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PUBLIC HEARING ON THE CONSULTATION PAPER AND DRAFT RTS ON ESG DISCLOSURES

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Legal Briefings

On 2 July 2020, the three European Supervisory Authorities (ESAs) held a public hearing to explain and discuss the content of the Consultation Paper and Draft RTS with regard to the content, methodologies and presentation of disclosures to be made pursuant to Regulation (EU) 2019/2088 (Disclosures Regulation) published by the ESAs on 23 April 2020. The format of the hearing was a brief presentation on each of the following topics (available here), followed by Q&A sessions on each:

- Principal adverse impact disclosure at entity level
- Product disclosures: pre-contractual and periodic disclosures
- Product disclosures: website disclosures
- Product disclosures: DNSH provisions

Following on from our previous briefing on the Consultation Paper and Draft RTS (available here), this briefing highlights some key takeaways from the hearing which are of relevance to asset managers. We would note that the ESAs' observations should not be relied on as official guidance, and are of only limited value when interpreting the Disclosures Regulation or the Draft RTS. However, it is nevertheless helpful to understand the ESAs' thinking behind the Draft RTS and the expected direction of travel.

1. INSUFFICIENCY AND UNRELIABILITY OF ESG DATA

The ESAs recognised that the limited availability of sufficient and reliable data to make the disclosures required by the Draft RTS is an area of significant concern. However, they noted that the Draft RTS only requires financial market participants to use "best efforts" to obtain information from investee companies and, where information cannot be obtained despite such best efforts, requires them to use best efforts to assess the adverse impacts (based on reasonable assumptions, research and third party data) (Article 7(2) of the Draft RTS). The ESAs did reiterate, however, that it is the financial market participant which would be ultimately responsible for the accuracy of disclosures made in respect of a financial product.

2. ARTICLE 9 PRODUCTS MAY HOLD NON-TAXONOMY-COMPLIANT INVESTMENTS

As explained in our previous briefing, an Article 9 Product is a financial product which "*has sustainable investment as its objective*". "*Sustainable investments*" is defined under the Disclosures Regulation without reference to the Taxonomy Regulation. The ESAs acknowledged, both in the Consultation Paper and in the hearing, that as a potential consequence a financial product may qualify as an Article 9 Product under the Disclosures Regulation notwithstanding that its portfolio is fully or partly composed of investments which are not Taxonomy-compliant (i.e. which are not invested in "*environmentally sustainable economic activities*" as defined under the Taxonomy Regulation).

3. SOME INFORMAL VIEWS ON THE SCOPE OF ARTICLES 8 AND 9, BUT NOTHING DEFINITIVE

The participants asked a number of questions about the scope of Articles 8 and 9. The ESAs stressed that the RTS cannot further define Article 8 or Article 9 Products – the ESAs consider that their hands are tied by the drafting of the relevant provisions in the Disclosures Regulation.

However, the ESAs did offer the following informal views:

a. The classification of a financial product as falling within Article 8 or Article 9 (or neither) depends on the product's design, rather than the investments it holds.

b. A financial product which has a simple exclusion strategy (for example, with respect to weapons or tobacco) could qualify as an Article 8 Product, though probably not if the exclusion solely arises from a legal obligation. This point was made several times as it was clearly of concern to some participants that the threshold could be so low. Further, if

a product has a "best in class" objective, it may qualify as an Article 9 Product if its investments are intended to comply with the criteria for "sustainable investment" in Article 2(17) of the Disclosures Regulation. It is expected that the majority of ESG products will fall under Article 8; Article 9 covers a smaller sub-set of products that have a specific sustainable investment objective.

c. It is important that financial market participants do not over-disclose in respect of simple Article 8 Products, or give any such product a misleading name, but the ESAs did not see that there was a hard restriction on using terms such as "sustainable" in the name of funds which were not within Article 9.

d. If an asset manager or pension scheme has an entity-level ESG commitment (e.g., to not itself invest in, or offer any financial products that invest in, fossil fuel companies), any financial products which it offers could be considered Article 8 Products if it is indicated that they are subject to that commitment and marketed on that basis.

4. APPLICATION OF THE "DO NO SIGNIFICANT HARM" PRINCIPLE TO ARTICLE 8 PRODUCTS

The ESAs confirmed that, in the context of Article 8 Products, the "do no significant harm" requirement applies only in respect of the sustainable investments held by that product. This is a welcome clarification on a point which is not entirely clear in the Draft RTS.

5. USE OF INDICATORS FOR ADVERSE IMPACT DISCLOSURES

As noted in our previous briefing, with respect to the adverse impacts disclosure required under the Disclosure Regulation, the Draft RTS prescribes a core set of indicators (set out in Table 1 of Annex I) and optional sets of environmental and social indicators (set out in Table 2 of Annex I).

The core set of indicators are deemed to always lead to principal adverse impacts, irrespective of the result of the assessment by the financial market participant. Though disclosure against those indicators is mandatory, the ESAs acknowledged that where an indicator is irrelevant to a given investment (e.g., the deforestation indicator in relation to an investment in an IT company), the financial market participant might be permitted to disclose a score of zero against that indicator and explain why it is irrelevant. What isn't clear, however, is the extent of due diligence to be carried out by the financial market participant before concluding that an indicator is not relevant to any given investment and whether a 'zero' value can be entered if it had not been verified.

On the optional indicators, the Draft RTS requires disclosure on at least one indicator selected from each of the sets of environmental and social indicators. The ESAs acknowledged that it is left to the financial market participant to determine which of the indicators should be disclosed against – however, in response to a question, the ESAs indicated that they would expect the financial market participant to select the indicator on which the investment had the most material impact.

6. SOCIAL INDICATORS MAY CHANGE OR BE DELAYED

The ESAs explained that they drafted the sustainability indicators for social factors (set out in Annex I to the Draft RTS) without material input from sector specialists. Before finalising those factors, the ESAs will take into account feedback on the Consultation Paper (which is open for responses until 1 September 2020). The social indicators may therefore change from their current formulation. The ESAs also acknowledged the possibility that the social indicators may be finalised after the environmental indicators (under Article 4(7) of the Disclosures Regulation, the ESAs have until 30 December 2021 to finalise the RTS containing social indicators, which is a year later than the environmental indicators which are due by 30 December 2020).

7. TIMING OF FIRST ADVERSE IMPACT REPORT AND CALCULATION METHODOLOGY

Several participants had questions about the timing of the first adverse impact disclosure. The ESAs clarified that for "large" financial market participants (who are required to make these disclosures under the Disclosures Regulation), the first disclosure would be due by 30 June 2022, in respect of the reference period from 30 June 2021 to 31 December 2021.

For other financial market participants (to whom this disclosure requirement applies on a 'comply or explain' basis), the first reference period commences on the later of 10 March 2021 and the date on which such financial market participant decides to consider principle adverse impacts, and ends on 31 December of the relevant year, with the report due by 30 June of the immediately following year.

There were also some questions about how adverse impacts are to be calculated over any reference period. Although several questions remain, the ESAs clarified that the adverse impact disclosures should relate to the entire reference period and should not be based merely on the portfolio as it stands at the end of the relevant reference period.

8. CLARIFICATION ON THE DEFINITION OF FOSSIL FUELS

Finally, on the hotly debated question of why the definition of fossil fuels is limited to solid fossil fuels, the ESAs emphasised that the intent is not to exclude non-solid fossil fuels from the adverse impact disclosures – the disclosures on GHG emissions, pollution, biodiversity and waste would apply equally to solid and other fossil fuels. The ESAs noted that the Taxonomy Regulation drew a distinction between solid fossil fuels and other fossil fuels (by requiring, in Article 19, that technical screening criteria should ensure that power generation activities that use solid fossil fuels do not qualify as "*environmentally sustainable economic activities*") and explained that the approach in the Draft RTS was intended to be consistent with this, whereby solid fossil fuels are considered *prima facie* unsustainable. This does not, however, suggest that adverse impacts relating to other fossil fuels did not require disclosure.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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