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cep**Adhoc**

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The Sustainability Disclosure Regulation

The Commission's proposal and the issues at stake in the negotiations between the European Parliament and the Council

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In May 2018, the European Commission proposed a Regulation on disclosures relating to sustainable investments and sustainability risks. This cep**Adhoc** briefly summarises and assesses the Commission's proposal. Furthermore, it gives an overview of the positions of the European Parliament and the Council with regard to the main issues at stake for the next trilogue meetings in the coming days and weeks.

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1 Introduction

In May 2018, the European Commission proposed a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 [COM(2018) 354]. The new rules that are about to force certain financial market participants and financial advisors to systematically take into consideration "sustainability risks" in their investment decisions, advice offerings and disclosure processes. In the meantime, both the European Parliament (EP) on November 9, 2018 and the Council on December 17, 2018 adopted their respective position on the proposal. Since then, trilogue negotiations are ongoing. It is likely that negotiations will be finalised on time in order to adopt the Regulation in an European Parliament plenary session before the European elections due in May 2019.

This cep**Adhoc** consists of two parts. The first part deals with the Commission's original proposal from May 2018. It briefly summarises and assesses the proposal from an economic and legal point of view. The second part gives an overview of the positions of the European Parliament and the Council with regard to the Regulation and the main issues at stake for the next trilogue meetings.

2 The Commission's original Proposal

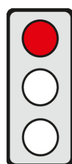
2.1 Executive Summary

KEY ISSUES

Objective of the Regulation: The Regulation introduces disclosure rules on environmental, social and governance (ESG) factors to direct more financial resources towards sustainable investments.

Affected parties: Financial market participants, especially investors and financial advisors

Pro: –



Contra: (1) Financial market participants and financial advisors should not be obliged to inform investors on sustainability factors in their investment decisions and advisory processes.

(2) An objective definition of sustainability does not exist. Law makers are not better equipped than market participants to define what a sustainable investment is.

(3) Financial market participants and financial advisors should not be forced to disclose whether their remuneration policies are in accordance with sustainability considerations. This distorts competition.

(4) The integration of ESG considerations in the investment decisions of institutions for occupational retirement provisions is substantial and may, therefore, not be prescribed by the Commission but only by the legislator.

2.2 Brief Summary

- **Context and objectives**
  - According to the Commission, an "additional annual investment of 180 billion euro" is necessary to meet the European Union's climate and energy targets by 2030 [p. 2].
  - Financial market participants and financial advisors are obliged under EU law to act "in the best interest" of their end-investors, beneficiaries and clients. However, they do not systematically take into consideration "sustainability risks" in their investment decisions, advice offerings and disclosure processes. [p. 2 and 3]
  - The Regulation introduces harmonised transparency rules regarding the consideration of sustainability factors. It is addressed to "financial market participants" and "financial advisors". [Art. 1]
- **Definitions**
  - "Financial markets participants" are [Art. 2 (a)]
    - managers of the following investment funds harmonised at EU-level: alternative investment funds (AIF), undertakings for collective investment in transferable securities (UCITS), venture capital funds (EuVECA) and social entrepreneurship funds (EuSEF) [Art. 2 (d), (i), (k), (m)],
    - insurance companies that offer insurance-based investment products (IBIPs), i.e. products which offer a maturity or surrender value which is exposed to market fluctuations [Art. 2 (c)],
    - investment firms that provide portfolio management [Art. 2 (e), (f)],
    - institutions for occupational retirement provision (IORPs), i.e. institutions which provide retirement benefits based on agreements between employers and employees [Art. 2 (g), (l)],
    - providers of pension products [Art. 2 (h)].
  - "Financial advisors" are
    - insurance intermediaries that provide insurance advice with regard to IBIP [Art. 2 (r), (s), (c)] and
    - investment firms that provide investment advice [Art. 2 (e), (n)].
  - "Sustainable investments" are investments in [Art. 2 (o)]:
    - economic activities that contribute to
      - "an environmental objective", including investments labelled as "environmentally sustainable" according to the proposed regulation on a green taxonomy [COM(2018) 353, see cep**PolicyBrief**] or
      - "a social objective", in particular "tackling inequality" or "fostering social cohesion";
    - companies with "good governance practices", e.g. "sound remuneration of relevant staff and tax compliance".
- **Pre-contractual disclosures**
  - Financial market participants and financial advisors shall, within pre-contractual disclosures, inform potential investors about [Art. 4 (1) and (2)]
    - the "procedures and conditions" that they apply to integrate "sustainability risks" in their investment decisions or investment or insurance advice,
    - the impact they expect "sustainability risks" to have on the returns of the products they offer or advise on, and
    - "how their remuneration policy is consistent" with the integration of "sustainability risks" and, if relevant, with the "sustainable investment target" of the financial products they offer or advise on.
  - When a financial product targets "sustainable investments or investments with similar characteristics", financial market participants shall inform potential investors
    - if an index is used as a reference benchmark to measure the sustainability of the financial product,
      - how the index is aligned with the target and
      - why the "weighting and constituents" of the index differ from a broad market index [Art. 5 (1)],
    - if no index is used as a reference benchmark, how the target is reached [Art. 5 (2)].
  - When a financial product targets a reduction in carbon emissions, financial market participants shall inform potential investors [Art. 5 (3)]
    - about the targeted aim of reduction of carbon emissions and

- with a "detailed explanation", how the efforts to reduce emissions can be ensured if the "EU low carbon benchmark" or the "positive carbon impact benchmark" [cf. COM(2018) 355, see cep**PolicyBrief**] are not available.
– When a financial product targets sustainable investments or a reduction in carbon emissions, financial market participants shall also inform potential investors about the calculation methodology of the indexes and benchmarks [Art. 5 (4)].

► **Disclosures on websites**
– Financial market participants and financial advisors shall publish "written policies" on their websites explaining how they integrate "sustainability risks" in their investment decisions and advisory processes [Art. 3].
– For financial products that aim at sustainable or "similar" investments or carbon emission reductions, financial market participants shall inform on their websites about [Art. 6]
  - the sustainable investment target,
  - the methodologies and data used to "assess, measure and monitor" the impact of the sustainable investments,
  - the information included in pre-contractual disclosures and periodical reports.
– Financial market participants and financial advisors shall keep the information on their websites up-to-date and shall explain all changes made [Art. 8 (1)].

► **Disclosures in periodical reports**
– For financial products that aim at sustainable or "similar" investments or carbon emission reductions, financial market participants shall inform in periodical reports about [Art. 7 (1)]
  - the "overall sustainability related impact" of the products, by using "relevant sustainability indicators", and
  - the impact of the products by comparing the index used as a reference benchmark with a "broad market index".

► **Marketing communications**
Marketing communications by financial market participants and advisors must not contradict information that has been disclosed pre-contractually on websites and in periodical reports according to this Regulation [Art. 9 (1)].

► **Changes in the IORP-II-Directive**
– The existing IORP-II-Directive [(EU) 2016/2341] stipulates that investments by IORPs must follow the "prudent person" rule, meaning among others that IORPs must invest "in the best long-term interests of members and beneficiaries as a whole". Also, Member States must "allow" IORPs to take into account the "potential long-term impact of investment decisions on environmental, social, and governance factors" ('ESG factors'). [Art. 19 (1), IORP II-Directive]
– In future, the Commission may adopt delegated acts specifying that institutions for occupational retirement provisions (IORPs) shall [Art.10 (1)]
  - 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.

► **Tasks for the European Supervisory Authorities EBA, EIOPA and ESMA**
– The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) shall develop regulatory technical standards on the presentation and content of
  - those pre-contractual disclosures, that are specifically necessary if a product targets sustainable investments or a reduction in carbon emissions [Art. 5 (5)],
  - the website disclosures on the sustainable investment target and the methodologies and data that are used to "assess, measure and monitor" the impact of the investments [Art. 6 (2)], and
  - the periodical reporting disclosures [Art. 7 (4)].

– EBA, EIOPA and ESMA shall develop implementing technical standards on the "standard presentation of information on sustainable investments" within marketing communications [Art. 9 (2)].

Policy Context

In May 2018 the Commission proposed a Regulation on a taxonomy for sustainable investments [COM(2018) 353, see cep**PolicyBrief**] and on one on sustainable benchmarks [COM (2018) 355, see cep**PolicyBrief**]. Also, it proposed amendments to delegated acts to better include ESG considerations into the advice that investment firms and insurance distributors offer to clients.

Statement on Subsidiarity by the Commission

According to the Commission, the identified problems are not limited to one Member State. Thus a coordinated approach is required.

2.3 Procedures & Formalities

Legislative Procedure

24.05.2018	Adoption by the Commission
09.11.2018	Adoption by the Committee on Economic and Monetary Affairs
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA)
Committees of the European Parliament:	Economic and Monetary Affairs (leading), Rapporteur Paul Tang (S&D, NL)
Federal Germany Ministries:	Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Regulation: Art. 114 TFEU (Internal Market)
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

2.4 Assessment

2.4.1 Economic Impact Assessment

Financial market participants and financial advisors should not generally **be obliged to inform** potential **investors on** whether and how they deal with **sustainability factors in their investment decisions and advisory processes.**

Firstly, if investors have no interest in sustainability factors, obligatory sustainability disclosures put administrative burden, i.e. costs, on financial market participants and financial advisors without producing any benefits. **If**, on the other hand, **investors** do **care about sustainability factors, financial market participants and advisors have a self-interest in disclosing information on sustainability factors** in order to remain competitive in their respective markets.

Secondly, the Commission indirectly assumes that taking account of sustainability risks is in the best interest of investors. However, this might not be the case. Investors might have good reasons – e.g. they might be of an advanced age – to invest with a short time horizon. Also, sustainable investments may incorporate higher

risks or achieve lower returns than other investments.

Thirdly, the disclosure obligations are supposed to rest on legal definitions of sustainability [COM(2018) 353, see cep**PolicyBrief** on the green taxonomy]. **An objective definition of sustainability**, however, **does not**, and cannot, **exist. Law makers are not better equipped than market participants to define what a sustainable investment is** and what is not.

All in all, there is no convincing argument for obligatory disclosure rules. The true aim of the regulation seems to be to exert soft pressure ("nudging") on investors towards sustainable investments. This is patronising and incompatible with the model of an empowered investor.

In addition, the proposed Regulation has several flaws. Firstly, financial markets participants and financial advisors might have difficulties in disclosing the correct information about their sustainability policies, as essential terms such as "sustainability risks" or "sustainable or similar investments" are not at all or not adequately defined. This gives room for regulatory uncertainty and liability risks.

Secondly, the impact of "sustainability risks" on the return of financial products is often hard to assess and to quantify. The impact assessment that financial market participants and financial advisors have to offer in pre-contractual disclosures may well be arbitrary and leave investors with false or misleading information.

Thirdly, **financial market participants and financial advisors should not be forced to disclose** in pre-contractual documents about **whether their remuneration policies are in accordance with sustainability considerations.** Not only is it unclear what "sustainability" may mean. Such a requirement also constitutes a major and unacceptable intervention in the freedom of contract as not all investors attach the same relevance to "sustainability" considerations. Furthermore, this rule may induce financial market participants to increase their investments in "sustainable" products and induce financial advisors to recommend "sustainable" products as compared to other products. **This distorts competition** on a general scale as it leads to higher financing costs for "non-sustainable" activities. Also such remuneration may stand in conflict with other important dimensions often addressed by remuneration policies, such as risk considerations.

2.4.2 Legal Assessment

Legislative Competence

The Regulation is correctly based on the internal market competence (Art. 114 TFEU).

Subsidiarity and Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

The authorisation of the Commission to adopt delegated acts that ensure the incorporation of ESG factors in the investment decisions of institutions for occupational retirement provisions (IORPs) is incompatible with other provisions of the IORP II Directive, which do not oblige IORPs to consider these factors. The introduction of such an obligation therefore constitutes a material change in the level I act. **The integration of ESG considerations in the investment decisions of IORPs is substantial and may, therefore, not be prescribed by the Commission** by way of delegated acts (Art. 290 TFEU), **but only by the legislator** through an amendment to the material rules of the directive.

It is unclear why technical standards on "the standard presentation of information on sustainable investments" relating to marketing communications are necessary and how they relate to the requirement for marketing communications to be consistent with information disclosed. The empowerment of ESAs to develop such technical standards should therefore be reassessed.

2.4.3 Alternative Approach

Law makers are currently discussing the establishment of an EU-Taxonomy on sustainable investments [COM(2018) 353, see cep**PolicyBrief**]. This taxonomy is de facto a public label for "sustainable financial investments". In case they reach an agreement on the taxonomy, the sustainability disclosure rules of this regulation should apply only to financial market participants and financial advisors who wish to use this label for their marketing or distributing sustainable financial products.

2.4.4 Conclusion

Financial market participants and financial advisors should not be obliged to inform investors on sustainability factors in their investment decisions and advisory processes. If investors care about sustainability factors, financial market participants and advisors have a self-interest in disclosing information on sustainability factors. An objective definition of sustainability does not exist. Law makers are not better equipped than market participants to define what a sustainable investment is. Financial market participants and financial advisors should not be forced to disclose whether their remuneration policies are in accordance with sustainability considerations. This distorts competition. The integration of ESG considerations by IORPs in the investment decisions of IORPs is substantial and may, therefore, not be prescribed by the Commission, but only by the legislator.

3 Crucial points in the ongoing trilogue

3.1 Scope

In general, the Commission proposed to apply the Regulation to a wide range of financial market players and financial advisors. Both the EP and the Council want to extend the scope:

- The EP and the Council want to add banks to the scope of the Regulation. While the EP wants to include those that provide investment or credit risk-management processes, the Council refers to banks providing portfolio management.
- Additionally, the Council also claims that insurances that provide advice with regard to insurance-based investment products as well as banks and investment funds (UCITS and AIF) that provide investment advice should be seen as "financial advisors" and thus fall within the scope of the Regulation.
- Furthermore, the Council wants to give Member States the right to apply the Regulation also to manufacturers of pension products that operate national social security schemes.

3.2 Exemptions to the scope

Both EP and Council want to exclude selected actors from the scope of the Regulation:

- The EP wants to exempt both small and non-complex banks and small and non-interconnected investment firms from the disclosure rules of the Regulation.
- The Council wants to exempt institutions for occupational pension provision (IORP) that have less than 15 beneficiaries. Additionally, if Member States have decided to exempt IORPs with less than 100 beneficiaries from the scope of the IORP-II-Directive, those IORP should also not fall under the scope of the Regulation.
- The Council also wants insurance intermediaries and investment firms that provide investment advice and have less than three employees to be exempted from the scope. However, Member States may nevertheless choose to insert them so that the Regulation applies to them.

3.3 Definition of sustainable investments and sustainability risks

The Commission introduced a definition of "sustainable investments" in the Regulation stating that these are investments in "economic activities" that contribute to an environmental or a social objective and investments in companies with good governance practices:

- While the Commission's proposal includes a reference to the Regulation on a framework to facilitate sustainable investments (COM (2018) 353) for a precise definition what environmental friendly investments entail, both EP and Council want this to be decided within the disclosure Regulation and thus deletes the reference.
- The Council does not stick to the point that investments must necessarily be in "economic activities" and thus deleted the two words.
- The Council deletes investments in companies with good governance practices from the definition of "sustainable investments" leaving only environmental and social ones. However, it introduces a rule stating that all environmental and/or social investments in companies must be in companies with good governance practices.
- The Council claims that environmentally sustainable investments should only be investments that contribute to environmental objectives "as measured by key resource efficiency indicators", e.g. on energy use and greenhouse gas emissions. The EP's definition of environmentally sustainable investments is near to identical to that of the Council, referring however to CO_2 emissions instead of greenhouse gas emissions (Council) as an indicator.
- The EP adds that sustainable "economic activities" do not only have to contribute to an environmental or a social objective, but have to do so "substantially". Instead of "investments in companies with good governance practices", sustainable investments should only "promote or support good governance practices in companies".
- Both EP and Council demand that each investment that follows one of the three (ESG for the EP) respectively two (ES for the Council) objectives should not substantially (EP) / not significantly (Council) harm the respective other objectives.

The Commission did not clearly define "sustainability risks" within its proposal, although referring to it several times. Both EP and Council introduce a definition of "sustainability risks". However, their suggestions for a definition differ:

- "Sustainability risks" in EP's view are "financial or non-financial risks, material or likely to be materialised, linked to environmental, social and governance risks and factors, where material for a particular investment approach". "Sustainability risks" in Council's view are "an uncertain environmental, social or governance event or condition that, if it occurs, could cause a material negative relevant impact on the value of the investment".

3.4 Financial products affected by disclosure duties

The Commission introduced several rules to oblige financial market participants and advisors to publish information in relation to "sustainable investments". The Commission targets financial products that aim at "sustainable investments or investments with similar characteristics". For these financial products only, information must be disclosed in certain pre-contractual disclosures, on websites and in periodical reports.

- The EP wants to broaden the scope of these disclosure obligations to all financial products put on the market and not only to the ones aiming at sustainable or "similar" investments.

- The Council sticks to the Commission's proposal and targets financial products having as their objective (the redefined) sustainable investments, but deletes the notion of "investments with similar characteristics".
- The Council also adds disclosure obligations on financial products promoting "environmental or social characteristics" in pre-contractual disclosures, on websites and in periodical reports.

3.5 Remuneration

The Commission proposed that financial market participants and advisors shall, within pre-contractual disclosures, inform investors about "how their remuneration policy is consistent" with the integration of "sustainability risks" and, if relevant, with the "sustainable investment target" of the financial products they offer or advise on:

- The Council deletes the requirement. Instead, it demands financial market players and advisors to only inform investors about "how their remuneration policy is consistent" with the integration of "sustainability risks" on their websites. These transparency requirements shall be included in existing sectoral remuneration rules applicable to the different players.
- The EP keeps the requirement, but adds some specifications.

3.6 Due diligence

The Commission wanted financial market participants and advisors to publish written policies on the integration of sustainability risks, and to inform potential investors on the procedures and conditions applied to integrate sustainability risks in their investment decisions as well in investment or insurance advice:

- The EP wants financial market participants and advisors to have in place "due diligence policies" to assess sustainability risks, and to report these policies yearly to competent authorities. The notion of "due diligence" means that they should act with "reasonable care and investigation".
- The EP also introduces the notion of „due diligence" with regard to the integration of sustainability risks in pre-contractual disclosures, i.e. financial market participants and advisors shall inform on "the due diligence procedures and conditions" to integrate sustainability risks.
- The Council does not significantly alter the approach of the Commission and does not add any "due diligence" rules.

3.7 Sustainability performance

The Commission did not propose disclosure rules with respect to the "sustainability performance" of an investment:

- The EP wants financial market participants and advisors to disclose information also on the "sustainability performance" of investments. This added "sustainability performance" dimension concerns the consistency of a financial product with ESG factors or risks, based on sustainability indicators.

3.9 Amendments to IORP II Directive

The Commission proposed changes to the IORP II Directive allowing the Commission to adopt delegated acts to ensure that IORPs consider ESG-factors in investment decisions and risk management, while at the same time applying the prudent person rule:

- The Council removed these amendments to the IORP II Directive and added an article stating that IORPs and insurance intermediaries shall disclose information on the integration of sustainability risks, on the promotion of environmental or social characteristics and on sustainable investments on their websites.
- The EP made no changes to the proposals of the Commission.