

# GREEN DEAL

## Why ESG disclosure should be taken seriously



With the application of the Level 2 requirements of the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation's product disclosure rules approaching, the pressure is on for firms to ensure full compliance. We asked **Thibault Gobert, Spectrum Markets' Head of Liquidity Pool**, to provide a recap of the rules and comment on which other changes will be, or will become, relevant in relation to sustainability disclosure.

### Thibault, for those not familiar with the matter, can you please recap what the SFDR and the Taxonomy Regulation are about?

The SFDR<sup>1</sup> is a regulation that has been introduced to increase transparency for sustainable investment products in defining relevant disclosures. The Taxonomy Regulation<sup>2</sup> is a framework defining which economic activities count as environmentally sustainable. Together, they aim at avoiding the practice of providing false or misleading information about investment products' environmental soundness. It will also help investors to better identify eligible products when they're pursuing an investment strategy oriented towards ESG<sup>3</sup> criteria.

### They are both "phasing-in" regulations – to whom do they apply?

The Taxonomy Regulation already applies to all companies that are required to publish non-financial statements, i.e., large capital market-oriented corporations with more than five hundred employees. In 2023, the capital-market-orientation ceases to exist as a limiting factor for large companies and commercial partnerships equivalent to these companies will also be affected. Starting in 2026, the regulation will also apply to small and medium-sized capital market-oriented companies.

For the SFDR, Level 1 disclosures are also applicable. These comprise disclosures at entity level for Financial Market Participants (FMPs) and Financial Advisors. FMPs, according to the regulation, are insurance companies making available insurance-based investment products, investment firms providing portfolio management, occupational retirement provision institutions and manufacturers of pension products and fund managers or banks if they provide portfolio management services. Level 2 disclosure will become due on 1 January 2023.

### What are the disclosure obligations under both frameworks?

The Taxonomy Regulation classifies an economic activity as sustainable when it contributes to at least one of six defined environmental objectives and if it does no significant harm to any of the other objectives. These six objectives are climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems.

The disclosure obligations differ between those for financial and non-financial undertakings. In other words, there is an SFDR Taxonomy Disclosure and an NFRD<sup>4</sup> Taxonomy Disclosure for non-financial undertakings. Companies falling under the scope of the SFDR must disclose how Taxonomy-eligible or non-eligible their products are. This includes the disclosure for products that have environmental or social characteristics (Art. 8 SFDR) and that have sustainable investment as their objective (Art. 9 SFDR).

### Can you provide a bit more detail on SFDR disclosure?

Under the SFDR, firms must disclose how their investment decisions may potentially adversely impact sustainability factors including how they intend to mitigate these impacts. Vice versa, they need to disclose how an ESG event could negatively impact investments and align their remuneration policies with sustainability risk management. They have to establish policies to identify and prioritise Principal Adverse Impacts (PAI), describe these PAI and counter-actions including how they aim to prevent them in the first place.

On top of this entity-level disclosure, they have to provide disclosure at product level. This includes pre-contractual information, which will be familiar from MiFID<sup>5</sup>, is similar to the entity-level information for all products. For products according to articles 8 and 9 of the SFDR, additional information is required. This, in turn, includes periodic reporting obligations on the two Taxonomy goals as discussed above – e.g., how some ESG objectives are met on a benchmark comparison basis while there is no harm to other of the six ESG objectives. Furthermore, categorisation attributes of Art. 8 and Art. 9 products including their metrics and how they are monitored must be disclosed on the company website.

### Taxonomy Regulation and SFDR are EU-Regulations – isn't the European Union at risk of isolating itself and overregulating financial undertakings within the jurisdiction?

The financial sector's ESG footprint has, indeed, only minor impacts attributable to the maintenance of its operations – if we leave aside factors such as office buildings' energy consumption or the impact of employees commuting there. Through the process of investing, however, a significant impact is generated, and it is no secret that people are increasingly considerate of ESG factors. What's more, it would be wrong to imply that ESG regulation is a financial sector specific issue or that its reach would be regionally limited.

In that context, I would like to refer to the Corporate Sustainability Due Diligence Directive (CSDDD) or the Corporate Sustainability Reporting Directive (CSRD) that will encompass a very broad corporate universe. The CSDDD, in addition to defining tough new due diligence obligations for companies, stipulates clear responsibilities for their management and supervisory boards, too. And it will not just apply to around 13,000 companies based in the EU. Depending on where revenues are generated or where certain production or service processes are located, it also applies to around 4,000 companies from third countries<sup>6</sup>.

And it doesn't end there. In March of this year, the US Securities and Exchange Commission made a proposal<sup>7</sup> according to which climate-related disclosure shall become a mandatory reporting element for registered companies. So, my advice to the industry would be to no-longer look at ESG disclosure as either a means of marketing or an annoying chore, but to accept it as an integral part of corporate culture.

### Thank you very much!

<sup>1</sup> Regulation (EU) 2019/2088, the "Sustainable Finance Disclosure Regulation"

<sup>2</sup> Regulation (EU) 2020/852

<sup>3</sup> Environment, Social, Governance

<sup>4</sup> Non-Financial Reporting Directive

<sup>5</sup> Markets in Financial Instruments Directive

<sup>6</sup> According to estimates by the European Commission

<sup>7</sup> <https://www.sec.gov/news/press-release/2022-46>

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