financial market participants.

3. What are the reporting obligations at the entity level?

Entities are required to publish on their website:

- Information on the sustainability risk integration policy.
- Information on the consistency of remuneration policies with the integration of sustainability risks.
- Statement on the consideration and due diligence mechanisms with respect to the principal adverse impacts (PAIs) of investment decisions on sustainability factors, showing how investments negatively affect indicators in relation to climate and environment and social and employee matters, respect for human rights, and anti-corruption and anti-bribery.

4. What are the product-level reporting obligations and what types of products does SFDR differentiate?

In addition to the information required at entity level, SFDR requires disclosure of product information, both in pre-contractual documentation and on the entity's own website.

The Regulation distinguishes 3 types of products:

- Article 8: financial products that promote environmental or social characteristics as part of the investment strategy.
- Article 9: products that have sustainable investment objectives.
- Article 6: other products.

For all of them, it is required to include in the pre-contractual information, an explanation on whether and how sustainability risks are integrated, as well as the consideration or not of the principal adverse impacts derived from the investments.

Furthermore, for Article 8 and 9 products, additional information must be provided on how the social or environmental characteristics are promoted in the first case, or how the sustainable objective is achieved in the second case. These products also carry a requirement for additional disclosures in the periodic reports.

5. What other regulation is relevant in this respect?

In parallel to SFDR the European Union has developed other related and complementary regulations. Some of the most relevant are:

- EU Taxonomy Regulation.

  It sets out the criteria for determining whether economic activities can be considered sustainable. Asset managers and other professional investors will be required to disclose the proportion of our investments that fund taxonomy-eligible activities.

  The taxonomy, which currently focuses on environmental issues, may be extended in the future to cover social issues. The application of the taxonomy for 2 of the 6 EU environmental objectives (climate adaptation and mitigation) is expected in January 2022 and will be applied to the other 4 objectives (water, circular economy, pollution prevention and biodiversity) in January 2023.

- Modification of the UCITS and AIFMD sector regulations.

  These modifications refer to the integration of sustainability in the organizational structure, investment processes (due diligence and investment selection), risk management and other internal controls of harmonized and alternative fund management companies.

- Modification of MiFID II and IDD sector regulations.

  This revision entails the consideration of clients' ESG preferences in suitability tests for investment advisory and portfolio management services. Clients' ESG preferences will determine the range of products recommended or included in their portfolios.

- SRD II: Shareholders' Rights Directive

  This directive aims to engage shareholders by encouraging them to participate more actively in corporate governance, promote long-term participation and establishes new transparency obligations for asset managers to communicate how they have exercised their voting rights or explain why they have not exercised them.

- Climate Benchmarks

  The Climate Benchmark Regulation aims to ensure greater clarity and transparency for investors by defining the minimum requirements for benchmarks to be categorized as low-carbon indices. It establishes two categories: EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks.

Asset Management