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Policy Briefing: EU's Regulation on Investor Disclosure on sustainability risks and due diligence: How can it work most effectively for people and planet?

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Disclosures relating to the sustainability impact of mainstream investments

There are no reliable estimates of the global footprint of European investments, but research by civil society organisations including Global Witness, shows that they can often have significant and detrimental effects on climate change, human rights and deforestation, to name just a few.

The EU adopted significant new rules in December 2019, requiring a wide range of investors to integrate sustainability considerations into mainstream investments and to disclose their impact on people and planet.

Now investors will need to publish their "due diligence" policies that guide how they systematically identify, prevent and mitigate and account for adverse impacts on people and planet and be transparent about the actual adverse impacts of their investments on people and planet and any actions taken or planned to manage the impacts. In other words, investors will need to put in place a systematic approach so that they can "know and show" how they are managing sustainability impacts. This briefing looks to break down these requirements and advises how to interpret the new rules in a way that is most effective for investors, people and planet.

1. SUMMARY OF THE NEW EU RULES

EU adopts significant new rules requiring investors to disclose their impacts on people and planet

In March 2018, the European Union (EU) published its Action Plan on Financing Sustainable Growth which seeks to achieve the ambitious goal of reorienting private capital towards more sustainable investments. It also looks to align EU financial sector policy with the Sustainable Development Goals (SDGs) and the Paris Climate Change Agreement.

One of the very first pieces of legislation under the Action Plan, the "Regulation on Disclosures Relating to Sustainable Investments and Sustainability Risks" (DSR Regulation),[1] was adopted in record time by the EU, showing the urgency of the transformations needed to achieve these important goals.

There are no reliable estimates of the global footprint of European investments, but research by civil society organisations shows that they can often have significant detrimental effects on climate change, human rights, deforestation, poor working conditions, land grabs, threats against (women) human rights defenders, environmental degradation leading to

widespread food insecurity for women and men living in poverty around the globe[2] that undermine the achievement of these important goals. The DSR Regulation addresses these challenges by driving greater transparency about how they are being addressed through the financial value chain.

How significant is the DSR Regulation for people and planet?

The DSR Regulation is significant – potentially a game changer – for several reasons:

- More and more investors are integrating "environmental, social and governance" (ESG) issues into their analysis, looking at how these issues have an impact on the financial returns on their investments. The DSR Regulation now requires *all* investors covered by the Regulation to do so and to be transparent about it.
- More significantly, for the first time, it also requires all investors covered by the Regulation to be transparent about the impacts of investments *on* ESG issues – i.e. on people and planet. Investors will have to disclose the principal adverse impacts their investments have on people and planet and what actions they are taking to address those impacts.
- Investors will need to publish details of their "due diligence" policies that should guide the processes they use to systematically identify, prevent and mitigate and account for those adverse impacts. The implication of this provision is that investors must have in place due diligence policies and disclose the output of undertaking due diligence – i.e. the identification and management of risks and impacts on people and planet.
- While EU financial regulations already include increasing references to environmental impacts, and climate change, the DSR Regulation also introduces requirements around human rights and social and employee matters, as well as anti-bribery and anti-corruption matters.
- In order to fulfil their own disclosure requirements, investors will require information from the companies they invest in about how the companies manage their impacts on people and planet. This should in turn prompt those companies to improve their sustainability practices on the ground wherever they operate, as they will have to report on their impacts in a credible and systematic way to their investors – and hopefully also to the wider public. Thus, the Regulation's emphasis on transparency is expected to drive improved sustainability practices up and down the financial value chain.

The DSR Regulation expects investors and the government agencies that supervise them to take into account guidance from relevant international standards such as: the due diligence guidance for responsible business conduct developed by the Organisation for Economic Co-operation and Development (OECD)[3] and the United Nations-supported Principles for Responsible Investment (UN PRI)[4].

Given these international standards were agreed through tripartite process involving the financial sector, civil society and governments – investors and regulators should have these standards front of mind when designing their due diligence systems.

2. WHO IS COVERED BY THE NEW RULES AND WHAT ARE THE NEW REQUIREMENTS FOR INVESTORS?

Who is covered?

The DSR Regulation[5] covers: banks[6] and investment firms that provide portfolio management, asset managers, certain insurance companies and pension funds, and financial advisers.[7] In other words, it covers a wide range of financial institutions. This Briefing refers to them as "mainstream investors."

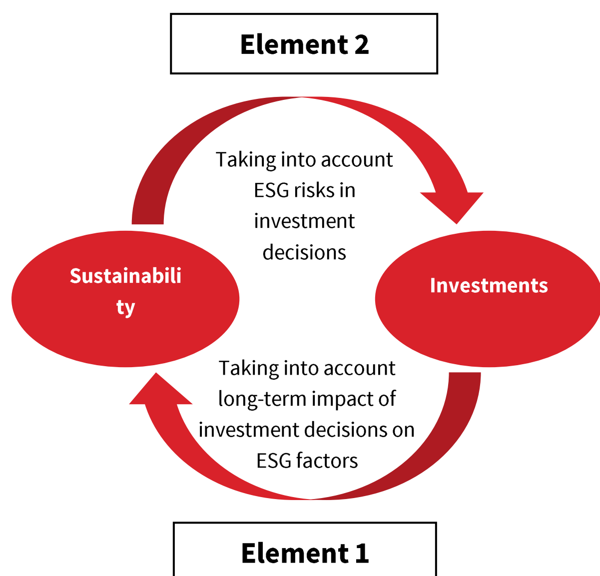
What is covered: The Regulation has two parts:

- Part I focuses on the **vast majority of financial market participants, financial advisers and financial products on the European market. This Briefing focuses on this part of the Regulation** because it covers such a wide swathe of **mainstream investments**.
- Part II is focused on financial products that are **specifically designed** to be **"environmental" or "social" or "sustainable"**.[8] The requirements are designed to address concerns of "greenwashing" (i.e. claims to have more sustainability benefits than they actually do). These products show that it is possible to design financial products that have positive impacts, but they are an unfortunately small (but growing) part of the market at the moment.[9] This Briefing therefore does not focus on this part of the DSR Regulation.

What are the major innovations introduced by the DSR Regulations for mainstream investors?

The DSR Regulation introduces a major innovation to advance the sustainable finance agenda by requiring investors to disclose **two inter-related types of risks and impacts**:[10]

Figure 1: Overview of the Regulation's two-track approach & key terms[11]



- **Element 1: Impacts on people and planet** from investments (also referred to as "environmental, social and governance (ESG)" or "sustainability")[12]

- **Element 2: Impacts on the value of investments** from ESG/sustainability issues.

TERMS USED IN THE DSR REGULATION

For Element 1 – Impacts on people and planet are referred to as: "**Principal adverse impacts** should be understood as those impacts of investment decisions and advice that result in negative effects on **sustainability factors.**"[13] → adverse impacts **of** the investment **on** the environment, society and governance.

- *For example, damage to the environment, to workers and communities, to good governance. There may be financial impacts on the company causing them, and ultimately to the investor, but not always. The core objective to take into account the impacts on the environment, to workers and communities, to good governance, even where there may not be material financial impact on the investment. This is about good stewardship of the environment and society and contributing to sustainable development.*

'**Sustainability factors'** mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."[14]

For Element 2

"**Sustainability risks** means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential **material negative impact on the value of the investment.**"[15] → These are risks **to** the investment.

- *For example, the value of an investment can be diminished by a major pollution incident resulting in closure of facilities; losses due to reputational damage when a company is found to engage in modern slavery; large fines for involvement in bribery*

The European Commission and the European Supervisory Agencies (ESAs) that design and implement the technical rules covering supervision of investors consider that both dimensions are of "paramount importance" to sustainable finance.[16]

Element 1: What are the requirements for the disclosure of adverse impacts of investments *on* sustainability?

The DSR Regulation builds on emerging investor practice of considering impacts of investments on people and planet but takes a major step forward to "level the playing field" by requiring all EU based investors covered by the Regulation to:

1. **Take into account and disclose information about the principal adverse impacts of their investments on sustainability factors:**

Investors must must publish and maintain on their websites the following information:

- A description of the **principal adverse sustainability impacts *of* investments** on people and planet.[17] The adverse impacts should be described "concisely in qualitative or quantitative terms", and that information should be "available in the ongoing reporting."[18]
- A description of the **actions taken** and **planned to address** them.[19]

These disclosures apply **both at the entity level** (i.e. the investor)[20] and at the level of **each financial product.**[21]

These disclosures are **mandatory for investors that have more than 500 staff**,[22] and on a "**comply or explain**" basis **for smaller investors**.[23]

This is however not a "get out of jail free card" for smaller investors, as any smaller entity that does not consider adverse impacts of investment decisions on sustainability factors must provide "clear reasons for not doing so, and, where relevant, including information as to whether and when they intend to consider such adverse impacts."[24]

2. Disclose information on their due diligence policies and practices to address adverse impacts of their investments on sustainability factors

- Investors must publish and maintain on their websites information on their **due diligence policies** that sets out how they address the principal adverse impacts noted above that must include at least:
  - Information about their **policies on the identification and prioritisation of principal adverse sustainability impacts and indicators**
  - Summaries of **engagement policies** with shareholders
  - **Adherence to responsible business conduct codes and internationally recognised standards for due diligence**
  - Reporting where relevant, the **degree of alignment** with the **targets** of the **Paris Agreement** on climate change.[25]

These disclosures are **mandatory for investors that have more than 500 staff**,[26] and on a "**comply or explain**" basis **for smaller investors**.[27]

The DSR Regulation does not tell investors how to undertake sustainability (or responsible business conduct) due diligence – as it acknowledges that flexibility is needed, taking due account of their size, the nature and scale of their activities and the types of financial products they make available. However, the ESAs will be developing more detailed legal guidance on due diligence (referred to as "Level 2" or "regulatory technical standards").

The Regulation also requires investors to disclose adherence to "**responsible business conduct codes**" and "**internationally recognised standards for due diligence.**"[28]

The Regulation highlights due diligence guidance for responsible business conduct developed by the Organisation for Economic Co-operation and Development (OECD) that has guidance specifically directed to institutional investors[29] and guidance developed by the UN-supported Principles for Responsible Investment (PRI).[30]

The ESAs are also directed to take account of these documents[31] as part of the process of developing regulatory technical standards.

DUE DILIGENCE

"**Due diligence**" processes are dynamic processes to identify and manage risks and impacts. The usual focus of due diligence is identifying risks *to* the business. Several types of financial entities are already obliged to carry out various types of due diligence under relevant EU financial legislation.[32]

What is different about the due diligence required by the DSR Regulation, is that the **focus of the due diligence is on adverse impacts on environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters** (referred to as "sustainability factors") resulting from the investments – i.e. for example, land grabs, excessive CO_2 emissions, deforestation, undermining trade unions or corruption – rather than purely on risks to the investor or the investment.

It is through sustainability or responsible business conduct due diligence that investors can identify and take action to address the adverse impacts that must be reported to the public under the Regulation.

"Due diligence" is understood as a process (or processes) through which entities can **"identify, prevent, mitigate and account for how they address their actual and potential adverse impacts** as an integral part of business decision-making and risk management systems."[33] More specifically due diligence involves: "1) identifying actual and potential adverse impacts; 2) preventing or mitigating adverse impacts; 3) accounting for how adverse impacts are addressed, by (a) tracking performance and (b) communicating results."[34]

The OECD Due Diligence Guidance for Responsible Business Conduct highlights a number of "essential" characteristics of due diligence including that it is preventive, risk-based, dynamic, is based on internationally recognised standards of responsible business conduct, and is informed by engagement with stakeholders.[35] These will be important characteristics for ESAs to build on when developing regulatory technical standards on due diligence.

Element 2: What are the requirements for disclosure of sustainability impacts *on* investments?

The investors covered by the DSR Regulation typically already have very sophisticated systems for managing and mitigating the impacts of financial risks *on* their investments – this is their bread and butter. Increasingly, more and more investors may already also be considering and addressing how sustainability or ESG issues can have an impact *on* the value of their investments (referred to as "**sustainability risk**" in the Regulation).

The Regulation now makes it mandatory for investors to **take sustainability risks into consideration**. More specifically, it requires investors to:

- Publish and maintain written **policies** on their websites, describing the **integration of sustainability risks** (i.e. material negative impacts on the value of the investment from ESG events or conditions) in their investment decision-making or advice.[36]
- Publish and maintain on their websites information on how their **remuneration policies** are consistent with the

- integration of sustainability risks,[37] which is a crucial point to ensure that remuneration policies are not at cross-purposes with sustainability objectives.
- Include in their pre-contractual disclosures information about:
  - The **manner** in which **sustainability risks are integrated** into their **investment decisions**
  - The **result of the assessment of the likely impacts of** sustainability risks **on the returns** of the financial products – on a comply or explain basis.[38]

Are there further requirements to make sure disclosures are accurate and up to date?

The DSR Regulation has specific requirements to make sure that information on websites is kept up to date, and, crucially that investors are being consistent in the information they provide. Marketing communications must not contradict information disclosed pursuant to the Regulation.[39]

What happens next?

- **Date of publication - December 9 2019** the final text of the Regulation has been published in the EU Official Journal (OJ).
- **Date of publication + 20 days:** The Regulation enters into force 20 days after this publication date. [40]
- **Application date 10 March 2021:** Application of many of the requirements of the Regulation, with some requirements phased in later.[41]
- **By 30 December 2020**: European Supervisory Authorities (ESAs – ESMA, EIOPA, EBA) develop regulatory technical standards on **sustainability indicators** of **climate and other environment-related adverse impacts** and the **content, methodologies and presentation** of information on **adverse sustainability impacts** and **due diligence.**[42]
- **By 30 December 2020:** ESAs develop regulatory technical standards on **sustainability indicators** in relation to adverse impacts **in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters**[43]
- **By 30 December 2022**: The Commission **evaluates the application of the Regulation**, in particular whether the threshold on comply or explain should be limited to even smaller firms and whether application is hindered by the lack of relevant company disclosure and data being made available to investors.[44]
- **By 10 September 2021+ annually:** The ESAs will report annually on best practices and the implications of due diligence.[45]

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ENDNOTES

[1] The final, official version of the Regulation has been published in the EU's Official Journal on December 9 2019.

[2] Such examples can be found here: https://www.globalwitness.org/en/campaigns/land-deals/indecent-exposure/

https://www.globalwitness.org/en-gb/campaigns/forests/money-to-burn-how-iconic-banks-and-

investors-fund-the-destruction-of-the-worlds-largest-rainforests/

https://www.europarl.europa.eu/RegData/etudes/STUD/2016/578007/EXPO_STU(2016)578007_EN.pdf

https://www.europarl.europa.eu/RegData/etudes/STUD/2016/578007/EXPO_STU(2016)578007_EN.pdf

3 OECD, "Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises," (2017)

[4] See also PRI, "Policy Briefing: EU Regulation on Sustainability-Related Disclosures in the Financial Services Sector," Aug. 2019.

[5] DSR Regulation, Art. 1.

[6] Although the term "banks" does not appear in the Regulation, banks provide the types of products and services covered in Art. 2(1)(a, b, d, e, j) and 2(11)(c - d).

[7] They are referred to as "Financial Market Participants" and "Financial Advisers" in the Regulation.

[8] DSR Regulation, Art. 8-11.

[9] For example, green bonds are less than 1% of the market. G20 Green Finance Study Group, G20 Green Finance Synthesis Report, 2016.

[10] Note that "risks" are potential impacts. Because they are potential, they can be avoided or managed. Impacts are risks that have matured. This Briefing is focused on adverse or negative risks and impacts on people and planet. It is also of course possible for projects to have positive impacts – reducing CO2 emissions, improving water quality, improving workers' skills, etc. But this Briefing focuses on adverse or negative impacts because there are so many to address.

[11] The figure is from: European Insurance and Occupational Pensions Authority (EIOPA), "Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs" 10 July 2019 (EIOPA-BoS-19-248).

[12] There is a range of terminology that is used; it Is often used interchangeably and typically covers the same issues: "people-planet-prosperity" or "environmental, social and (corporate) governance (ESG)" or "sustainability." It is always important to see exactly how terms are defined and how they are used. The Regulation helpfully uses defined terms.

[13] DSR Regulation, Recital 18.

[14] DSR Regulation, Art. 2(24).

[15] DSR Regulation, Art 2 (22).

[16] A European Insurance and Occupational Pensions Authority (EIOPA), "Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs" 10 July 2019 (EIOPA-BoS-19-248) and European Securities and Markets Authority, "ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD" 30 April 2019 (ESMA34-45-688), para. 40: "To this end, sustainability must be assessed in a more nuanced manner. Authorised entities' due diligence processes are most effective where they assess sustainability both in relation to (i) risks of a decrease in the financial value or performance for the investment portfolios due to sustainability-related causes and (ii) the potential long- term impact of the investee companies' business activities on sustainability factors."

[17] DSR Regulation, Art. 6(1-2), Art. 11.

[18] DSR Regulation, Recital 20.

[19] DSR Regulation, Art. a4 (2)(b)

[20] DSR Regulation, Art.4.

[21] DSR Regulation, Art 7 and see Recital 20. For financial products, this disclosure requirement applies 36 months after the date of entry into force of the Regulation and must include "a clear and reasoned explanation of how a financial product takes into account principal adverse impacts on sustainability factors."

[22] With an 18-month delay from the entry into force of the Regulation, DSR Regulation, Art. 4(3).
[23] DSR Regulation, Art. 4(1) and 4(3).

[24] DSR Regulation, Art. 4(1)(b).

[25] DSR Regulation, Art. 4(2)(d).

[26] With an 18-month delay from the entry into force of the Regulation, DSR Regulation, Art. 4(3).
[27] DSR Regulation, Art. 4(1) and 4(3).

[28] DSR Regulation, Art. 4(2)(d)

[29] OECD, "Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises," (2017).

[30] PRI Reporting Framework Main definitions 2018 https://www.unpri.org/

[31] DSR Regulation, Recital 18.

[32] DSR Regulation, Recital 12.

[33] OECD Guidelines for Multinational Enterprises, Chapter II, General Policies, Commentary para. 14

[34] OECD, "Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises," (2017), p. 15.

[35] OECD, "Due Diligence Guidance on Responsible Business Conduct," (2019) Chapter I. The other essential characteristics are: it does not shift responsibility, is appropriate to the enterprise's circumstances, can be adapted to working with business relationships, is and involves on-going communications.

[36] DSR Regulation, Art. 3.

[37] DSR Regulation, Art. 5.

[38] DSR Regulation, Art. 6.

[39] DSR Regulation, Art. 12 & 13.

[40] DSR Regulation, Art. 20.

[41] DSR Regulation Art. 12 [20] and 4 (3-4) – (18 months delay for reporting on adverse sustainability impacts for financial market participants with more than 500 employees and certain groups) and Art. 7 (36 months for reporting on financial products).

[42] DSR Regulation, Art. 4(6).

[43] DSR Regulation, Art. 4 (7)

[44] DSR Regulation, Art. 19.

[45] DSR Regulation, Art. 18.