cepAdhoc

25.06.2019

Disclosures on Sustainability

The new European Regulation for the financial services sector

Philipp Eckhardt, Anne-Carine Pierrat and Dr. Bert Van Roosebeke

© Shutterstock

On 27 March 2019, political agreement was reached regarding a new EU-Regulation on sustainability-related disclosures in the financial services sector. This cep**Adhoc** gives an overview of its main elements and assesses them.

- Financial market participants and advisers must inform potential investors on websites, in pre-contractual documents and in periodical reports on how they deal with sustainability risks and broader sustainability factors in investment decisions, advice and remuneration policies.
- The Regulation creates legal uncertainty: several disclosure rules are imprecise, making it unclear whether they only entail a general disclosure duty or effectively a duty for financial market participants to incorporate sustainability issues. Also, the definition of "sustainable investments" should be identical in both the Regulation and the – still to be adopted – Taxonomy Regulation.
- There is no convincing argument for obligatory disclosure rules as financial market participants and advisers have their own interest in disclosing information on sustainability if this matches investors' preferences. The Regulation obviously aims to exert soft pressure ("nudging"). This is paternalism and incompatible with the model of an empowered investor.

Philipp Eckhardt and Anne-Carine Pierrat are policy analysts at the financial markets department of cep.
Bert Van Roosebeke is head of the financial markets department of cep.
cep | Kaiser-Joseph-Straße 266 | 79098 Freiburg | Telefon 0761 38693-107 | cep@cep.eu | www.cep.eu

Table of Content

1 Introduction **3**

2 Scope **3**

2.1 Financial market participants 3

2.2 Financial advisers 4

3 Definitions **4**

3.1 Sustainability risks 4

3.2 Sustainability factors 4

3.3 Sustainable investments 4

4 Disclosures rules **5**

4.1 Disclosures on websites 5

4.1.1 Sustainability risks: Transparency on integration in investment decisions and advice 5

4.1.2 Sustainability risks: Transparency on integration in remuneration policies 5

4.1.3 Sustainability factors: Transparency on integration in investment decisions and advice 5

4.1.4 Sustainable investments and investments with environmental or social characteristics 6

4.2 Disclosures in pre-contractual documents 7

4.2.1 Sustainability risks 7

4.2.2 Sustainability factors 7

4.2.3 Sustainable investments and investments with environmental or social characteristics 8

4.3 Disclosures in periodical reports 8

5 Level 2 measures on disclosures **8**

6 Entry into force and application of the Disclosure Regulation **9**

7 Assessment **9**

1 Introduction

On 27 March 2019, the negotiators of the EU-Commission, the EU-Parliament and the Council reached an agreement regarding the Regulation on sustainability-related disclosures in the financial services sector (hereinafter: Disclosure Regulation).[1,2] The Disclosure Regulation is part of a wider sustainable finance agenda of the EU-Commission. In addition to the Disclosure Regulation, the EU-Commission proposed a Regulation on the establishment of a framework to facilitate sustainable investment ('Green taxonomy", COM (2018) 353, see cep**PolicyBrief** on the proposal of the Commission and cep**Adhoc** on the position of the European Parliament) and a Regulation on low carbon benchmarks and positive carbon impact benchmarks (COM (2018) 355). Furthermore, the Commission has recently published new guidelines on the disclosure of climate related, non-financial information by large public interest companies (see cep**Adhoc**). In June 2019, the technical expert group of the Commission is expected to issue a final recommendation regarding the EU Green Bond Standard (see cep**Input**). The Disclosure Regulation will apply probably as of the spring 2021.[3]

This cep**Adhoc** gives an overview of the main elements of the Disclosure Regulation. Section 2 deals with the scope of the Regulation. Section 3 looks at the definitions. Section 4 contains a summary of the new disclosure requirements for financial market participants and financial advisers, whether on their websites, in pre-contractual documents or in periodical reports. Section 5 deals with the empowerment of European Supervisory Authorities to draft level 2 measures. Section 6 sets out the specific dates for entry into force of the various provisions on disclosures and Section 7 provides an assessment of the new Disclosure Regulation.

2 Scope

The Disclosure Regulation applies to certain financial market participants (see 2.1) and financial advisers (see 2.2).[4]

2.1 Financial market participants

The Disclosure Regulation lists the "financial market participants" who have to disclose sustainability-related information. These are the following entities:[5]

- insurance companies offering insurance-based investment products (IBIPs);
- investment firms and credit institutions providing portfolio management;
- managers of alternative investment funds (AIFMs), undertakings for collective investment in transferable securities (UCITS), European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF);
- pension product manufacturers and providers of pan-European personal pension products (PEPP);
- institutions for occupational retirement provision (IORPs), except for small IORPs – i.e. those with less than 15 members, or with less than 100 members when a Member State decided not to apply the

[1] https://data.consilium.europa.eu/doc/document/ST-7571-2019-ADD-1/en/pdf

[2] According to the General Secretariat of the Council, the Disclosure Regulation "is expected to undergo the Corrigendum Procedure in the European Parliament" (Rule 231, EP Rules of Procedure) before it is adopted by the Council. [Information note, Files under the ordinary legislative procedure expected to undergo the Corrigendum Procedure in the European Parliament, General Secretariat of the Council, 8507/19, 2 May 2019.

[3] The Regulation has not been adopted yet. The exact application date depends upon the date of publication in the official journal of the European Commission.

[4] Art. 1, Disclosure Regulation.

[5] Art. 2 (a), Disclosure Regulation.

IORP-II-Directive to these IORPs.[6]

Furthermore, Member States may decide to apply the disclosure requirements to manufacturers of pension products, who operate national social security schemes.[7]

2.2 Financial advisers

The Disclosure Regulation lists the "financial advisers" who have to disclose sustainability-related information. These are the following entities:[8]

- insurance intermediaries and insurance companies providing insurance advice concerning IBIPs; and
- credit institutions, investment firms, AIFMs and UCITS management companies providing investment advice.

Insurance intermediaries that provide insurance advice concerning IBIPs and investment firms that provide investment advice are exempt from the Regulation if they have fewer than three employees. However, Member States may decide that the Regulation applies to them as well.[9]

3 Definitions

The Disclosure Regulation defines the crucial terms for sustainability-related disclosures by financial actors, i.e. "sustainability risks" (see 3.1), "sustainability factors" (see 3.2) and "sustainable investments" (see 3.3). While the Parliament and the Council introduced new definitions of "sustainability risks" and "sustainability factors", which the Commission had left undefined, they modified the Commission's definition of "sustainable investments".

3.1 Sustainability risks

According to the trialogue agreement, a "sustainability risk" is a potential "environmental, social or governance event or condition" which may potentially have a negative impact on an investment's value because of an "adverse sustainability impact".[10]

3.2 Sustainability factors

"Sustainability factors" are defined in the trialogue agreement as "environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters".[11]

3.3 Sustainable investments

"Sustainable investments" are investments in an economic activity which contribute to an environmental and/or a social objective. According to the Disclosure Regulation, environmental objectives can be measured by indicators of resource efficiency regarding the use of energy and renewable energy, or regarding the

[6] According to Article 5 of the Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs) ("IORP-II-Directive"), Member States can choose not to apply fully or partially this Directive to an IORP "registered or authorised in their territories which operates pension schemes which together have less than 100 members in total".

[7] Art. 9c, Disclosure Regulation.

[8] Art. 2 (ib), Disclosure Regulation.

[9] Art. 9d, Disclosure Regulation.

[10] Art. 2(t) Disclosure Regulation.

[11] Art. 2(v) Disclosure Regulation.

production of waste or greenhouse gas emissions. Social objectives may for example aim at combatting inequalities or investing in economically or socially disadvantaged communities.

In addition, to qualify as “sustainable”, investments must not harm any of the environmental and social objectives, and the investee company must respect good governance practices, e.g. regarding remuneration of staff or tax compliance.[12]

4 Disclosures rules

The Disclosure Regulation as agreed upon by the European Parliament and Council contains several provisions on sustainability-related disclosures. While some of the agreed rules are applicable for both financial market participants and financial advisers, others only apply to the former. Disclosures have to be made on the websites of the financial market participants or advisers (see 4.1), in their pre-contractual documents (see 4.2) and in periodical reports (see 4.3).

4.1 Disclosures on websites

4.1.1 Sustainability risks: Transparency on integration in investment decisions and advice

Financial market participants and financial advisers must publish on their websites information on their policies regarding the integration of “sustainability risks” in their investment decisions and advisory processes.[13]

The Disclosure Regulation does not directly introduce additional obligations for financial market participants and financial advisers to integrate sustainability risks. Instead, it makes clear that, when acting in the “best interest” of customers, financial market participants and advisers must consider both financial and sustainability risks that may have a negative impact on the financial return of an investment.[14]

4.1.2 Sustainability risks: Transparency on integration in remuneration policies

Financial market participants and financial advisers must publish information on their websites “on how their remuneration policies are consistent with the integration of sustainability risks”.[15] The aim of the Disclosure Regulation is not to change the existing material rules regarding remuneration but to make sure that the “structure of remuneration does not encourage excessive risk taking with respect to sustainability risks” and hence to “promote sound and effective risk management”.[16]

4.1.3 Sustainability factors: Transparency on integration in investment decisions and advice

Large financial market participants[17] must publish on their websites “a statement on due diligence policies” that explains how they take into account the negative effects of their investment decisions on “sustainability

[12] Art. 2(o) Disclosure Regulation.
[13] Art. 3 Disclosure Regulation.
[14] Recitals 3c and 3f Disclosure Regulation.
[15] Art. 3a Disclosure Regulation.
[16] Recital 4 Disclosure Regulation.
[17] Large financial market participants are those with more than 500 employees on average within a financial year, and those which are parent undertakings of large groups, where the parent has more than 500 employees on average within a financial year; a large group is a group where at least two of the three following criteria are fulfilled: (1) The balance sheet of the parent exceeds 20 000 000 euros, (2) the net turnover of the parent exceeds 40 000 000 euros, and (3) the group has more than 250 employees on average within a financial year.

factors" – so-called "principal adverse impacts" – such as environment, social and employee matters, respect for human rights, anti-corruption and bribery matters.[18] There is no direct obligation for financial market participants to take these effects into account, beyond the general duty to act in the customers' "best interest".[19]

The statement must include information on[20]

- how they identify and prioritise the negative effects on sustainability factors,
- the negative effects on sustainability factors,
- (planned) actions to address negative effects on sustainability factors,
- "where applicable", their engagement policies – this comprises information on "how they integrate shareholder engagement in their investment strategies" and, in particular, how "they monitor investee companies on relevant matters, including […] social and environmental impact"[21],
- "responsible business conduct codes and internationally recognised standards for due diligence and reporting and
- "where relevant", the degree of alignment with the "long-term global warming targets of the Paris Climate Agreement".[22]

The statement must take into account the "size, nature and scale" of the financial market participants' activities and the "type" of financial products they offer.[23]

"Smaller" financial market participants[24] as well as all financial advisers may[25]

- either publish the statement on due diligence policies that applies to large market participants explaining how they consider negative effects on sustainability factors;
- or explain why they do not consider negative effects on sustainability factors.

4.1.4 Sustainable investments and investments with environmental or social characteristics

The Disclosure Regulation distinguishes between financial products that[26]

- aim at "sustainable investments"[27] and those that
- promote "environmental or social characteristics".

Financial market participants offering either of the two types of financial products, must indicate on their websites which sustainable investment objective they want to pursue, or the "environmental or social

---

[18] Art. 3gamma (1–4), Recitals 4-a and 4---a Disclosure Regulation.

[19] Recital 3c Disclosure Regulation. According to Art. 3gamma (1) of the Disclosure Regulation, there is no direct obligation to consider sustainability factors ("principal adverse impacts"). However, Recital 3c leaves room for interpretation by including a duty for financial market participants to integrate these negative effects in their "due diligence processes": they "should integrate in their processes, including their due diligence processes, […] all relevant sustainability risks that may have a relevant material negative impact on the financial return of an investment".

[20] Art. 3gamma (2) Disclosure Regulation.

[21] Art 3g Directive 2007/36/EC.

[22] Art. 3gamma (2) (d) Disclosure Regulation.

[23] Art. 3gamma (1) (a) Disclosure Regulation.

[24] These are financial market participants with less than 500 employees, as opposed to the large financial market participants defined above (see footnote 18).

[25] Art. 3gamma (1–2 and 5) Disclosure Regulation.

[26] Recital 4a Disclosure Regulation.

[27] Financial products that aim at sustainable investments are those that have "a positive impact for the environment and the society [Recital 4a Disclosure Regulation].

characteristics" they want to promote with their products, as applicable.[28] Furthermore, they must provide information on the methodologies they use to measure and monitor the "impact of the sustainable investments" and the "environmental or social characteristics".[29]

Additionally, the information that financial market participants have to provide in pre-contractual documents (see Section 4.2) and in periodical reports (see Section 4.3) with regard to such financial products must be included on their websites.[30]

4.2 Disclosures in pre-contractual documents

4.2.1 Sustainability risks

Financial market participants and financial advisers must assess whether sustainability risks are relevant for the financial products they offer or advise on. Depending on the results of such assessment[31], but independent of the sustainability preferences of the end-investor, the following pre-contractual disclosure rules apply:[32]

- If they consider sustainability risks to be of relevance, financial market participants and financial advisers must indicate in their pre-contractual documents
  - how they integrate sustainability risks in their investment decisions or in their investment or insurance advice,
  - the likely impact that sustainability risks could have on the returns of the financial products they offer or advise on.
- If they consider sustainability risks to be of no relevance, they must explain in their pre-contractual disclosures why they think so.

Financial advisers should be able to use the pre-contractual disclosures of financial market participants for their own pre-contractual documents.[33]

4.2.2 Sustainability factors

For every financial product they offer, large[34] financial market participants must explain in the pre-contractual documents whether the product considers the negative effects of their investment decisions on sustainability factors ("principal adverse sustainability impacts"). Large financial market participants, who take those effects into account, [35] must explain how the financial product does this[36], and must do so in "qualitative or quantitative terms".[37]

Small financial market participants may apply the same regime as large financial market participants. However, they may also decide not to consider the negative effects on sustainability factors. In this case, they

---

[28] Art. 6 (1) (a) Disclosure Regulation.
[29] Art. 6 (1) (b) Disclosure Regulation.
[30] Art. 6(1) (c and d) Disclosure Regulation.
[31] Recital 3f Disclosure Regulation.
[32] Art. 4 Disclosure Regulation.
[33] Recital 3f Disclosure Regulation.
[34] The same definition as above applies.
[35] See footnote 17 on the inclusion in the Disclosure Regulation of an obligation to consider these effects.
[36] Art. 4gamma (1) (a) Disclosure Regulation.
[37] Recital 4---a Disclosure Regulation.

must state this in their pre-contractual documents and provide reasons.[38]

4.2.3 Sustainable investments and investments with environmental or social characteristics

Financial market participants who offer financial products which aim at "sustainable investments" and who have designated an index as a reference benchmark, must indicate in pre-contractual documents how that index aligns with the objective of the investments. Furthermore, they must explain why and how the index differs from a broad market index. If no index is used, they must declare "how that objective is attained".[39]

Financial market participants that offer financial products which "present […) the promotion" of "environmental or social characteristics" must indicate in pre-contractual documents how these characteristics are met. If they use an index as a reference benchmark to measure the efficacy of their financial products, they must indicate whether and how the relevant index is "consistent" with the promoted characteristics.[40]

If financial products aim at reducing carbon emissions, financial market participants must indicate how the reductions relate to the long-term global warming targets of the Paris Climate Agreement. To do so, they should refer to "EU Climate Transition Benchmarks" or "Paris-aligned Benchmarks", if these benchmarks are available.[41] If such benchmarks are not available, financial market participants must explain how they will contribute to the targets of the Paris Agreement.[42]

4.3 Disclosures in periodical reports

Financial market participants that offer financial products which aim at "sustainable investments", must publish information in periodical reports on[43]

- the "overall sustainability-related impact" of the products, using "relevant sustainability indicators" or
- if an index has been designated, the "overall sustainability related impact" of the products as compared with the designated index and a broad market index.

Financial market participants that offer financial products which promote "environmental or social characteristics" must publish information about "the extent" to which the characteristics are attained.[44]

5 Level 2 measures on disclosures

The Disclosure Regulation empowers the European Financial Supervisory Authorities (EIOPA, ESMA and EBA) to draft regulatory technical standards on several of the disclosure requirements dealt with above, which the Commission has to adopt.[45] The Regulation does not, however, empower the Commission to adopt even some of them.[46] The technical standards will specify inter alia, the content, methodologies and presentation of information regarding

[38] Art. 4gamma (2) Disclosure Regulation.
[39] Art. 5 (1 and 2) Disclosure Regulation.
[40] Art. 4a Disclosure Regulation.
[41] Recently, the European Parliament and the Council agreed to introduce two new categories of carbon benchmarks: "EU Climate Transition Benchmarks" or "Paris-aligned Benchmarks".
[42] Art. 5 (3) Disclosure Regulation.
[43] Art. 7 (2) Disclosure Regulation.
[44] Art. 7 (1) Disclosure Regulation.
[45] Art. 3gamma (6) and (7), Art. 4a (3), Art. 5 (5), Art. 6 (2), Art. 7 (4) Disclosure Regulation.
[46] see Art. 3gamma (6) and (7). We assume this is an unintentional omission, which will be corrected.

- negative effects on sustainability factors such as climate and the environment, as well as social, employee and human rights matters, and
- sustainable investments and investments with environmental or social characteristics.

6 Entry into force and application of the Disclosure Regulation

In general, the Disclosure Regulation on sustainability disclosures must apply 15 months after its entry into force, i.e. approx. by spring 2021.[47][48] However, for some provisions different application dates are set out:

- Mandatory disclosures on websites by large financial market participants regarding negative effects on sustainability factors only apply 18 months after entry into force of the Disclosure Regulation, i.e. approx. by summer of 2021.[49]
- Pre-contractual disclosures with regard to sustainability factors apply 36 months after entry into force, i.e. approx. by end 2022.[50]
- The new disclosures in periodical reports will not apply until the summer of 2021.

7 Assessment

Rules that force financial market participants and financial advisers to inform potential investors on whether and how they deal with sustainability risks and factors in their investment decisions and advisory processes often have no added value.

Financial market participants and advisers have their own interest in disclosing information on sustainability risks and factors if their potential investors care about sustainability effects. Not disclosing that information would lower their attractiveness in the respective markets. Rules that stipulate disclosure have no benefit in these cases. If investors have no interest in the sustainability effects of their investments, the forced disclosure only puts an administrative burden on financial market participants and advisers. Disclosure rules do not produce benefits here. On the contrary, they increase the costs of financial products.

Moreover, financial markets regulation already includes the duty for financial market participants and advisers to act in the best interest of their clients. Consequently, if sustainability risks may affect the financial performance of a financial product, they already have to be considered by market participants and advisers and the forced disclosure is of no additional value. The Disclosure Regulation indirectly assumes that taking account of sustainability is always in the best interest of investors as e.g. some market participants will have to explain why they do *not* consider negative effects of sustainability factors. However, investors might have good reason for not caring about sustainability risks, such as e.g. where they are only interested in investing with a short time horizon or if a "sustainable investment" involves higher risks or achieves lower returns than other investments.

In conclusion, there is no convincing argument for obligatory disclosure rules. The Disclosure Regulation obviously aims to exert soft pressure ("nudging") on investors towards sustainable investments. This is paternalism and incompatible with the model of an empowered investor.

What is more, the Disclosure Regulation stipulates a definition of "sustainable investment" which may be different from the definition to be laid down by the EU Regulation to facilitate sustainable investments

---

[47] The Regulation has not been adopted by the Council yet. This will probably happen until the end of 2019.
[48] Art. 12 Disclosure Regulation.
[49] Art. 3gamma (3 and 4) Disclosure Regulation.
[50] Art. 4gamma (1) Disclosure Regulation.

["Green taxonomy", COM(2018) 353, see cep**PolicyBrief** and cep**Adhoc**] which is still to be agreed upon by the Parliament and the Council. Two different definitions of one and the same concept will create legal uncertainty and make it difficult for market participants to apply the Disclosure Regulation in a future-proof manner. Therefore, the definition of "sustainable investment" in the Disclosure Regulation should be linked to the one in the Regulation on the green taxonomy.

Furthermore, the Disclosure Regulation contains several provisions, which can be interpreted in different ways. First, it is often not clear, whether the duty to disclose information on the integration of sustainability risks and factors and to act in the best interest of investors in effect goes so far as to oblige financial market participants and advisers to take these risks and factors into account (see part 4.1.1 and 4.1.3).

The Disclosure Regulation empowers the EBA, EIOPA and ESMA to develop regulatory technical standards that specify the sustainability indicators regarding negative impacts on environmental, social and governance (ESG) factors, but the delegation of power from the European Parliament and the Council to the Commission to adopt these standards is lacking (see Part 5). The legislator should correct this.[51]

Initially, the Commission wanted to substantially change the IORP II Directive [(EU) 2016/2341] and force institutions for occupational retirement provision (IORPs) to take ESG considerations into account. Concretely, the Commission proposed that it be empowered to adopt delegated acts which specify that IORPs must inter alia consider environmental, social and governance factors in investment decisions and risk management processes.[52,53] It is to be welcomed that the Disclosure Regulation as agreed now by the co-legislators does not contain such a delegation of powers to the Commission, which would have raised the question of incompatibility with EU law[54].

[51] Before the regulation enters into force, the legislator should try to fix those flaws. This should be done, if possible, by using the expected corrigenda procedure (see also footnote 2).

[52] The Commission proposed that it may adopt delegated acts specifying that IORPs must consider environmental, social, and governance factors in investment decisions and risk management processes, and take the "prudent person rule" into account, when they consider environmental, social, and governance risks [Art.10 (1) of the proposed Regulation COM (2018) 354].

[53] See cep**Adhoc** on the trilogue negotiations of the Disclosure Regulation, p. 5

[54] See cep**Adhoc** on the trilogue negotiations of Disclosure Regulation, p. 7