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The EU's Sustainable Finance Disclosure Regulation: The fund managers' problem that will also affect issuers

The EU SFDR, which is part of the EU co-ordinated Green Deal, oversees ESG disclosure by investment firms. Crucially it governs which investment products are allowed to be described as sustainable. Inevitably it will result in the need for a raft of new datapoints from investee companies. While the compulsory disclosures have been simplified following a year of consultation, a lot of the data is still not readily available. Implementation by investors is due in March, meaning 2021 will be a year of heightened discussions and further preparation by issuers.

Although investors are not required to start periodical reporting on SFDR metrics until 2022, MSCI told issuers, in an interesting webinar last week, it is already seeing a flurry of activity from investors in preparation. Despite the fact that the SFDR officially applies from March 2021, the metrics around which ESG products must manage (known as Principal Adverse Indicators "PAI") are still neither finalised nor easily accessible. It is also not yet entirely clear how the new (and also yet to be finalised) EU Taxonomy-setting out what business activities count as sustainable- will feed into the disclosures. In addition, there remain gaps between the (already mandatory) disclosures for companies with more than 500 employees required by the EU's Non-Financial Reporting Directive ("NFRD"), and those that the SFDR will be asking for. The EU has pledged to close this gap but, as ever, the timing of any further convergence remains unclear.

Issuers could therefore be forgiven for adopting a wait-and-see attitude, particularly as the SFDR only applies to funds sold in the EU, and there are two other global/US initiatives aimed at unifying the unholy morass of standards/ratings etc of the ESG arena. Against that, the EU is trying to take a lead and lay down what it intends will become de facto global standards (since all global investors want to sell ESG funds into the EU) so things could happen quite quickly.

The latest development, and a major step forward, was the publication by the ESA's (ESMA et al) last week of the Regulatory Technical Standards, which include the PAI list to be ratified within 3 months by the European Commission (Annex 1 on pg 52 of the report).

EU consultation responses (particularly from fund managers) were pretty vocal in calling for a reduction in the number of compulsory PAIs and, reading the RTS report, it would appear that there has indeed been a significant simplification; we can only see 20 mandatory items, from the original 32. That said, the list still looks rather onerous, and investors are still concerned about the availability of data, as only a portion of it is already included in ESG ratings.

The EU has published a hierarchy to govern the data collection processes for investors, which states they must first look for readily available data, second ask the issuers, and third go to the rating agencies and seek any proxies they might have or be able to put together. It is clear to us where this is heading; fund managers' ESG/marketing and compliance departments will be crawling all over this for the whole of 2021, and investments in issuers with major gaps in their data may become uncomfortable for funds wishing to sell products under an ESG umbrella. That said, funds can always choose to explain to their clients why they hold those companies – after all, they exist to make money for their clients. So, the outcome of not being able to disclose all the data will not necessarily be catastrophic but, in a competitive world, cost of capital may be affected.

Many investors will turn to the major external data providers for help. MSCI showed graphics outlining the proportion of companies that already report on the PAI metrics, or where MSCI can fill in with proxy data already collected, but there were (by their own admission) a lot of gaps. Sustainalytics has also published a guidance document that shows how the PAIs map onto their data. In the light of the new RTS, both will probably need to amend the mapping as the list has dropped some indicators, and changed the scope of disclosure in some instances. That said, readers could view these lists in conjunction with the RTS document to get an idea of what is available.

With regards to forecasting which disclosure standards will prevail internationally, this effort gives the EU some advantage in becoming a global standard. We do continue to see strong support amongst financial market ESG practitioners for the frameworks of SASB, TCFD, and the UN PRI, as well as the CDP, and some of these bodies are coalescing to seek compatibility and equivalence. That said, it is not just first mover advantage that is rowing in the EU's favour.

Although the Taxonomy/SFDR/NFRD will, technically, only apply in the EU, it covers investment products sold to EU clients, so any fund manager wishing to sell products there will need to comply; European banks' private client fund lists are full of funds painstakingly sold by the likes of Wellington, Fidelity and Templeton Franklin and it is not a market they will want to lose ground in.

In addition, all European fund managers will have to secure SFDR metrics from issuers outside Europe, and Asian/US companies will not want to cut themselves off from that investor base or, for that matter, global funds that are also sold in Europe.

Lastly, it will be the first such system that is written into law in a major region, and market forces (increasing appetite for ESG funds) combining with legislation should prove pretty powerful, so, rather like MiFID2, it is likely to become more pervasive than generally appreciated at the outset.

In Summary

Issuers are likely in 2021 to be hit with a barrage of requests from investors or data providers for ESG data not currently (or, in some cases, easily) disclosed regarding the SFDR metrics not already in sustainability reports. The clear imperative, once the PAI's and the required timings of their reporting are finalised, is for issuers to fill in the gaps over the balance of this year. Given the EU rules have already been through consultation the list in the RTS report (linked above) is undoubtedly a good place to start, and we stand ready to help if required.

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