Supporting SFDR Implementation

Taking Your Governance and Sustainability Disclosures & Practices to the Next Level

Martin Steindl
Managing Director
msteindl@valoriscatalysts.com
Vienna | Austria

Valoris Stewardship Catalysts

www.valoriscatalysts.com

Table of contents

- Capabilities and Services:
  - SFDR-General Services
  - PAI-specific Services
  - Good Governance-specific Services
- Some insights into SFDR implementation
- Industry practices

Valoris
Stewardship Catalysts

Part 1: Our Services

Capabilities and Services (1/3): Valoris's SFDR-General Services

Valoris
Stewardship Catalysts

Offering 1: Review of Sustainability Practices and Disclosures	○ Internal analysis of all sustainability-related practices and disclosures ○ Gap Analysis ○ Benchmarking ○ Recommendations for regulatory compliance and industry competition
Offering 2: Formulation of SFDR-specific Disclosures	○ Formulation of all relevant SFDR statements and disclosures ○ Creation of internal tools for monitoring and due diligence
Offering 3: Assessment of further adjustment needs of existing policies, marketing material, etc.	○ Review of all practices and disclosures to ensure alignment with SFDR and other regulatory frameworks ○ Solution analysis for all types of limitations, including: ➢ Data limitations in terms of availability and quality ➢ Time limitation ➢ Lack of internally-developed tools to monitor on sustainability indicators.

Capabilities and Services (2/3): Valoris's PAI-specific Services

Valoris
Stewardship Catalysts

Offering 1: Data Collection	○ Internal makeover: ➢ Reviewing internal systems ➢ Enhancing internal tools to capture PAI-related information ○ Peer collaborations on PAI-related work: ➢ Identifying existing collaborative networks ➢ Initiation of client-led networks ○ External data providers: ➢ Connecting the client with the appropriate data providers ➢ Providing the client with our compiled list of providers
Offering 2: Statement Formulation and Enhancement	○ Formulating a PAI statement ○ Conducting historical comparison with previous PAI reference periods ○ Enhancing current PAI statement ○ Reviewing to ensure full regulatory compliance: ➢ reported PAI information ➢ all internal policies and documents

Capabilities and Services (3/3): Valoris's Good Governance-specific Services

Valoris
Stewardship Catalysts

Offering 1: Capacity-Building	Training and awareness raising to get started on how to assess good governance, in particular in an emerging market context
Offering 2: Policies and Tools	Developing/updating a good governance policy and integrating a good governance related test into investment and portfolio policies. Developing/updating an underlying CG approach/process with tools and questionnaires for every part of the investment decision process
Offering 3: Internal Makeover	Engaging in full-fledged CG diagnosis and CG engagements with portfolio companies

Offering 1 – Get Aware

Objective: Get familiar with the idiosyncrasies of CG in emerging markets
Deliverable: Workshops tailored to different internal audiences
Outcome: Participants will have a better insight on typical CG challenges and red flags
Pricing: from EUR 5000 onwards per workshop (depending on needs & duration)

Offering 2 – Get Set Up

Objective: Integrate CG into investment policy, strategy and due diligence
Deliverable: Design of policies, processes with accompanying tools
Outcome: CG integrated into investment process and aligned with E&S
Pricing: EUR 50-70k (completed over 12 weeks)

Offering 3 – Get Aligned

Objective: Provide external CG expertise where needed
Deliverable: Response to questions or dilemmas, due diligence support
Outcome: Robust analysis of CG issues and how risks can be mitigated
Pricing: hourly rate or retainer arrangement

Part 2: Some insights into SFDR implementation

Who does it apply to, what does it entail, and many more insights

Does SFDR apply to you?

Valoris
Stewardship Catalysts

It affects financial market participants (FMPs) and financial advisers (FAs) based in the EU as well as those based outside of it who market their products in the EU

Who are the FMPs?

- Insurance undertakings making available an insurance-based investment product (IBIP)
- Investment firms providing portfolio management
- Institutions for occupational retirement provision
- Manufacturers of a pension product
- Alternative investment fund managers
- Pan-European personal pension product providers
- Managers of a qualifying venture capital fund registered in accordance with EuVECA Regulation
- Managers of a qualifying social entrepreneurship fund registered in accordance with ESEF Regulation
- UCITS management companies
- Credit institutions providing portfolio management

Who are the FAs?

- Insurance intermediaries providing insurance advice with regard to IBIPs
- Insurance undertakings providing insurance advice with regard to IBIPs
- Credit institutions providing investment advice
- Investment firms providing investment advice
- AIFMs providing investment advice
- UCITS management companies providing investment advice

Which classification(s) to follow

Valoris
Stewardship Catalysts

The **EU's Sustainable Finance Disclosure Regulation ("SFDR")** asks financial market participants ("FMP") to classify their sustainable strategies/financial products in three ways:

- **Art 6 fund**: A fund that does not market itself as aiming to support, promote or improve sustainable environmental or social characteristics.
- **Art 8 fund**: A fund that aims to support, promote or improve sustainable environmental or social characteristics. Such funds have "*a sustainability-related ambition **lower** than the ambition*" of art 9 funds.
- **Art 9 fund**: A fund that has sustainable outcomes as an investment objective.

Consequences of classifying a fund as an Art 9 versus an Art 8 fund

Valoris
Stewardship Catalysts

Art 8

- A broad scope with comparatively more room for claims and arguments.
- Covers financial products that do not have 'sustainable investment' as their objective or that have an environmental/social objective but do not meet the "no significant harm" criteria under SFDR.
- The companies in which the investments are made must follow good governance practices.
- Art 8 financial products are not prohibited to be invested in 'sustainable investments'. However, they are only allowed to be in part/partially invested in such investments unlike art 9 financial products.

Art 9

- A narrower/smaller scope, which includes only funds that have a greater focus on impact.
- All of the investments held by an Article 9 financial product must be sustainable investments, except for investments held in order to meet requirements in accordance with prudential, product-related, sector specific rules (e.g., hedging or liquidity).
- For an investment to be considered 'sustainable' under SFDR, three conditions need to be met: (1) Be performed in an economic activity that contributes to an environmental or social objective; (2) does not significantly harm any other environmental or social objectives; (3) that the investee company follows good governance practices, specifically sound management structures, employee relations, remuneration of staff and tax compliance.
- Classifying as an Art 9 fund entails a full and clear reflection of any ESG/sustainability claims (*e.g.*, themes, outcomes, characteristics) the fund has made in its documentation and marketing materials in the sustainable investment policy and objectives. Such funds are expected to provide more detailed, data-backed and clear explanations and descriptions of its sustainability efforts.

Understand your website requirements

Valoris
Stewardship Catalysts

Overall/entity-level requirements

- **Sustainability risk management**

  A sustainability risk policy and explanation of how sustainability risks are integrated into investment decisions

- **Remuneration**

  An explanation of how the fund manager's remuneration policy (or policies) aligns with the consideration of sustainability risks

- **Principle Adverse Impacts (PAI)**

  An explanation of how the fund manager considers PAI on sustainability factors

Detailed/product-level requirements

- Summary
- No significant harm to the sustainable investment objective
- Sustainable investment objective of the financial product
- Investment strategy
- Proportion of investments
- Monitoring of sustainable investment objective
- Methodologies
- Data sources and processing
- Limitations to methodologies and data
- Due diligence
- Engagement policies
- Attainment of the sustainable investment objective

Understand your other requirements

Valoris Stewardship Catalysts

You are required to fill out the templates set out in the annexes for your precontractual and periodic reports (see below an example)

Did this financial product have a sustainable investment objective? *[tick and fill in as relevant, the percentage figure represents the minimum commitment to sustainable investments]*

☒ **Yes**	☐ **No**
☐ It made **sustainable investments with an environmental objective:** ___%	☐ It **promoted Environmental/Social (E/S) characteristics** and while it did not have as its objective a sustainable investment, it had a proportion of ___% of sustainable investments
☐ in economic activities that qualify as environmentally sustainable under the EU Taxonomy	☐ with an environmental objective in economic activities that qualify as environmentally sustainable under the EU Taxonomy
☐ in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy	☐ with an environmental objective in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy
	☐ with a social objective
☐ It made **sustainable investments with a social objective:** ___%	☐ It promoted E/S characteristics, but **did not make any sustainable investments**

Describe further:

- To what extent was the sustainable investment objective of this financial product met?
- How did the sustainability indicators perform? (also compared to previous periods)
- Negative impacts
- List of top investments
- Asset allocation and sectors
- (Non-) Alignment with EU taxonomy

Deep Dive: The PAI requirements

- PAI as defined by the EU is:

> *"Negative, material or likely to be material effects on sustainability factors that are caused, compounded by or directly linked to investment decisions and advice performed by the legal entity."*

- PAI Statement disclosure is on a comply or explain basis. Under both options, Financial Market Participants (FMPs) and Financial Advisors (FAs) need to publish specific information relating to the option chosen on their website (SFDR art. 4).

Comply

For an FMP:

✓ Publish and maintain a statement that includes; among other things:

1. Information about the FMP's policies on the identification and prioritisation of principal adverse sustainability impacts and indicators.
2. A description of the principal adverse sustainability impacts and of any actions taken or, where relevant, planned.

For an FA:

✓ Publish and maintain a statement that includes information *"as to whether, taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider in their investment advice or insurance advice the principal adverse impacts on sustainability factor"*.

Opt out and explain

✓ Publish and maintain a statement that includes the following:

1. Clear reasons for why the FMP/FA does not do so.
2. Where relevant, information as to whether and when they intend to consider such adverse impacts.

X Option to opt out is not available for FMPs with more than 500 employees during the financial year (or FMPs that are the parent undertaking of a large group with more than 500 employees).

Deep Dive: Where to fill out the PAI requirements

Summary statement in table 1 of the Annex	**Section 'Description of the principal adverse impacts on sustainability factors' in Annex I**
References to international standards	**Section 'Description of policies to identify and prioritise principal adverse impacts on sustainability factors'**
Historical comparison (for PAI statement in 2024 and afterwards)	**Section Engagement policies**

Deep Dive: the Good Governance Requirement

- SFDR requires portfolio companies of Article 8 and 9 funds to follow good governance practices.

- Otherwise, the financial product is in "breach" of SFDR with the consequence that the entity no longer qualifies as a sustainable investor. To avoid this, entities are required to disclose the policy or the criteria they use to evaluate the status of good governance of their portfolio companies.

- The good governance requirement only relates to investee companies for Article 9 products and Article 8 products and does not apply to government bonds.

- Complying with this requirement is not straightforward since the EU does not clearly define "good governance" or refer to existing definitions, but rather offers the following examples of good governance, namely: "***sound management structures, employee relations, remuneration of staff and tax compliance***". The European Supervisory Authorities (ESAs) also state that there are **no "mandatory metrics"** to fulfill the good governance requirement, but **some metrics**, such as the UN Global Compact, OECD or ILO principles, can be **part** of the *"policy to assess"* these good governance practices. This vagueness, to put it mildly, created further challenges and incited different reactions from FMPs.

Industry practices

PAI: Takeaways from examining the General Approach Taken by Others

Valoris
Stewardship Catalysts

Approach 1 : Compliance

- In terms of the number of PAI indicators reported on (or planned to be reported on), reporters can be categorized into two groups:
  1. Those who use a mix of methodologies to report on all indicators.
  2. Those who report on the indicators for which data is available (e.g., Generali Investment Partners S.p.A. SGR).

- In terms of investments regarding which PAI indicators are considered, there are also two categories of reporters:
  1. Those who report or plan to report regarding all investments (e.g., responsAbility).
  2. Those who only report on the investments for which data is available or easily obtained. Assets that are not reported on tend to be unlisted assets, mortgages, buildings and investment funds (e.g., Belfius) and alternative assets (e.g., Ethias).

Approach 2 : Opting Out

- The opting out decision is of a **temporary** nature subject to annual re-assessments.

- The reasons for opting out generally include one or more of the following:
  1. The nature of investments (e.g., unlisted assets, non-European, SMEs-target) and the difficulties they impose compared to other asset classes/types.
  2. Lack or insufficient level of readily available data.
  3. Restrictive nature of client contractual relationships (e.g., contractual limitations on how comprehensive or detailed reporting or monitoring with the investee companies can be).

PAI: Methodologies used by others to report on PAI indicators

Valoris
Stewardship Catalysts

Methodologies used to report on PAI

Publicly-available information
(Almost all reporters)

External Data Providers
(e.g., Aegon AM NL, Ethias, Generali Investment Partners S.p.A. SGR, Incofin and Belfius)

Due diligence/ESG assessment questionnaires
(e.g., Triple Jump,)

In-house constructed PAI databases
(e.g., Aegon AM NL)

Annual data collection processes
(e.g., Triple Jump, responsAbility,)

Consultant-led studies
(e.g., Eurazeo)

Quantitative audit tools
(e.g., Incofin)

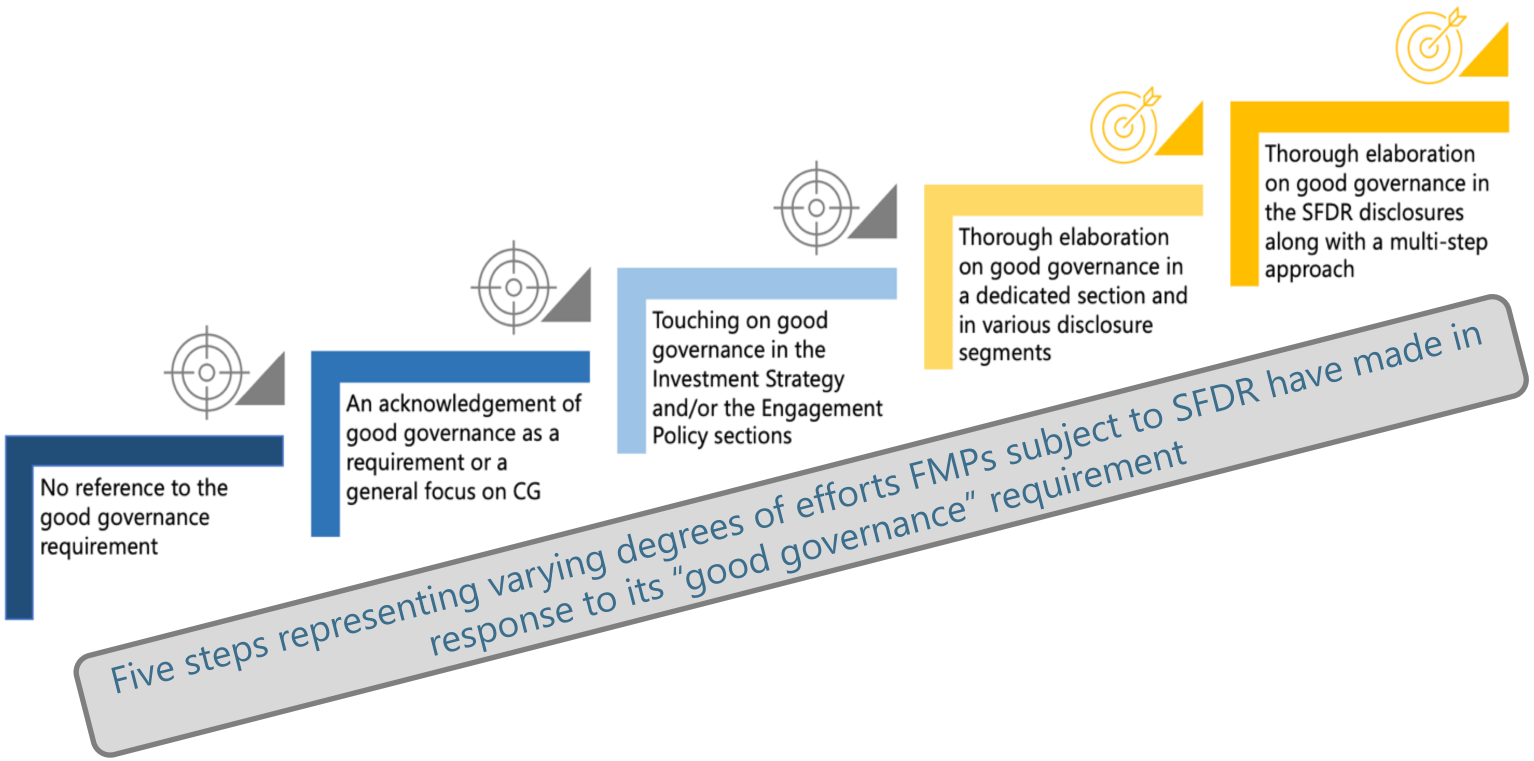
Peer collaborations to create standardized methodologies
(e.g., Incofin)

Some reporters solely depend on data from public sources while others use a mix of tools.

The Good Governance: Takeaways from examining the Disclosures of Others

Valoris
Stewardship Catalysts

- Our examination of public disclosures by FMPs so far revealed insufficient to non-existent acknowledgment of the third requirement regarding good governance.
- This may be largely due to a lack of understanding of this requirement and how it can be best met for investments with challenging characteristics (next slide) that may hinder reliable data collection and evaluation processes.
- This is nonetheless a dangerous shortcoming, since if just a single portfolio company fails to follow good governance practices, the FMP's fund cannot qualify as an Article 8 or Article 9 fund.



Valoris
Stewardship Catalysts

Contact us

✉: info@valoriscatalysts.com
LinkedIn: Valoris Stewardship Catalysts
www.valoriscatalysts.com