International
Capital
Market
Association

UPDATE ON THE EU'S SUSTAINABILITY DISCLOSURE REGIME

New and amended EU legislation is introducing significant sustainability and ESG related disclosure requirements that will impact all participants in the European capital markets. This document seeks to give as much as possible a comprehensive and practical overview of these developments. Key points to retain are:

- *The Disclosure Regulation aims to provide more transparency to end-investors on whether and how the buyside and financial advisers take into account ESG aspects.*
- *The Taxonomy Regulation creates obligations for large firms already subject to the Non-Financial Reporting Directive (NFRD) to disclose against the Taxonomy.*
- *The existing NFRD will most likely be revised after an ongoing consultation to better facilitate disclosures required from asset managers and pension providers under the Disclosure Regulation.*
- *Under the Low Carbon Benchmark Regulation, benchmark providers will have to disclose whether and how they take ESG factors into account.*
- *New ESMA guidelines mean that credit rating agencies have to disclose when considering ESG factors.*

For quick reference readers may especially wish to note the EU sustainability disclosures grid provided in Section C.

ICMA will aim to review and update this document in line with future developments.

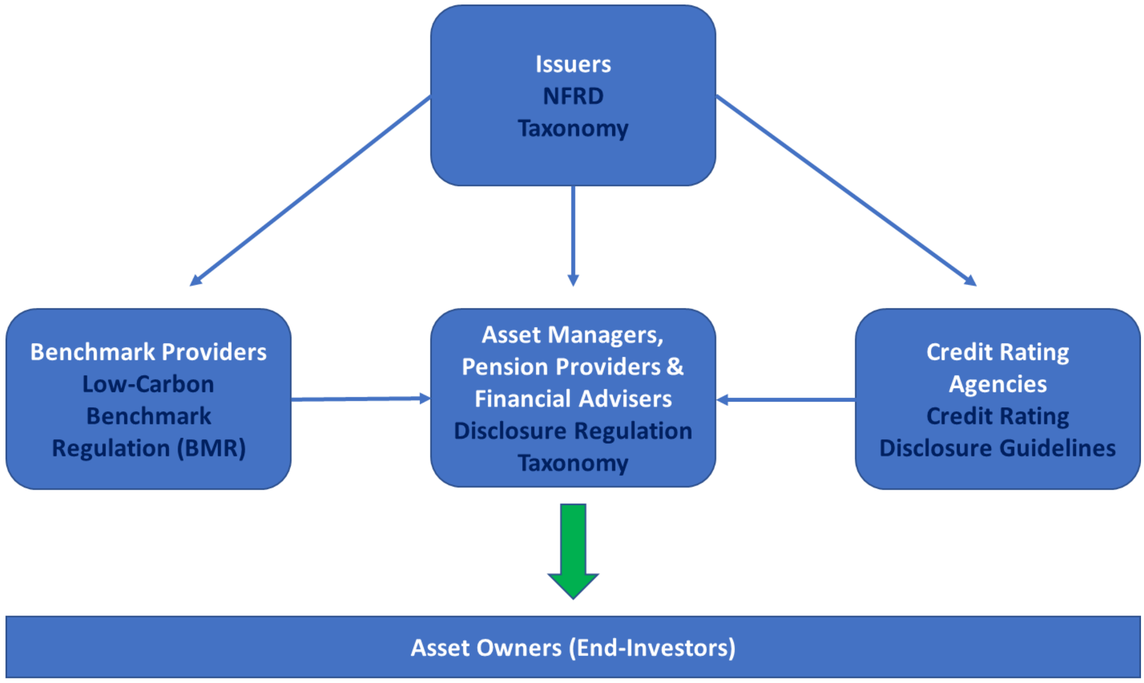
A. Background

In March 2018, the European Commission had published its Action Plan 'Financing Sustainable Growth'. Following this, it presented a package of measures related to sustainable finance: (i) Disclosure Regulation, (ii) Low Carbon Benchmark Regulation (amending Benchmark Regulation or BMR) and (iii) the Taxonomy Regulation. The Disclosure Regulation and Low Carbon Benchmark Regulation were both published in the Official Journal of the EU on 9 December 2019, and will apply from 10 March 2021 and 30 April 2020 respectively.

The main aim of the Disclosure Regulation is to provide more transparency to end-investors on whether and how the buyside and financial advisers take into account ESG aspects. This memorandum considers the implications of both the Disclosure Regulation and the Low Carbon Benchmark Regulation for investors. Furthermore, it will explain what the Taxonomy Regulation, which is closely linked to the Disclosure Regulation and will be formally adopted in 2020, will mean for both investors and issuers. NFRD already aims to provide data for investment decisions but both the Disclosure Regulation and the proposed Taxonomy Regulation can only fully meet their objectives if relevant non-financial information is available from investee companies.

To address this, in February, the European Commission launched a public consultation on possible revisions to NFRD. It remains open until 11 June 2020. To be comprehensive this paper will also explain requirements for issuers under NFRD, and lastly, it will look at guidelines on disclosure requirements applicable to credit rating agencies, both important to investors (in most of this document referred to as asset managers and pension providers) and issuers as well.

Data flows to benefiting parties from disclosure requirements under new or amended regulation



B. Summary of sustainability disclosure requirements by key constituency

Issuers

The **Taxonomy Regulation** brings new disclosure requirements for large listed companies that are already required to provide a non-financial statement under NFRD. They will have to start disclosing how their business activities (turnover, CapEx and, if relevant, OpEx) align with the climate objectives (adaptation and mitigation) under the EU Taxonomy Regulation **in the course of 2022** (covering the financial year 2021) and all six environmental objectives[1] **in the course of 2023** (covering the financial year 2022). This requirement aims to address the data gap for investors who in turn will be required to disclose the degree of alignment of their financial products with the Taxonomy objectives (see section below). Moreover, when reporting on the percentage of turnover and CapEx compliant with the EU Taxonomy, European companies bound by NFRD are also deemed to assess compliance with "do no significant harm" criteria and minimum safeguards.

Since the entry into application of NFRD in 2018, large listed companies with more than 500 employees by EU law have to report on non-financial aspects related to environmental, social, employee, human rights, anti-corruption and bribery matters. Non-financial statements on these aspects should include a brief description of companies' business models, policies (including on due diligence), outcomes of these policies, risks and risk management and non-financial KPIs. In June 2017, the European Commission provided Guidelines on non-financial reporting to help companies disclose relevant non-financial information in a more consistent and more comparable manner. And in June 2019, as a supplement to these 2017 guidelines the European Commission published Guidelines on reporting climate-related information which integrate the recommendations by the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) (see Annex). Both guidelines are voluntary (non-binding) and do not create any new legal obligations.

[1] Six environmental objectives are: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems

Table summarizing non-binding guidelines supporting NFRD implementation

NFRD Reporting Area	**Guidelines on non-financial reporting (June 2017)** Disclosure/description	**Guidelines on climate-related reporting (June 2019)** Disclosure/description
Business Model	• How it generates value in the long term • Organisation and structure • Markets • Objectives and strategies • Trends and factors for future development	• Impact of climate risks and opportunities on business model • Company's business model impact on climate Resilience of the business model (< 2 °C scenario and > 2 °C scenario)
Disclosure on Policies and Due Diligence Processes	• Objectives on key non-financial aspects • Resource allocation in relation to objectives/targets • Management and board responsibilities • Intended outcomes	• Company policies related to climate (mitigation or adaptation) • Climate-related targets the company has set as part of its policies • Board's oversight of climate risks and opportunities Management's role in assessing and managing climate-related risks
Outcomes	• Natural capital impacts and dependencies • Comparison against targets, developments over time • Mitigating effects of policies implemented	• Outcomes including the performance against the indicators used and targets • Description of the development of GHG emissions against the targets and related risks over time
Disclosure on Principal Risks and Their Management	• Information on principal risks • Potential impact of risks on activities/operations, supply chain, business relationships, business model, financial performance • Risk management and mitigation measures	• Processes for identifying and assessing climate risks in the short, medium, long-term • Principal climate risks over the short, medium, and long term throughout the value chain Processes for managing climate-related risks (relative significance of in relation to other risks)
Key performance indicators examples	• Social and employee: e.g. employee turnover, ratio of temporary contracts, avg hours of training, gender diversity, number of accidents. • Human rights: e.g. occurrence of impacts on human rights, operation and suppliers at risk of violations, respect of freedom of association. • Anti-corruption and bribery: e.g. internal control, employee training.	• GHG emissions • Energy • Physical risks • Products and services[2] • Green Finance (i.e. climate related green bond ratio[3] and/or climate related green debt ratio)

While companies are required to comply with NFRD when they meet the scoping requirements, the fact that each company must ultimately determine which disclosures are most relevant to its own stakeholders and can rely on a "comply or explain" provision, has led to a lack of comparability of the information reported. In addition to TCFD recommendations which focus only on climate-related financial disclosures, companies are currently using a number of standards and reporting frameworks like the GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board) and IIRF (International Integrated Reporting Council) to guide them in covering most or all relevant non-financial issues. Furthermore,

[2] This indicator is the direct link between the Guidelines and the EU Taxonomy as explained above.
[3] This KPI refers to both EU Green Bond Standard and other recognized green bond frameworks such as the Green Bond Principles.

investors can request companies to disclose environmental data related to climate change, deforestation and water security through questionnaires run by not-for-profit charity CDP (formerly known as the Carbon Disclosure Project). Companies that have been requested to disclose are listed on the CDP's website.

However, the growing need for yet more comparable non-financial data by the investment community with its own new disclosure requirements has pushed the European Commission to announce a **review of NFRD** (consultation on-going). Broadly, the consultation inquires if changes should be made regarding: (1) the quality and scope of non-financial information, (2) introduction of a common reporting standard, (3) application of the materiality principle, (4) introduction of assurance requirement for non-financial information, (5) digitisation of non-financial information, (6) structure and location of non-financial information, (7) potential expansion of the personal scope of NFRD (e.g. the size criteria to be revised from 500 to 250 employees), and (8) administrative burdens.

Asset managers, pension providers and financial advisers

Requirements in the **Disclosure Regulation** relate to three key concepts: sustainable investment, sustainability risk and sustainability factors which are defined as follows:

- **Sustainable investment** is an investment in an economic activity which (i) contributes either to an environmental or a social objective (ii) does not significantly harm any environmental or social objectives and (iii) where the investee company follows good governance practices.
  Sustainability risk is an environmental, social or governance event or condition which, if it occurs, could cause a material negative impact on the value of an investment.
- **Sustainability factors** are environmental, social and employee matters, respect for human rights, anticorruption and anti-bribery matters (N.B. this is the same as NFRD)

The focus hereby is on double materiality, i.e. both the integration of sustainability within the firm, and external impact of a firm's investing on sustainability factors.

In summary, bearing these definitions in mind, asset managers and pension providers[4] as well as financial advisors will have to disclose:

(1) If and how they integrate sustainability risks in their investment decisions, advice as well as their remuneration policy;
(2) If their investment decisions have any potential adverse impacts on sustainability factors;
(3) Information to show how a product[5] with ESG/sustainable characteristics/objectives meets those characteristics or objectives including the relevance of its benchmark.

There is no disclosure obligation under the Taxonomy for individual financial instruments such as bonds.

The Disclosure Regulation aims to increase transparency mainly through website and pre-contractual disclosures (e.g. in prospectuses) as well as periodic reports.

[4] Potentially leading to confusion, the Disclosure Regulation refers to "financial market participants" that are in fact essentially defined as asset managers and pension providers.
[5] The Disclosure Regulation refers to "financial products" meaning quite specifically: (a) a portfolio managed in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments (b) an alternative investment fund (AIF); (c) an IBIP; (d) a pension product; (e) a pension scheme; (f) a UCITS; or (g) a PEPP.

Table summarizing main provisions under the Disclosure Regulation

Types of disclosure	Legal obligation	Scope	Where to disclose
Policies on the integration of sustainability risks in **investment decisions or advice** (art.3)	Mandatory	Asset managers and pension providers **+** financial advisors	Website
Consideration of adverse sustainability impacts **at entity level** (art.4): • Principal adverse impacts/indicators/actions • Engagement policies • Adherence to standards on due diligence, alignment with Paris Agreement (where relevant)	Comply or explain Firms, group subsidiaries with > 500 employees cannot "explain" after 30 June 2021	Asset managers and pension providers + financial advisors	Website
Consistency between **remuneration policies** and sustainability risks (art.5)	Mandatory	Asset managers and pension providers + financial advisors	Website
Integration of sustainability risks in investment decisions or advice and **impacts of sustainability risks on the returns of the financial products** (art.6)	Comply or explain	Asset managers and pension providers + financial advisors	Pre-contractual documents
Consideration of adverse sustainability impacts **at product level** (art.7): • Methodology integrating sustainability adverse impacts into their investment decisions	Comply or explain By 2023 each financial product issued by firms needs to comply or explain unless firms < 3 persons	Asset managers and pension providers	Pre-contractual documents
Characteristics/objectives/benchmarks of ESG and "sustainable" financial products (art.8, 9, 10 & 11).	Mandatory	Asset managers and pension providers	Pre-contractual documents, website and periodic reports

As mentioned above, the Disclosure Regulation defines the concept of "sustainable investment" as an investment in an economic activity that contributes to an environmental or a social objective provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices. Importantly, the definition of "sustainable investment" introduces a new "do no significant harm" (DNSH) principle that is broader than the DNSH principle in the EU Taxonomy in that the scope here goes beyond the six environmental objectives.

More clarity is therefore needed on the extent to which the DNSH in the Disclosure Regulation and Taxonomy Regulation will apply to funds' disclosure obligations under article 8 (financial products promoting among other environmental or social characteristics) and article 9 (financial products having sustainable investment as their objective). The degree of alignment between those two DNSH principles will be addressed by one of the seven regulatory technical standards ("RTSs") to be developed by the European Supervisory Authorities (ESAs) by December 2020[6]. A consultation has been issued by the ESAs (ESMA, EBA, EIOPA) in April 2020 with a deadline of 1 September 2020. Our understanding from this consultation is that for the DNSH principle, asset managers and pension providers will have to show that a product takes into account adverse impact indicators, i.e. that their investments do not significantly harm environmental or social objectives (based on a list of adverse impact indicators) and to disclose how certain investments have been excluded.

[6] See Article 16(c) of the Taxonomy Regulation.

In addition to DNSH, the RTSs are meant to provide stakeholders with further details on how to comply with these new provisions by addressing content, methodology and presentation of ESG disclosures both at entity level and at product level.

Under the proposed **EU Taxonomy Regulation**, asset managers and pension providers (same definition as under the Disclosure Regulation) are also facing new disclosure requirements. This means, for products in scope, they need to disclose to what extent their portfolios align with the Taxonomy objectives. More specifically:

- **"Sustainable" products** (as defined by Disclosure Regulation): % of portfolio that is EU Taxonomy-aligned.
- **Products with ESG characteristics** (as defined by Disclosure Regulation): % of portfolio that is EU Taxonomy-aligned; "do no significant harm principle" only applies for the investments underlying the product[7] that consider the EU Taxonomy.
- **Mandatory statement products with <u>no</u> ESG characteristics**: "product does not consider the EU Taxonomy".

Asset managers and pension providers will be required to complete their first set of disclosures against the Taxonomy, covering activities that substantially contribute to climate change mitigation and/or adaptation, by **31 December 2021**. And disclosures in relation to all six environmental objectives by the **31 December 2022**. All these disclosures will have to be made in pre-contractual documents, the website and periodic reports.

For more details please see the TEG's final report on the EU Taxonomy published in March 2020.

Benchmark Providers

Under the Low Carbon Benchmark Regulation, which amends the existing **Benchmark Regulation**, all benchmark providers[8] (except interest rate and foreign exchange benchmarks) administrating benchmarks will have to disclose whether and how they take ESG factors into account. These disclosure requirements will also apply to two new categories of benchmarks introduced by the amended regulation, namely EU climate transition benchmarks (CTB) and EU Paris-aligned benchmarks (PAB).

Credit rating agencies

Under ESMA's guidelines on Disclosure Requirements applicable to Credit Ratings published on 18 July 2019, when a CRA consider ESG factors it needs to disclose in their press releases or reports:

- Whether the key drivers behind the change of rating/outlook correspond to ESG factors identified by the CRA;
- The key driving factors that were considered by that CRA to be ESG factors;
- An explanation of the impact of these ESG factors to the credit rating or rating outlook; and
- A link to the relevant source on the CRA's ESG methodology.

[7] Portfolio, AIF, IBIP, pension product, pension scheme, UCITS or PEPP
[8] Referred to as benchmark administrators in the regulation

C. EU sustainability disclosures grid

Who?	Which law?	What to disclose?	Where, how to report it?	Next steps
Issuers Large Public Interest Entities with more than 500 employees	NFRD	**Comply or explain** Information on environmental, social, employee, human rights, anti-corruption and bribery matters including description of business model, policies on sustainability matters, outcomes, principal risks, and KPIs.	**Where?** Quarterly/annual reports or dedicated CSR report **How?** Guidelines on non-financial reporting Guidelines on Climate-reporting	On-going review of NFRD: EC consultation
	Taxonomy	**Mandatory** • Turnover derived from products/services associated with the Taxonomy • CapEx and/or OpEx related to asset/ processes associated with the Taxonomy	**Where?** Quarterly/annual reports or dedicated CSR report **How?** Delegated act by 1 June 2021	EC to adopt delegated act by 01.06.2021
Asset managers and pension providers	Disclosure Regulation	**Mandatory** • Integration of sustainability risks in investment decisions or advice, and remuneration	**Where?** Website **How?** Technical standards pending	ESAs to submit draft technical standards by 30.12.2020 Applies from: 10.03.2021
		Comply or explain • Consideration of adverse sustainability impacts at product and entity levels: firms and group subsidiaries with > 500 employees cannot "explain" after 30 June 2021	**Where?** Website, Pre-contractual documents **How?** Technical standards pending	
		Comply or explain • Impacts of sustainability risks on the returns of the financial products	**Where?** Pre-contractual documents **How?** No technical standard	
		Mandatory • Characteristics/objectives/benchmarks of ESG and "sustainable" financial products	**Where?** Pre-contractual documents, website and periodic reports **How?** Technical standards pending	
	Taxonomy	**Mandatory** • Alignment of "Sustainable" and ESG products (as defined in the Disclosure Regulation) aligns with the EU Taxonomy objectives, including the "do no harm objective" • Statement for products with no ESG characteristics: "does not consider Taxonomy"	**Where?** Pre-contractual documents and periodic reports **How?** No precision	Applies from: • "Sustainable" products: 31.12.2021 • others: 31.12.2022
Benchmarks administrators All except interest rate and foreign exchange	Low Carbon Benchmark Regulation	**Comply of explain** • Consideration of ESG factors for each benchmark **Mandatory** • EU PAB carbon emissions are aligned with the objectives of the Paris Agreement • EU CTB: underlying assets are on a decarbonisation trajectory	**Where?** Websites and statements **How?** Delegated act pending	Applies from: 30.04.2020
Credit rating agencies	CR disclosure guidelines	**Mandatory** When a CRA consider ESG factors it needs to disclose: • whether the key drivers behind the change of rating/outlook correspond to ESG factors identified by the CRA • key driving factors that were considered by that CRA to be ESG factors • explanation of the impact of these ESG factors to the credit rating or rating outlook • A link to the relevant source on the CRA's ESG methodology.	**Where?** Press releases or reports **How?** Guidelines on Disclosure Requirements Applicable to Credit Ratings	Applies from: 30.03.2020

Annex: Integration of TCFD recommendations in NFRD guidelines on climate reporting

		NFRD guidelines on climate reporting				
TCFD		Business Model	Policies and due diligence	Outcomes	Principal risks & MGMT	KPIs
Governance	Board oversight		✓			
	Management role		✓			
Strategy	Climate risks and opportunities				✓	
	Impact of climate risks & opportunities	✓				
	Resilience of the operation strategy	✓				
Risk Management	Processes for identifying & assessing				✓	
	Processes for managing				✓	
	Integration risk management				✓	
Metrics & targets	Metrics used to assess					✓
	GHG emissions			✓		
	Targets			✓		

Source: ICMA based on regulation

The **Guidelines on reporting climate-related information** integrating the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures and encourage companies to disclose information in accordance with globally accepted reporting standards and frameworks: e.g. GHG Protocol for GHG emissions reporting, also embedded in standards and frameworks such as the GRI Standards, CDP, SASB.