ESG disclosure standards for investment managers: similarities and differences between the UK and EU regimes

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The Sustainable Finance Disclosure Regulation (SFDR) and the Recommendations of the Task Force on Climate related Financial Disclosures (TCFD) together form the blue print for ESG-disclosures for investment managers in the EU and in the UK. This article compares and contrasts the disclosure standards and outlines the principal similarities and differences between the two disclosure regimes.

Background and scope

The SFDR is a part of the European Commission's package of reforms relating to sustainable finance under the EU Action Plan on Financing Sustainable Growth. The SFDR aims to harmonise disclosures by investment managers, financial advisers and other financial institutions to investors on sustainability information and the integration of sustainability risks in investment decision#making and in advisory processes, and on the consideration of adverse impacts on sustainable investment objectives or in the promotion of products that have environmental or social characteristics.

The TCFD recommendations aim to create voluntary, consistent climate-related financial disclosures for businesses to provide information to investors, lenders, insurance underwriters, and other stakeholders. The objective is to provide a standardised approach to climate change reporting, so that risks and opportunities can be categorised consistently, and organisations across different sectors and jurisdictions can be compared.

The SFDR has a broader sustainability focus than the TCFD recommendations, as evidenced from the SFDR key concepts of "sustainable investment", "sustainability risk" and "sustainability factors", which cover the full spectrum of Environmental, Social and Governmental matters and beyond. By contrast, the TCFD's focus is limited to climate change, as evidenced from the key concepts under the TCFD recommendations such as "climate-related risks" and "climate-related opportunities."

The SFDR is law in the EU having gone through the legislative processes in the EU. By contrast, the TCFD recommendations are international standards made by a Task Force with market participants from across the G20, created by the Financial Stability Board.

Basis for compliance

Most provisions of SFDR are to be phased in across the EU from March 10, 2021. The SFDR has not been onshored into UK domestic law following the end of the Brexit transition period, therefore UK investment managers will not be required to comply with an equivalent UK version from March 10. The European supervisory authorities have written to the European Commission to obtain clarification on the extraterritorial application of the SFDR to non-EU investment managers, such as when marketing a fund under a national private placement regime in the EU.

Although compliance with the TCFD recommendations by UK investment managers is voluntary, the UK joint regulator and government TCFD Taskforce has stated that a significant part of the requirements will be mandatory by 2023. The FCA's proposals will be included in a consultation paper that is expected to publish in the first half of 2021.

The disclosure requirements

Both the SFDR and the TCFD recommendations disclosures require investment managers to make both entity-level (i.e., the investment manager) and product-level (i.e., the fund or portfolio-specific) disclosures.

The SFDR splits the product-level disclosures into three categories: products that promote environmental or social characteristics (light green), products that have sustainability as an investment objective (dark green) and all other products that are neither light green nor dark green (other products). By contrast, the TCFD recommendations disclosures are structured around four levels or areas that represent the "core elements of how organisations operate" and are intended to apply equally at the manager level as well as to funds or portfolios as asset owners:

The SFDR investment manager disclosures are:

(1) *Sustainability risks policy*: Have a policy on the integration of sustainability risks in its investment decision making process and disclosure details of such policy on its website.

(2) *Due diligence policy*: Either comply with the requirement to implement a due diligence policy with respect to the principal adverse impacts of investment decisions on sustainability factors or explain why it does not consider such adverse impacts. Details about the policy or reasons for non-compliance should be provided on the manager's website.

(3) *Remuneration policy*: Review and update its remuneration policy to include information on how the policy is consistent with the integration of sustainability risks as well as disclose details of such on its website.

(4) *Marketing communications*: Review all marketing communications (including in respect of financial products) to ensure those communications do not contradict any information disclosed pursuant to SFDR.

The SFDR fund or portfolio-level disclosures are:

(1) The baseline requirements, namely, disclosure in pre-contractual documentation of:

(a) whether the specific product complies with the requirement to assess the impact of sustainability risks on the returns of the specific product, or, provide an explanation for why such assessment is not relevant;

(b) whether and how the specific product considers the principal adverse impact on sustainability factors, or, a negative statement with reasons for not considering such adverse impact, depending on whether the investment manager has complied with the due diligence policy requirements at an entity.

(2) The enhanced requirements applicable to light green and dark green products in addition to the baseline requirements.

The four levels of disclosures under the TCFD recommendations are:

(1) *Governance disclosures*: Requirement to disclose the organisation's governance around climate related risks and opportunities.

(2) *Strategy disclosures*: Requirement to disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

(3) *Risk management disclosures*: Requirement to disclose how the organisation identifies, assesses, and manages climate-related risks.

(4) *Metrics and targets disclosures*: Requirement to disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Medium of the disclosures

The SFDR disclosure requirements prescribe the medium through which the relevant disclosure must be made or provided, with requirements to disclose certain information on a website, in pre-contractual documentation, in periodic reporting to investors or in internal policies and procedures. The SFDR framework includes templates prescribed by law that investment managers, funds or portfolios must use when providing or disclosing certain information.

In contrast to the SFDR, the recommendations generally state that asset owners and asset managers should report to their beneficiaries and clients, respectively, through existing means of financial reporting and publicly via their websites or other public avenues of disclosure. In practice, reporting may take different forms, depending on the requirements of the client and the types of investments made.

Entities subject to the disclosure requirements

The SFDR applies to "financial market participants" and "financial products", each of which is defined by reference to EU legislation and includes MiFID investment firms, alternative investment fund managers (AIFMs) and UCITS management companies and the funds and portfolios they manage (e.g. AIFs, UCITS and managed/segregated accounts). The SFDR also applies to "financial advisers", including investment advice provided by AIFMs, MiFID investment firms and UCITS management companies.

The TCFD recommendations are broader in scope, with the Task Force recommending all financial and non-financial organisations with public debt or equity implement its recommendations across all sectors, including asset managers and asset owners (which includes funds). Similarly, The UK TCFD-based disclosures regime will apply to seven "categories of organisation", which includes FCA-authorised investment managers (defined to include AIFMs, investment firms providing portfolio management services and UK UCITS management companies) as one of those categories (see a Roadmap towards mandatory climate-related disclosures, HM Treasury).

Complaints Procedure