TRANSCENDENT GROUP INSIGHT

Will the Regulatory Technical Standards (RTS) in Sustainable Finance Disclosure Regulation (SFDR) be the strong push needed for a more impactful ESG implementation?

ESG ethos under pressure

ESG has had a though ride in the last few months as it has met criticism on several fronts and the expected impact of ESG has been delayed. For example, available ESG data is often unreliable, and valuations are not comparable due to non-uniform standards. This further impacts the analysis of the data, which in turn will affect the overall reliability of the sustainability measures. Firstly, solid criticism came from some experienced Bloomberg Market journalist, followed by a stream of more or less interesting and competent criticism in media. An ill-famed example of ESG rating is the exclusion of electric mobility pioneer Tesla from S&P Global's sustainability indices because of alleged disregard for workers' rights, while major fossil fuel companies, like Exxon, remained in the grouping. While Exxon was rated among the top ten constituents by S&P 500 ESG Index, Tesla did not make it to that list at all. One of the more influential media – the Economist – had a rather harsh criticism of ESG in a special investigation report this summer. The criticism is both alarming and needed for a successful and impactful ESG implementation.

Also regulators starts to pay attention to companies ESG claims. Deutsche Bank are under investigation which revolves around allegations—leveled by a former DWS manager—that the retail money management business engaged in "greenwashing," in which ESG investments are sold under false claims. DWS is Deutsche Bank's asset management division. This case also highlight the possibility of greenwashing, where disinformation disseminated by an financial market participants (FMP), so as to present an environmentally responsible public image.

Strengthening of EUs Sustainable Action plan

EU has now solidified their regulatory technical standards (RTS) for their Sustainable Finance Disclosure Regulation (SFDR) and are now ready to enforce it as of January 2023. SFDR is a European regulation introduced to improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by FMP. This work has nothing to do with the criticism, the reality is that EU are just following their Sustainable Action Plan – a long term plan that will produce more regulatory frameworks and standard that will need to be adhered to. However, the timing of the RTS might contribute to strengthening the ESG reputation, at least within the EU, by providing better and more reliable data as well a more comparable valuation method.

The SDFR required each fund to disclose whether it has a sustainability objective (article 9), promotes sustainability characteristics (article 8) or neither (article 6). The articles refer to the original SFDR regulation. This has caused the financial market to classify financial products based on their sustainability-related ambitions.

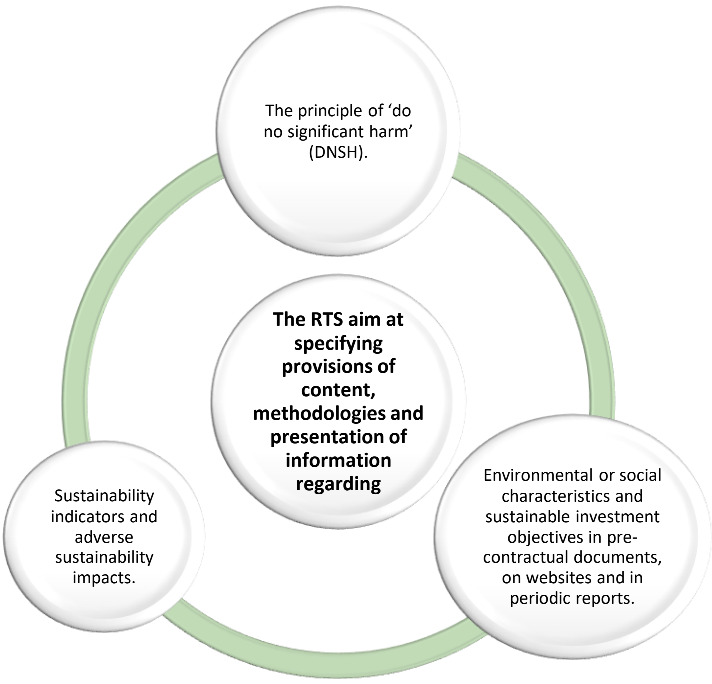
To achieve a transparent and communicative ESG implementation, ESG-data is of central importance. The Commission highlight that sustainability-related disclosures in the financial services sector should be sufficiently clear, concise, and prominent to enable end investors to take informed decisions. To that end, end investors should have access to reliable data that they can use and analyse in a timely and efficient manner.

The Commission further stress that it is necessary to ensure that the information disclosed can be easily compared and that the indicators of principal adverse impacts (PAI) of investment decisions on sustainability factors can be easily understood. Such comparability and comprehensibility would be improved by making a distinction between, on the one hand, indicators of adverse impacts that always lead to principal adverse impacts, and, on the other hand, additional indicators of adverse impacts on sustainability factors that are principal for the FMPs. The RTS brings a set of standard indicators for the former, and the FMPs are more free to choose indicators for the latter.

The Regulatory Technical Standards and the potential impacts

The RTS are a consolidated set of technical standards, which provide additional detail on the content, methodology and presentation of certain existing disclosure requirements under SFDR and the Taxonomy Regulation. Companies subject to these requirements will need to ensure that their existing principles-based disclosures are updated to reflect the detailed requirements of the RTS, ahead of the RTS coming into force. The final RTS are the result of several drafts circulated for the last two years. As we will see, improvements are being made but important issues remained unsolved or at least needs further refinement, which is to be expected in the complexity that is ESG.

The European Commission has now published in the Official Journal its proposed RTS, with formal name "SFDR Level 2 Regulatory Technical Standards" to supplement the Level 1 measures which have applied since 10 March 2021.



These RTS will apply as of 1st January 2023 and will be essential and guiding for SFDR reporting. For example, the RTS regulate the section heading/title of some key sections for the disclosure in websites. The RTS brings specific templates to use for disclosing information about sustainable investments. They also bring indictors to use, metrics as well as formulas. Businesses that are within the scope of the RTS will swiftly need to understand the transparency tools and communication measures that the provisions of RTS lays out.

Principal Adverse Impact (PAI) – the negative impacts caused by investment decisions and advice

The RTS are detailed and regulate the PAI statements. PAI are a practical application of the "Do Not Significant Harm" principle (DNSH), which both require the use of the same adverse impact indicators. Again, this will enforce the same standard when mapping out negative impacts, which will further strengthen the capability and possibility to review and compare different investment decisions and advice. For the avoidance of doubt - there is no direct link between the PAI and DNSH disclosures, which apply independently.

PAI statements describe how the business has considered the PAI in their operational and strategic processes. A PAI have been defined by the EU as *"negative effects, material or likely to be material on sustainability factors that are caused, aggravated by or directly linked to investment decisions and advice performed by the legal entity" in [the original SFDR regulation](#).*
They are provided on two levels - the entity level and product level. PAIs are intended to assess and avoid significant adverse effects on the environmental taxonomy objectives such as the sustainable investments goals of the SFDR regulation. These assessments on PIA will be central when working with sustainability measures and challenges.

As of today, these sustainability factors are mainly focused on climate and more broadly on environmental issues. Needless to say, the social dimension of ESG should not be forgotten since it contributes to the overall sustainability purposes that ESG sets up. It is worthwhile to highlight an introductory comment made by the Commission in the Regulation on this subject.

Environmental and Social issues and challenges are equal

The Commission are clear that it is important to ensure that adverse impacts of investment decisions on climate, or on other environment-related sustainability factors, are considered as important as adverse impacts of investment decisions on social, employee, human rights, anti-corruption, or anti-bribery sustainability factors. This fact – that E = S when it comes to importance – is crucial to bring forward in the ESG work as focus now has often been on the E – Environment. This is contrary to the critic made by The Economist mentioned above, that ESG should skip the S and only focus on the E. In our opinion, neither E nor S can be fully achieved without the other. They interlink in many dimensions, and it would not foster the holistic approach if our focus were only directed towards either E or S.

What to do?

The RTS is now decided upon, and all affected FMPs should align their report with it, early the better. In such, the RTS is sympathetic to FMPs in that it brings templates, formulas, and guidance.

Do you need help or like to talk about the RTS, please reach out to:

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