SPECTRUM

THE ‘R’ IN ESG

Can the New European Sustainability Reporting Regime prevent greenwashing?

Interview with Alpay Soytürk, Spectrum Markets’ Chief Regulatory Officer

ESG - Economic Social Governance - has developed from a buzzword to a multi-billion-dollar trend in investing. Investment managers across the globe are trying to pick securities based on the issuers’ compliance with ESG criteria. A new disclosure standard introduced by the European Union (EU) – the Sustainable Finance Disclosure Regulation (SFDR)[1] – is designed to not only make the lives of asset managers easier but to also inform the public and the end consumer about corporate behaviour in the relevant context. I interviewed Alpay Soytürk, our Chief Regulatory Officer, to find out about the framework, the criteria financial market participants use to define, measure and report on the sustainability of their economic activities and the relevant implementation timelines.

Alpay, what is the SFDR about and what is the link between the SFDR and ESG?

The SFDR is one cornerstone of the EU sustainable finance plan which, in turn, is part of the European Green Deal[2]. Defining sustainable finance, the EU describes the process of considering environmental, social and governance (ESG) criteria in long-term financial sector investments. ‘Environmental’ includes preservation of biodiversity, pollution prevention, recycling and everything that is appropriate to mitigate climate change. ‘Social’ refers to inequality issues, issues of inclusiveness or labour relations, investment in human capital and human rights issues. ‘Governance’ refers to issues – in both public and private institutions – related to management structures, employee relations, executive remuneration and so-on. Basically the incorporation of economic and social criteria into the corporate and management decision-making process. While these attributes are rather self-explanatory, they’re also difficult to measure and control. With the SFDR, the EU wants to significantly increase the transparency of market participants towards end-investors and apply an effective regime against greenwashing.

How can the SFDR achieve this?

The SFDR applies to all financial market participants and financial advisers. As a financial market participant, or, “FMP”, the SFDR defines entities that create investment products and advisers as those who provide investment or insurance advice.

The rules aim at creating a level playing field for FMPs and advisors by providing transparency regarding sustainability risks and adverse sustainability impacts. This means that they have to integrate sustainability risks into the risk policies of their product manufacturing, distribution or advice processes. They must describe how they identify and prioritise principal adverse sustainability impacts and what they intend to do if they come across those impacts. In this context, a Sustainability Risk means an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment. An Adverse Sustainability Impact is characterised as a negative, material or likely to be material effect on sustainability factors caused, compounded by or directly linked to investment decisions or advice. It’s a quasi-bidirectional mechanism where one question is whether your investment can suffer from sustainability risks and the other is whether your investment is suitable to harm sustainability goals...

...Well, paper doesn’t blush, right?

That’s a nice metaphor. But seriously, the aforementioned measures are just those to be implemented at management level and there is a ‘comply or explain’ mechanism that we already know from other EU regulations. Here, however, it applies slightly different. Complying obviously entails the full set of follow-up obligations. The “Explain” option normally refers to cases where a national competent authority intends to not comply with an EU rule; then having to explain to the ESMA[3] and the European Commission the reasons why it doesn’t. In this case it entails that a company must publicly announce, prominently on its website, the reasons for not considering the adverse impact of its investment decisions. If you think of the immense public interest in sustainability and the huge demand for ESG investment products, there will be hardly any asset manager or adviser wanting to be earmarked as non-compliant.

But I still don’t understand what prevents companies from, say, stretching the truth a bit?

On top of the obligations at management level there are significant disclosure obligations at product level. There are some disclosure requirements applicable irrespective of whether the product has an ESG focus or not and there are significant disclosure obligations if ESG is a factor, based on a staggered approach. This means, depending on whether the financial products offered promote environmental or social characteristics, whether they are products with the objective of sustainable investments or whether they are other financial products – where sustainability is not a key objective but where sustainability risks are also considered as a factor among others – there will be different disclosure consequences. Disclosures have to be made on the corporate website, as pre-contractual information in prospectuses and in periodic reports. Marketing material is also falling under the regime of the SFDR and an accompanying piece of regulation, the so called “Taxonomy Regulation”[4], is delivering clear criteria for determining what is environmentally sustainable or how an activity is in conflict or compliance with an environmental objective.

Can you give some more details on the SFDR product categories, please?

Let’s start with the category of products with no explicit ESG or sustainability focus. The comply-or-explain-mechanism is not just applicable at management level but on a product-by-product basis, too. That is, FMPs and advisors must formally decide for each product whether they will assess the impacts of sustainability risks on the return of that financial product. If they do, they must implement a methodology for the calculation and publish the results accordingly. If they don’t, they must provide explicit negative disclosures, precisely explaining why sustainability risks are not relevant for the returns of the given product.

The same logic is not just applicable to the question of whether you may lose money on your investment due to sustainability risks but, again, also to the question of whether it can harm sustainability goals. If a company had decided at management level that to implement a sustainability due diligence policy, it must also disclose if and how each product is considering the principal adverse impacts on sustainability factors.

If the company had opted for non-compliance, the explain mechanism applies with the obligation to line out that adverse impacts are not relevant for that product and why they are considered irrelevant. So that’s another link between the announcement of compliance and effectively proving it. Bear in mind that all of this is not yet including product categories with an explicit ESG focus.

If there is an explicit ESG focus of the product, it can fall under the category “other”, where sustainability risks are also considered as a factor among others; it can be “light-green”, where sustainable investment is the objective of the product and “dark-green”, if the product is promoting ESG objectives, as for example the reduction of carbon emissions. These three categories, covered by articles 7, 8 and 9 of the SFDR come with a more detailed and comprehensive mandatory schedule of website disclosure, information to be disclosed in prospectuses and PRIIPs[5]/KID[6] documents and periodic reports.

So, staying with the metaphors, the SFDR is not a toothless tiger?

No. In combination with the Taxonomy Regulation, the SFDR is an effective framework against greenwashing from a judicial standpoint. The fact that it applies to FMPs or advisers outside of the EU – which traditionally have a strong distribution focus on Europe – and, most importantly, end investors’ massive interest in these products will lead to strong supervisory scrutiny. During the Covid-19 pandemic, many rules have been temporarily relaxed or paused while implementation deadlines and phase-in schedules have been postponed. Level 1 of the SFDR, referring to disclosures at entity level and focusing on the identification and prioritisation of principal adverse sustainability impacts, came into force on 10 March 2021. The level 2 text, which includes rules governing binding website, pre-contractual and periodic reporting, has been postponed by another six months and will enter into force in June 2022. The phase-in of reporting of ‘Principal Adverse Impact’ (PAI) indicators is scheduled for June 2023. While this may sound like the remote future, this schedule does not allow a very long time for the full implementation of the SFDR. The fact that ESMA, in the context of ESG ratings, has warned of increased risks of greenwashing and has called for legislative action to counter these risks, is another strong indicator that ESG compliance will likely be a core supervisory focus in years to come.

Thank you very much!

1 Regulation (EU) 2019/2088, the “Sustainable Finance Disclosure Regulation”
2 A European Green Deal
3 The European Securities and Markets Authority
4 Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, the “Taxonomy Regulation”
5 Packaged Retail and Insurance-based Investment Products
6 Key Investor Document

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