

EU Action Plan on Sustainable Finance – New Sustainability-related Disclosures in the Financial Services Sector

Executive Summary

- From **March 2021** on, financial market participants and financial advisers will be subject to new, **sustainability-related transparency requirements**, which include certain disclosure obligations on websites and in pre-contractual information.
- Transparency requirements with regard to “adverse sustainability impacts” apply on two levels: to the **company** and **the respective financial product** it is offering.
- The *EU Action Plan on Sustainable Finance* includes definitions of **central terms**, including among others “**sustainable investments**” and “**sustainability risks**”.
- The draft **Taxonomy Regulation** is going to make some initial changes to the Disclosure Regulation. In particular, the **investor guidance** is being added regarding the consideration of sustainability factors and risks in pre-contractual information and regular reports.
- In mid-April 2020, the ESAs (European Supervisory Authorities) published a Joint Consultation Paper with a **draft of Regulatory Technical Standards (RTS) specifying the disclosure requirements of the Disclosure Regulation in more detail**.

In May 2018, the EU Commission published its *EU Action Plan on Sustainable Finance (“Action Plan”)* – a set of measures comprising on Level 1 the so-called “**Disclosure Regulation**”¹ as well as changes to the Benchmark Directive² and the so-called “Taxonomy Regulation”³ that is yet to be passed into law.

The Disclosure Regulation was published in the Official Journal of the European Union at the beginning of December 2019 and entered into force as of 29 December 2019. The concerned market participants must fulfil the transparency requirements starting 10 March 2021.

The European Supervisory Authorities are developing comprehensive Level 2 measures, such as legislation specifying the individual transparency requirements, until 30 December 2020. In mid-April 2020, the ESAs published a first Joint Consultation Paper on the specification of ESG disclosure obligations under the Disclosure Regulation.

¹ Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (“**Disclosure Regulation**”).

² Regulation (EU) amending Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (“**Benchmark Regulation**”).

³ Cf. 2018/0178/COD, Proposal for a Regulation of the European Parliament and of the Council establishing a framework for facilitating sustainable investment and amending Regulation (EU) 2019/2088, Council position at 1st reading of 16 April 2020 (“**Taxonomy Regulation**”).



1. Who does the Disclosure Regulation apply to?

The Disclosure Regulation distinguishes between “**financial market participants**” (Art. 2(1)⁴) and “**financial advisers**” (Art. 2(11)) (jointly referred to here as “**market participants**”). The definition for “financial market participants” includes credit institutions and investment firms that provide portfolio management as well as capital management companies. The term “financial advisers” includes market participants offering the investment service of investment advice.

Thus, the Regulation applies to (almost) all companies in the financial market providing portfolio management and/or the investment service of investment advice. However, the Regulation covers neither companies that offer only investment brokerage nor – at least in the current legal situation – independent agents, meaning financial investment brokers and fee-based financial investment advisers licensed under the German Trade, Commerce and Industry Regulation Act.



2. Definitions

The Disclosure Regulation defines essential terms offering a basis for correctly understanding this Regulation itself but the same terms are also used across all of the Action Plan within other measures. The definitions of “**sustainable investments**”, “**sustainability risks**” and “**sustainability factors**” are of particular importance.

⁴ Any articles cited in this GSK Update without further identification are referring to the Disclosure Regulation.

Sustainable investment (Art. 2(17))

- means an investment in an economic activity that contributes to an **environmental objective**, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy,
- or**
- an investment in an economic activity that contributes to a **social objective**, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities,

provided that such investments **do not significantly harm any of those objectives** (“*do no significant harm-principle*” – DNSH) and that the investee companies follow **good governance practices**, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

Sustainability risk (Art. 2(22))

means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Sustainability factors (Art. 2(24))

means environmental, social and employee matters, human rights, anti-corruption and anti-bribery issues.



3. Transparency regarding sustainability risks and adverse sustainability impacts

When it comes to disclosure requirements, the Disclosure Regulation distinguishes between market participants that take into account adverse sustainability impacts and those that do not. Additionally, the Regulation stipulates special duties for market participants with more than 500 employees or parent companies of a company group of a total of more than 500 employees.

a. Transparency on websites

Market participants are required to publish a range of information on the sustainability risks and adverse sustainability impacts. This includes in particular **(i)** their policies on the integration of sustainability risks in their investment decision-making processes (financial market participants, Art. 3(1)) and risks in their investment advice or insurance advice. (financial advisers, Art. 3(2)), **(ii)** information on adverse sustainability impacts on the company level and an explanation of how these are taken into consideration or an explanation of why they are not (Art. 4, “**comply or explain**”) as well as **(iii)** information on how their remuneration policies are consistent with the integration of sustainability risks (Art. 5). This information must always be kept up to date. If a market participant changes this information, a clear explanation of the changes in question must be published on the same website (Art. 12).

b. Transparency in pre-contractual disclosures

Further disclosure requirements concern **pre-contractual disclosure requirements**. In particular, market participants shall include **descriptions** (Art. 6(1), (2)) **(i.)** of the manner in which sustainability risks are integrated in their investment decisions (financial market participants) or in their investment or insurance advice (financial advisers), and **(ii.)** of the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available (financial market participants) or advise on (financial advisers). Where market participants deem sustainability risks not to be relevant, the descriptions referred to

must include a clear and concise explanation of the reasons. The Disclosure Regulation also regulates in which manner the preceding information shall be disclosed depending on the specific market participant (Art. 6(3)). In addition, an **explanation of weather, and, if so, how a financial product considers principal adverse sustainability impacts**⁵ (Art. 7) must be included in pre-contractual disclosures, provided that the principal adverse impacts of investment decisions on sustainability factors are taken into account (cf. Art. 4(1)(a)) or the enterprise or group of enterprises has more than 500 employees.



4. Transparency regarding financial products which promote environmental or social characteristics and sustainable investments

The Disclosure Regulation differentiates between financial products that promote environmental or social features or a combination of both (“**ESG products**”) and financial products aiming to be sustainable investment (“**impact products**”).⁶ A further distinction is made as to whether or not an index has been determined as a reference value for the financial product.

a. Transparency when promoting environmental or social characteristics (Art. 8) and sustainable investments (Art. 9) in pre-contractual disclosures

⁵ Under the Disclosure Regulation, the term “financial product” is not identical to the term “financial instrument” as used in Art. 4(1)(15) of Directive 2014/65/EU; rather, it only covers some financial instruments, e.g., units of AIF or UCITS (cf. enumerative list in Art. 2(12)).

⁶ Cf. Recital (21) of the Disclosure Regulation.



The first condition is that the companies in which the investment is made must follow good (corporate) governance practices. The information to be disclosed must include details on how the environmental/social characteristics are met and, where an index has been determined, whether and how this index is consistent with those characteristics and where a description of the method of calculating the index is to be found (Art. 8).

For sustainable investments, a distinction is made between different constellations (Art. 9):

- (1) If an **index** was designated as a reference benchmark:
Information on how the designated index is aligned with that objective and an explanation of why and how the index differs from a broad market index as well as information on where the methods of calculating the indices may be found (Art. 9(1)(4)).
- (2) If **no index** was designated as a reference benchmark:
The pre-contractual information must contain explanations on how to achieve the desired objective (Art. 9(2)).
- (3) If the financial product aims to reduce **CO2 emissions**:
A detailed explanation in the pre-contractual information of how the objectives of lower carbon emissions will be ensured to meet the long-term global warming objectives of the Paris Agreement.

b. Transparency on websites and in periodic reports (Art. 10, 11)

For the above-mentioned financial products, financial market participants shall publish information for each financial product on their websites, in particular a description of the environmental or social characteristics or the sustainable investment objective and their assessment methodologies. This information shall always be kept up to date. If the company makes changes to this

information, a clear explanation of the changes in question must be published on the same website (Art. 12).

In addition, financial market participants must include a description in their periodic reports, in particular regarding to what extent the environmental or social characteristics have been met or on the overall sustainability-related impact of the financial product (substantiated by relevant sustainability indicators). The manner in which to make this information available depends on the “type of company” (e.g., in the annual report).

5. Marketing communications (Art. 13)

Without prejudice to stricter sectoral legislation, market participants shall ensure that their marketing communications do not contradict the information disclosed under the Disclosure Regulation.

6. Taxonomy Regulation: Extension of the disclosure requirements

Within the framework of the Taxonomy Regulation, the Disclosure Regulation’s requirements are going to be extended further.⁷

a. Transparency regarding financial products with environmental characteristics and sustainable investments

For sustainable investments, pre-contractual disclosures and periodic reports (Art. 6(3) and Art. 11(2) Disclosure Regulation) should now also contain information on the environmental objective defined under the Taxonomy Regulation to which the investment is contributing, as well as a description of how and to what extent the investments “behind” the financial product fund environmentally sustainable economic activities (Art. 5 Taxonomy Regulation).

⁷ Council and European Parliament reached a political agreement on the Taxonomy Regulation in December 2019. The Council adopted its position at 1st reading in mid-April 2020. In order to pass the Regulation, the European Parliament must approve it in 2nd reading, which is currently considered likely.



This also applies to financial products whose environmental or social characteristics are promoted. In the future, pre-contractual disclosures and periodic reports shall also be accompanied by the following statement (Art. 6 Taxonomy Regulation):

"The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities.

The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities."

b. Transparency of other financial products in pre-contractual disclosures and periodic reports (Art. 7 Taxonomy Regulation)

Financial products that are not subject to the rules set out in point a.) above must be accompanied by the following statement:

"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."

c. Transparency of companies in non-financial statements (Art. 8 Taxonomy Regulation)

Further disclosure requirements apply to companies that are obliged to publish a non-financial statement under Articles 19a and 29a of the Accounting Directive⁸. This will affect in particular large companies that are of public interest and employ more than 500 employees.

d. Applicability

The newly expanded disclosure requirements by the Taxonomy Regulation will apply from 01 January 2022

⁸ Directive 2013/34/EU.

with regard to environmental objectives a and b (adaptation to climate change, climate protection) and from 01 January 2023 with regard to the environmental objectives c-f (protection of water and marine resources, circular economy, pollution and protection of biodiversity and ecosystems).

7. ESA Joint Consultation Paper specifying the Disclosure Regulation

On 23 April 2020, the ESA (EIOPA, EBA, ESMA) published a comprehensive Joint Consultation⁹ Paper on ESG disclosures under the Disclosure Regulation for financial market participants, advisers and products. The consultation paper includes a draft Regulatory Technical Standards (RTS) regarding the content, methodology and presentation of ESG disclosures at company and product level. The **key points** of the RTS draft are:

- a **mandatory reporting template** with prescribed reporting elements for the statement on the **consideration of the main adverse impacts of investment decisions on sustainability factors**;
- **indicators of adverse impacts on ESG factors**, including a **core set of mandatory indicators** that will always lead to the main adverse impacts of investment decisions on sustainability factors, regardless of the financial market participants' assessment result;
- a **mandatory reporting format** to meet **pre-contractual disclosure requirements**, clearly indicating the product type and the way in which the environmental and/or social characteristic or sustainable investment objective is achieved;
- guidelines for the implementation of **website disclosure requirements**, including a **two-page summary** of information, methodology, data sources and audit criteria used;

⁹ ESAs Joint Consultation Paper on ESG disclosures (JC 2020-16) of 23 April 2020.



- a **mandatory reporting format** to comply with **regular disclosure requirements** and reporting requirements that focuses on the success of a product in achieving its environmental and/or social characteristics or sustainable investment objective.

The paper also contains proposals for the design of the "**do no significant harm**" (DNSH) principle under the Taxonomy Regulation.

It is worth pointing out that the guidelines submitted for consultation do not provide any differentiation in terms of the type of investment and the type of assets (e.g., securities, real estate, and other tangible assets).

It remains to be seen how the draft RTS will be received by the European economic and financial community. Relevant comments and assessments will be only forthcoming in the course of the next weeks and months. The consultation period ends on 01 September 2020.

8. Conclusion / Outlook

The adoption of the Disclosure Regulation completes the large first part of the Action Plan. On first reading of the text of the Regulation, one could assume that it is only a matter of slightly extended transparency requirements for regulated market participants. But this first impression is deceptive. With its definitions of impact and ESG products and sustainability risks, among other things, the Disclosure Regulation represents the EU's first major regulatory milestone on the way to sustainable finance and will have a significant impact on the financial sector. With regard to the RTS currently under consultation, it is to be hoped that its far-reaching requirements – which are likely to demand considerable additional time and effort, especially of smaller market participants – will not negatively impact the Disclosure Regulation's original objective.

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