

Sustainable Finance Disclosure Regulation - Article 8 Funds or “Light Green Funds”

What to consider for Article 8 Funds based on the draft regulatory technical standard issued by the European Supervisory Authorities (“ESAs”) on 4 February 2021

On Thursday 4 February 2021, the European Supervisory Authorities (“ESAs”) published the updated [draft regulatory technical standards](#) (“Draft RTS”), which is intended to supplement the [Sustainable Finance Disclosure Regulation \(“SFDR”\)](#). If approved, these will come into force on 1 January 2022.

In the absence of regulatory guidance for firms to comply with SFDR, we produced our first paper on the implications for [Article 6 Funds](#) earlier this year. Some of

the key highlights from our initial paper were:

- Fund managers and Funds should document their policy on integrating sustainability. The policy should be documented for each Fund, be reviewed and approved by the board of directors of the Fund manager on an annual basis.
- The sustainability policy should be included on the website and the website disclosure should be a separate section which states whether the Fund manager

and Fund considers sustainability risk or not and it should be updated on a regular basis.

- Sustainability risk is integrated into the existing Risk Management Frameworks demonstrating linkages, dependencies and potential impacts to support decision making.

The areas above should be applicable for all Funds, unless sustainability is deemed to not be relevant for a specific Fund. Following on from the Article 6 guide, we are now going to focus on the additional requirements for Article 8 Funds.

Scope

An Article 8 Fund under SFDR is defined as “a Fund which promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.”

The Draft RTS contains some limited guidance and indications as to what constitutes an Article 8 Fund. One way for a Fund to promote environmental and social characteristics and to be an Article 8 Fund is to adopt the mandatory principal

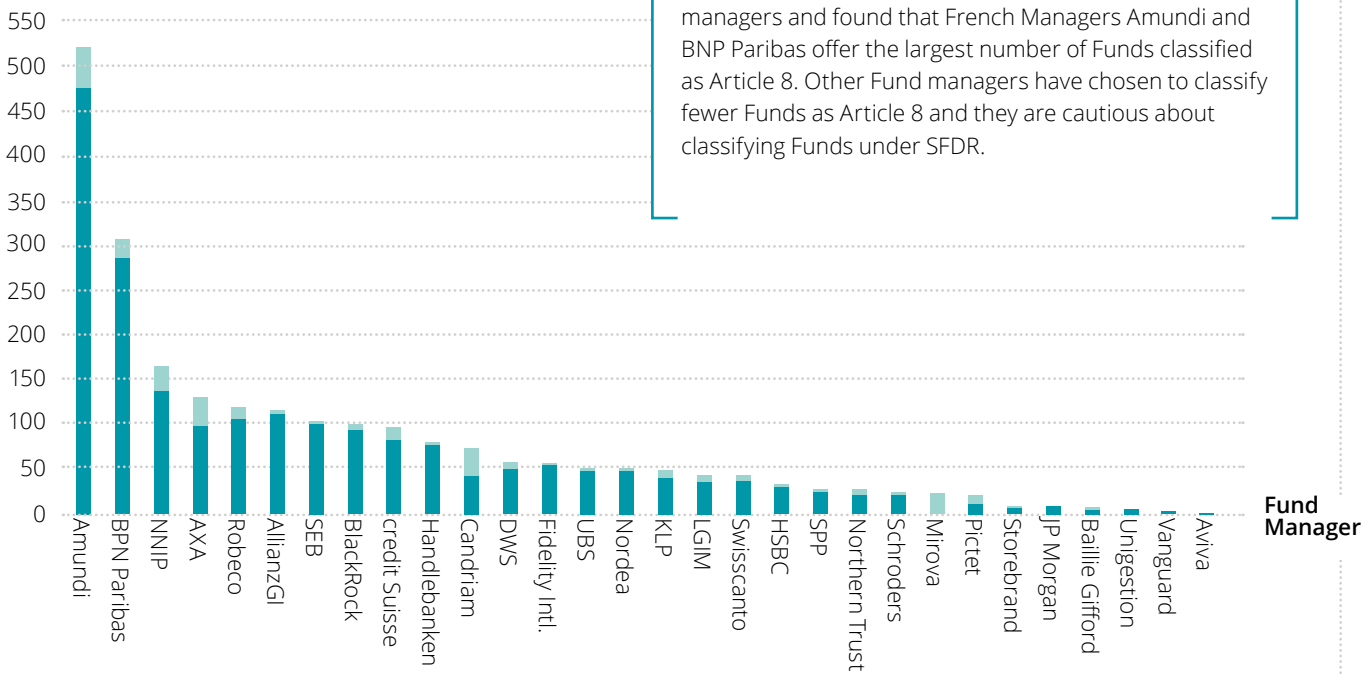
adverse sustainability indicators (“PASIs”). In our view if a Fund considers the PASIs, this does not mean they are automatically an Article 8 Fund. The Fund Manager must integrate the sustainability risk indicators into their investment decisions. In the feedback in the Draft RTS the ESAs have noted some key unanswered questions e.g. whether Funds using exclusion strategies that are not actively promoted are Article 8 Funds, but the ESAs have deferred this to the European Commission and we are still waiting on clarification on this and some other questions.



Deloitte’s view:
Not all funds that adopt the PASIs are automatically considered Article 8 Funds. The risk indicators should be integrated into investment decisions.

A look at the funds

Number of funds



Morningstar has surveyed a sample of the 30 Fund managers and found that French Managers Amundi and BNP Paribas offer the largest number of Funds classified as Article 8. Other Fund managers have chosen to classify fewer Funds as Article 8 and they are cautious about classifying Funds under SFDR.

Source: <https://www.morningstar.co.uk/uk/news/211061/finding-esg-funds-just-got-easier.aspx>

■ Article 8 ■ Article 9



Deloitte’s view:
Fund Managers should see SFDR as an opportunity to demonstrate their commitment to sustainable investing and as investor demand grows, sustainability funds will become a standard requirement.

Principal adverse impact disclosures

The Draft RTS has addressed some of the feedback from the industry by reducing the number of mandatory PASIs that firms are expected to monitor and report against. In addition, the new mandatory templates for pre-contractual and periodic reporting disclosures allow for consistency in reporting across Funds.

In the Draft RTS the ESAs have reduced the indicators from 32 to:

- 14 for investments in investee companies (plus one additional environmental indicator (Table 2) and one additional social indicator (Table 3));
- 2 for investments in sovereigns and supranationals; and
- 2 for real estate assets as included in Annex I of the Draft RTS.

The table below illustrates the 14 mandatory indicators from the Draft RTS and any changes from the initial draft RTS issued on the 23 April 2020:

Adverse sustainability indicator		Metric	Change from 23 April 2020
Climate and other environment-related indicators			
Greenhouse gas emissions	GHG – Carbon emissions	GHG – Carbon emissions	Scope 3 GHG to be disclosed from 1 January 2023
	Carbon footprint	Carbon footprint	No change
	GHG intensity of investee companies	GHG intensity of investee companies	Previously weighted average GHG intensity
	Exposure to companies active in the fossil fuel sector	Share of investments in companies active in the fossil fuel sector	Previously share of investments in solid fossil fuel sectors
	Share of non-renewable energy consumption and production	Share of non-renewable energy consumption and non-renewable energy production of investee companies from non-renewable energy sources compared to renewable energy sources, expressed as a percentage	Previously total energy consumption from non-renewable sources and share of non-renewable energy consumption
	Energy consumption intensity per high impact climate sector	Energy consumption in GWh per million EUR of revenue of investee companies, per high impact climate sector	Previously Energy consumption intensity per sector
Biodiversity	Activities negatively affecting biodiversity sensitive areas	Share of investments in investee companies with sites/operations located in or near to biodiversity-sensitive areas where activities of those investee companies negatively affect those areas	Previously share of investments that do not assess, monitor or control the pressures corresponding to the indirect and direct drivers of biodiversity and ecosystem change
Water	Emissions to water	Tonnes of emissions to water generated by investee companies per million EUR invested, expressed as a weighted average	No change
Waste	Hazardous waste ratio	Tonnes of hazardous waste generated by investee companies per million EUR invested, expressed as a weighted average	No change

Adverse sustainability indicator		Metric	Change from 23 April 2020
Social and employee, respect for human rights, anti-corruption and anti-bribery matters			
Social and employee matters	Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises	Share of investments in investee companies that have been involved in violations of the UNGC principles or OECD Guidelines for Multinational Enterprises	Previously share of investments in entities without due diligence policies on issues addressed by the fundamental ILO Conventions 1 to 8
	Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises	Share of investments in investee companies without policies to monitor compliance with the UNGC principles or OECD Guidelines for Multinational Enterprises or grievance/complaints handling mechanisms to address violations of the UNGC principles or OECD Guidelines for Multinational Enterprises	
	Unadjusted gender pay gap	Average unadjusted gender pay gap of investee companies	Previously average gender pay gap of investee companies
	Board gender diversity	Average ratio of female to male board members in investee companies	No change
	Exposure to controversial weapons (antipersonnel mines, cluster munitions, chemical weapons and biological weapons)	Share of investments in investee companies involved in the manufacture or selling of controversial weapons	Previously only included land mines and cluster bombs
Indicators applicable to investments in sovereigns and supnationals			
Environmental	GHG intensity	GHG intensity of investee countries	New
Social	Investee countries subject to social violations	Number of investee countries subject to social violations (absolute number and relative number divided by all investee countries), as referred to in international treaties and conventions, United Nations principles and, where applicable, national law	New
Indicators applicable to investments in real estate assets			
Fossil fuels	Exposure to fossil fuels through real estate assets	Share of investments in real estate assets involved in the extraction, storage, transport or manufacture of fossil fuels	New
	Exposure to energy-inefficient real estate assets	Share of investments in energy inefficient real estate assets	Previously mandatory indicator for all funds and now only real estate

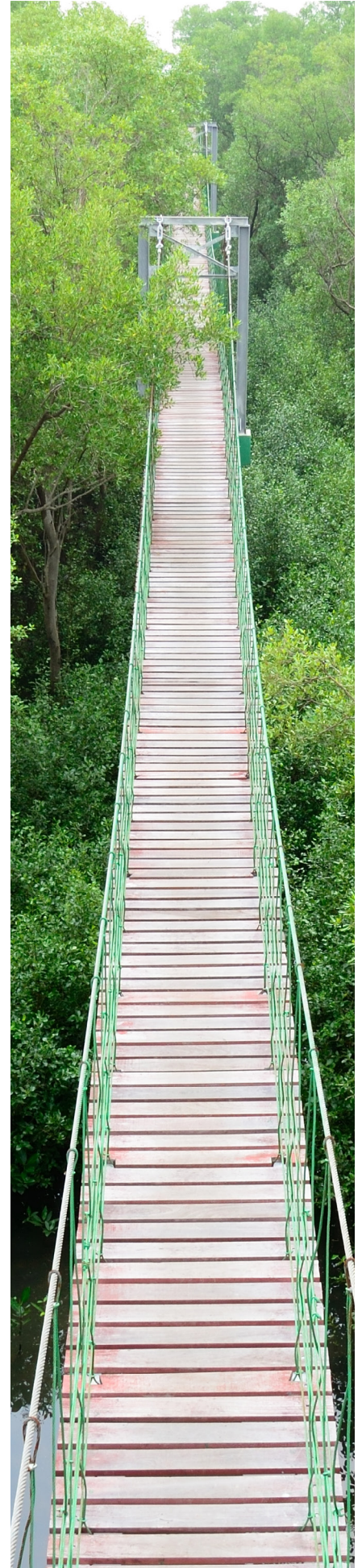


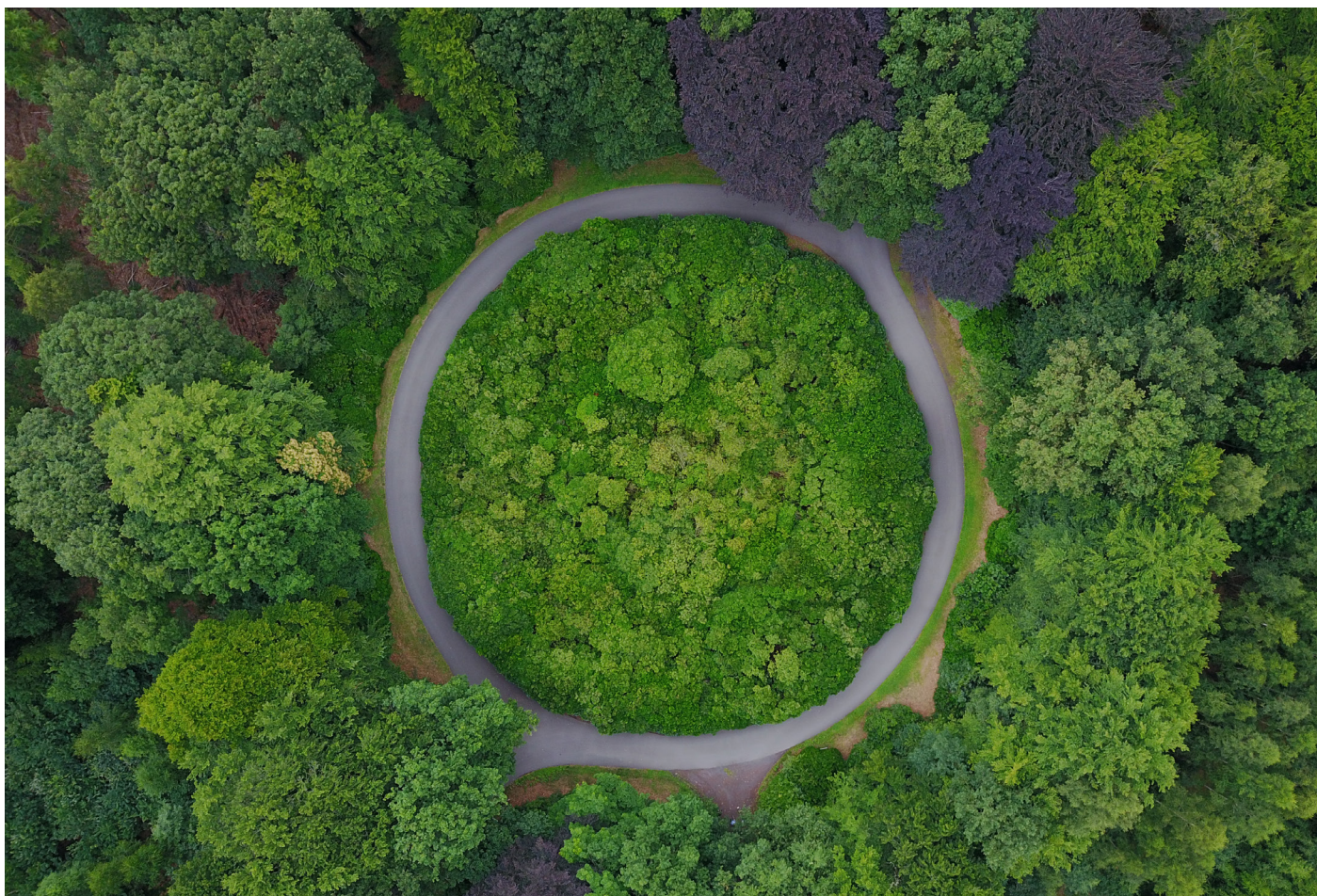
Some of the changes above were designed to align the metrics to other frameworks. The key highlights are:

- The updates in respect of investments in sovereigns, supnationals and real estate assets are a particularly welcome change, due to the unique nature of these investments.
- The PASIs now include violations of UN Global Compact principles and OECD Guidelines for Multinational Enterprises, and lack of processes to monitor adherence to the same.
- For climate related PASIs, the metrics have now been aligned in part to the indicators used for EU Climate Transition or Paris-aligned Benchmarks under the Low Carbon Benchmark Regulation (EU 2019/2089).
- For Fund of Funds, firms should do a look through to the end investment, holding company or special purpose vehicle (SPV) in order to assess the PASIs.
- For green bond investments financing a specific project the PASIs should be assessed for the specific project rather than the entire business of the issuer.
- PASIs should be assessed quarterly i.e. March, June, September and December. This allows for a yearly average to be calculated providing a representative PASIs for the reporting period which should be easier for Funds that have portfolio turnover.
- The PASIs should be completed for at least the five previous reporting periods.

Deloitte's view:

The reduced mandatory indicators is a welcome decision for the Irish funds industry and the alignment of some of the indicators to existing frameworks shows harmonisation by the European Commission. In addition there are still complexities with accessing the data from investee companies and this will be only be enhanced with the recent announcement on the proposed [Corporate Sustainability Reporting Directive \("CSRD"\)](#) by the European Commission on the 21 April 2021. This will bring more companies in scope and the CSRD will align with the SFDR and the Taxonomy. European Financial Reporting Advisory Group ("EFRAG") will be tasked to develop the new EU sustainability-reporting standards.





Disclosures and reporting

The Draft RTS has now included mandatory templates (Annexes II – V) for PASIs reporting for per contractual disclosures and the periodic reporting. In accordance with Article 2 of the Draft RTS some general principles for the presentation of information on the PASIs disclosure include:

- The information is easily accessible, non-discriminatory, free of charge, prominent, simple, concise, comprehensible, fair, clear and not misleading.
- Must be in a searchable electronic format except where the manner referred to in Articles 6(3) and 11(2) of SFDR requires the information to be provided on paper.
- The information shall be published on the websites and kept up to date.
- Legal entity identifiers should be provided when referring to investee companies.

Product Level Pre Contractual Disclosures

For Article 8 Funds Annex II in the Draft RTS is the template to be used for disclosure in pre contractual documents. In the pre contract document the Fund needs to include a statement at the beginning of the Annex to explain the following:

- a) whether the Fund intends to make any sustainable investments;
- b) that the Fund promotes environmental or social characteristics, but does not have as its objective a sustainable investment; and
- c) The details of any index that has been designated as a reference benchmark.

The statement should be a summary and include the following sections:

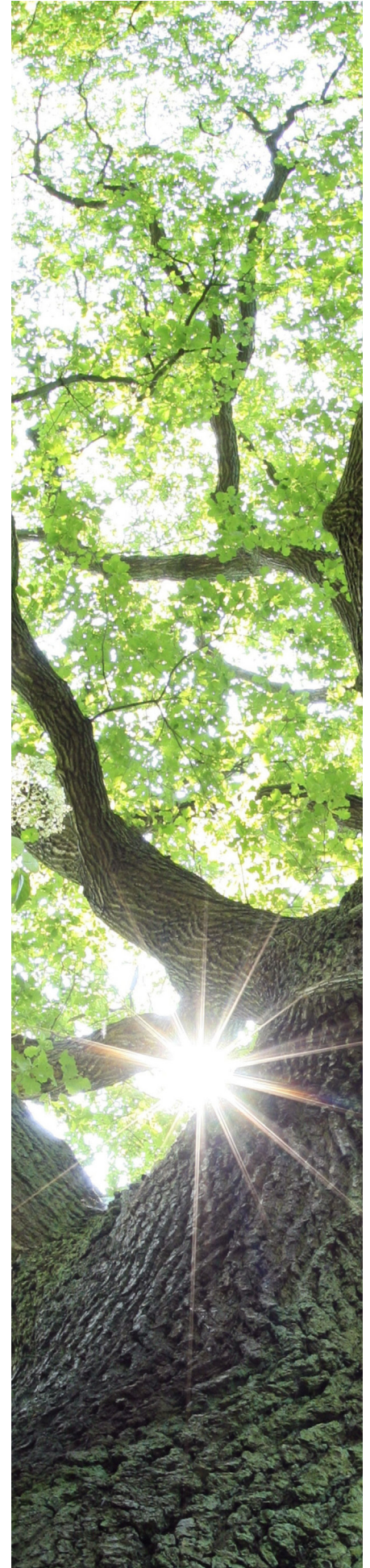
- The types of environmental and/or social characteristics promoted by the Fund;

- The investment strategy followed by the Fund, including to meet its binding Article 8 criteria;
- The asset allocation planned for this Fund in terms of ESG vs. non ESG products;
- A summary of whether the Fund takes into account PASIs as its Article 8 feature;
- Link to website product disclosures; and
- How any reference benchmarks are aligned with the environmental and/or social characteristics promoted by the product.

Product-level website disclosures

The website disclosures for Article 8 Funds must include the following:

- Summary;
- No sustainable investment objective – This includes a) The following statement should be included “This Fund promotes environmental or social characteristics, but does not have as its objective a sustainable investment”; or b) Where the Fund commits to making one or more sustainable investments, the section shall also contain an explanation of how the sustainable investment does not significantly harm any of the sustainable investment objectives;
- Environmental or social characteristics of the Fund;
- Investment strategy – This section shall include the investment strategy and a description of the policy to assess good governance practices of the investee companies including with respect to sound management structures, employee relations, remuneration of staff and tax compliance;
- Proportion of investments in ESG vs. non ESG assets – This section shall distinguish between direct exposures in investee entities and all other types of exposures to those entities;
- Monitoring of environmental or social characteristics – This section discloses how the environmental and social sustainability indicators are monitored throughout the lifecycle of the Fund and the related internal or external control mechanisms;
- Methodologies used to assess and monitor Article 8 criteria – This section is the description of the methodologies to measure the attainment of the social or environmental characteristics promoted by the Fund using the sustainability indicators;
- Data sources and processing – This refers to (a) the data sources used to attain each of the environmental or social characteristics promoted by the Fund; (b) the measures taken to ensure data quality; (c) how data is processed; and (d) the proportion of data that is estimated;
- Limitations to methodology and data – A description of: (a) any limitations to the methodologies, and the data sources; (b) how such limitations do not affect the attainment of the environmental or social characteristics promoted by the Fund; and (c) the actions taken to address such limitations;
- Due diligence done on underlying assets regarding ESG criteria – A description of the due diligence carried out on the underlying assets of the Fund, including the internal and external controls on that due diligence;
- Engagement policies – A description of the engagement policies implemented where engagement is part of the environmental or social investment strategy, including any management procedures applicable to sustainability-related controversies in investee companies; and
- Information on any designated reference benchmarks used – A description of how the index designated as a reference benchmark is aligned with the environmental or social characteristics promoted by the Fund, including the input data, the methodologies used to select that data, the rebalancing methodologies and how the index is calculated.





Deloitte's view:

There has been significant alignment between the disclosures included in the pre contractual documents, the website and the periodic reports. There is currently some ongoing discussions between ESAs and the European Commission on the first reporting period for disclosures to be included in the annual report. As the RTS comes into effect on the 1 January 2022 it is likely that the first disclosures will be included in the annual report for periods ending 31 December 2022.

Product-level periodic disclosures

For Article 8 Funds Annex IV in the Draft RTS is the template to be used for periodic disclosure in the annual report. The following is included in the disclosure template:

- The extent to which the environmental and/or social characteristics promoted by the Fund were met during the reference period i.e. the PASIs compare to the prior periods;
- The top investments of the Fund by sector, % of Assets and Country;
- The proportion of sustainability linked investments i.e. % of sustainable investments and ESG investments and other;
- For the other investments what was their purpose and were there any minimum environmental or social safeguards;
- How did sustainable investments not significantly harm any sustainable investment objectives as outlined in the Taxonomy;
- Actions taken to meet the environmental and/or social characteristics during the reference period; and
- Where a reference index had been designated – how did this Fund perform versus the designated reference benchmark i.e. comparison of the PASIs between the Fund and the reference benchmark.





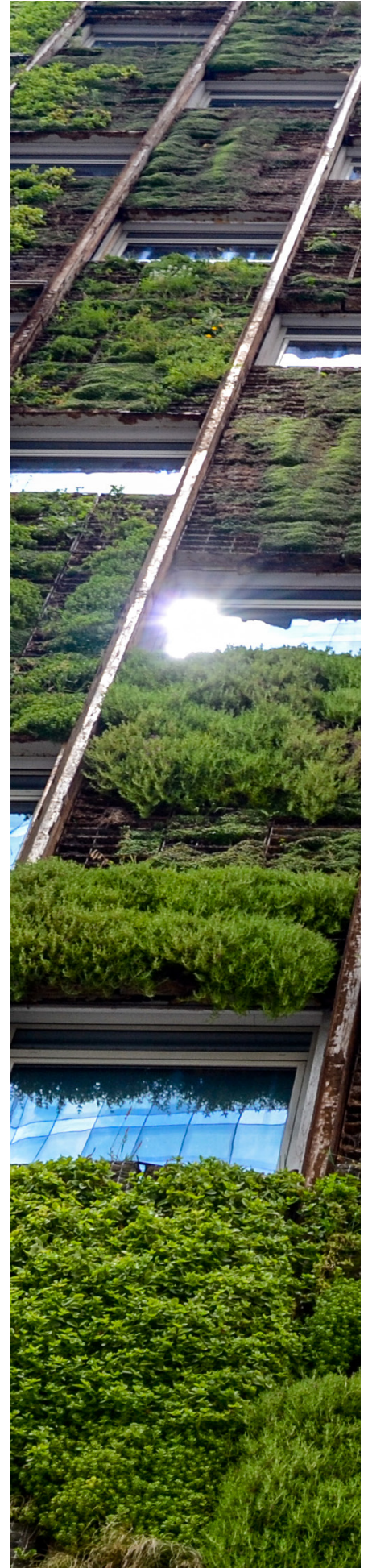
Assurance over non-financial information

In order to be ready for the wave of change that is required, Deloitte can support Fund Managers in getting ready for the detail requirements for SFDR. In addition as the information disclosed will be used by stakeholders to make investment decisions any assurance provided over this information will provide stakeholders with greater confidence over the reporting of the disclosures. The benefits of assurance over non-financial information include:

- Improved transparency and credibility of non-financial information, resulting in a higher level of trust for potential investors;
- Increased business opportunities for becoming a part of reliable supply chains, due to improved capabilities;
- Improved engagement from board of directors and the Fund Manager;
- Improved internal reporting and management systems;
- Improved communication with stakeholders; and
- Reduced risk and increased value.

Deloitte's view:

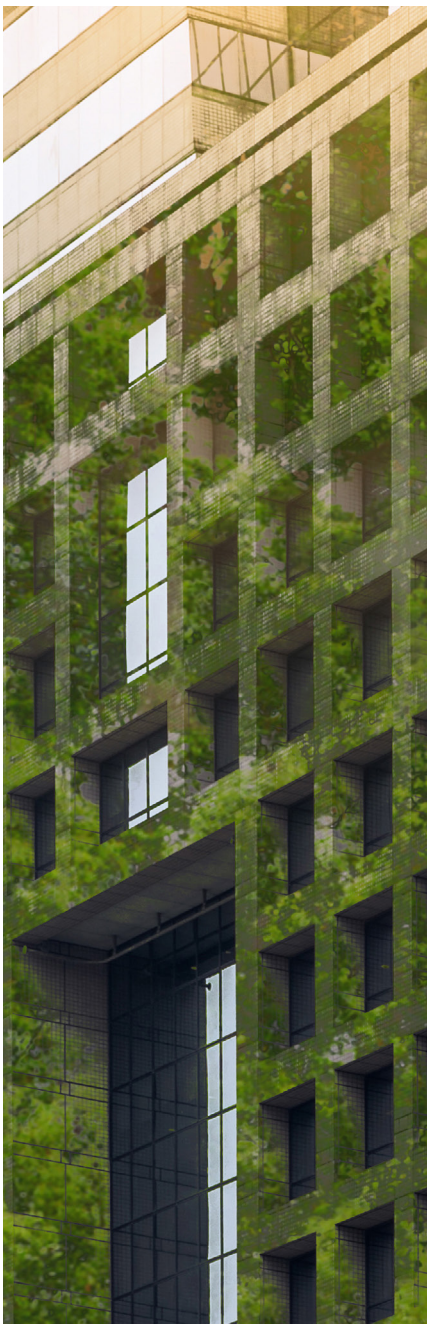
There has been significant progress made on assurance over non-financial information. In March 2021 the International Federation of Accountants ("IFAC") has set out a [road map for accelerating integrated reporting assurance](#). In addition the International Audit and Assurance Standards Board ("IAASB") approved Non-Authoritative Guidance on Applying ISAE 3000 (Revised) to Extended External Reporting (EER) Assurance Engagements, which will be published in April 2021. This guidance marks a significant step forward in supporting the evolving field of assurance for non-financial information.





How can Deloitte Help

We have designed a framework to support sustainability risk integration and the provision of assurance over your ESG disclosures that can support boards of directors, audit committees and management in their journey towards compliance with SFDR disclosure requirements or other ESG frameworks.



Product and innovation

What is it:

Product feasibility study

What is it used for:

Focusing on concept, market, criteria and impact assessment within regulatory guidelines.



Benchmarking and gap analysis

What is it:

Independent benchmarking of your current disclosures against recommendations and/or identifying gaps in your disclosures, processes or controls and reporting privately to management and those charged with governance.

What is it used for:

Benchmarking and gap analysis provides the basis of a roadmap to ESG disclosures.



Designing and Implementing ESG frameworks

What is it:

Designing and implementing a policy and risk management framework that captures processes, controls and reporting privately to management and those charged with governance on the ESG integration.

What is it used for:

Policy and framework can be used to monitor ESG for all investment products.



Assurance over selected ESG metrics

What is it:

Private or public independent ISAE 3000 assurance over your ESG disclosures and metrics.

What is it used for:

Assurance over ESG disclosures and metrics can be a useful starting point on a path to SFDR disclosure compliance or provide investors with confidence you have integrated sustainability risk in investment decisions.

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