

## How to Prepare for SFDR Disclosure

Big changes are on the way in the world of European sustainability regulation. The European Union's new Sustainable Finance Disclosure Regulation (SFDR) program is already here. In less than a year, it will move forward into its second phase, which will require a new level of sustainability compliance from all organisations categorised as either Financial Market Participants (FMPs) or financial advisors.



### What Is SFDR and What Will It Require of Your Organisation?

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SFDR is an EU-wide attempt to promote sustainability in the financial system, calling on investment companies to report on the impact of their investments. The framework is a new EU regulation that affects all FMPs and financial advisors who operate their businesses in the EU, with new guidelines and requirements about what sustainability disclosures investment organisations will need to make about the companies in their portfolios.

Sustainability here does not only refer to environmental or “green” sustainability. Instead, sustainable behaviour under SFDR aligns with the latest EU Taxonomy rules on sustainable finance to include “environmental, social and employee matters” and matters relating to the “human rights, anti-corruption and anti-bribery” scope of the regulations.

According to the regulation, organisations must disclose unsustainable behaviour in these fields in the form of Principal Adverse Impacts (PAIs). The PAIs are an entirely new unit of corporate regulation. So, it's critical to begin assessing and organising your company's [environmental, social and corporate governance data \(ESG\)](#) now, as many organisations may have PAI indicators in their portfolios that they have not yet identified. Maybe some of your investments have an outsized environmental impact or touch on human rights or social issues. All of those, and more, represent potential PAI indicators that will need to be reported on to ensure compliance. The first landmark date of SFDR compliance has already passed. The law came into effect on March 10, 2021, and is currently in a compliance grace period, structured to give organisations time to discover their PAIs and prepare to disclose them at some point after July 2022, when phase 2 of SFDR will come into effect.



### What's Changing for Financial Market Participants as a Result of SFDR?

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Because the regulations will require two different categories of disclosures, entity level and product level, compliance disclosure and asset stewardship officers/teams will need to be prepared to make regular disclosures. Large firms (with 500 or more employees) are already required to have made [entity-level disclosures on their websites](#) “describing the policies in place and any actions taken to address adverse impacts.”

Essentially, compliance officers will have to work together to create new systems for consistent, intermittent disclosures. Some of these disclosures, such as entity-level ones, can be published on the organisation's website. Other disclosures will have to be created for preexisting periodical reports, such as its annual report.



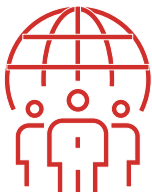
## What's the Risk of Noncompliance?

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As the SFDR revolves around a “comply or explain” basis, certain types of organisations have the option to “explain” gaps in their portfolio’s ESG compliance and disclosures. However, as of June 30, 2021, only firms that employ fewer than 500 people still have the option to choose the “explain” option. Additionally, there are some obvious downsides to this strategy for those firms, and more may emerge as the SFDR takes shape.

Opting for “explain” may require your compliance and data management officers to do a similar volume of work and facilitate similar levels of cross-functional coordination to prove that sustainability risks are not relevant to your portfolio. This may be extremely difficult to do, given the wide range of the SFDR’s definitions of sustainability. Any precontractual information you provide will also need to explain why sustainability risks don’t apply to your organisation. Also, your organisation would need to check all present and future marketing material to ensure that none of them contradicts your stance.

Whilst there currently isn’t good information regarding the penalties for failing to adequately accentuate the “comply or explain” options for SFDR, we can speculate that enforcement won’t be entirely toothless. Because of SFDR, the financial market is becoming more sustainability aware. Even if substantial penalties for full noncompliance don’t appear, the social and marketing penalties for not developing this kind of sustainability framework at your organisation may eventually prove harmful.



## How Your Organisation Can Prepare for Future SFDR Deadlines

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But what do financial services companies doing business in and with the EU need to do to prepare for SFDR compliance? As with every other regulatory concern, starting early is the key to ensuring you have the right data available when regulators need it and in a format that they expect. We recommend companies take the following steps today to ensure SFDR compliance when the time comes for enforcement.



### Step 1: Define the Data You Need

ESG data is the primary type of data you’ll be dealing with to satisfy SFDR. That data breaks down into several categories, with a total of 64 indicators of PAIs under the initial SFDR framework. The first step in navigating SFDR is to take a look at the different types of ESG data associated with the companies you are invested in:

- *Environmental data* refers to things like carbon footprint, natural resource use, renewability of energy sources used and other environmental aspects.
- *Social data* refers to the impact on the people that the companies you invest in employ and work with. This includes employee treatment and rights, human rights and labour issues.
- *Governance data*, in the context of ESG, refers to business ethics, corruption policies and actions, and statistics pulled from the company board of directors.

Take a look at these definitions and decide which aspects of the companies your organisation is invested in are likely PAI indicators.



## Step 2: Collect the Data

When you've decided which kinds of ESG data related to your investments you'll need to collect for SFDR compliance, you can begin to assemble it into a database. Whilst direct communication with the companies behind your investments will always be the best and most reliable source of this information, it's essential to consider other sources, too, to ensure you don't miss any essential elements.

Inaccuracies or omission of important information about the companies you are invested in could jam up the process later. It's important to remember that self-reported data can never be fully exempt from bias.

Fortunately, there are other resources to access unbiased sustainability data. Company reviews, social media and financial news can all provide valuable second viewpoints on ESG data and tip you off to aspects of your portfolio that you may want to double-check. There are also multiple NGOs that provide unbiased ESG data for many different companies.



## Step 3: Screen Your Portfolio Using These Data Sets

Using the database you've created, you'll want to screen your existing portfolio for existing PAI indicators, and then set up a system to screen future acquisitions and investments. ESG databases can help determine which areas of sustainability your organisation is most at risk to violate. Multiple tools and systems are available to help you cross-reference your ESG database with your portfolio, including Diligent ESG. More specific SFDR tools will most likely become available as the July 2022 deadline approaches.

Of course, this process of screening may not only reveal sustainability risks and PAIs. You may also find positive assets in your portfolio that you can use to elevate your sustainability status and branding.



## Step 4: Set a Reporting Process

Once you have a robust screening process in place to alert you to SFDR risks and PAIs as they arise in your investment portfolio, you can begin to develop your reporting strategy. To comply with SFDR, you will first have to make a disclosure about the current state of your investments. This can usually be made on your organisation's website, although further Regulatory Technical Standards (RTS) will clarify this reporting process as we get closer to full application of SFDR.

There are several landmark dates set over the next five years that will require compliant organisations to report on recent PAIs, although the format for these future disclosures is not always crystal clear. Here are some of the more important ones, according to [S&P Global](#):

**December 30, 2022:** Organisations considering PAIs must disclose how their products consider these sustainability impacts, whilst others have to explain why they do not.

**January 2023:** Products that promote "environmental" or "social" characteristics and products with sustainable investment as their objective must have periodic and precontractual reporting in place in alignment with the EU Taxonomy's remaining four objectives:

1. The sustainable use and protection of water and marine resources;
2. The transition to a circular economy;
3. Pollution prevention and control; and
4. The protection and restoration of biodiversity and ecosystems.

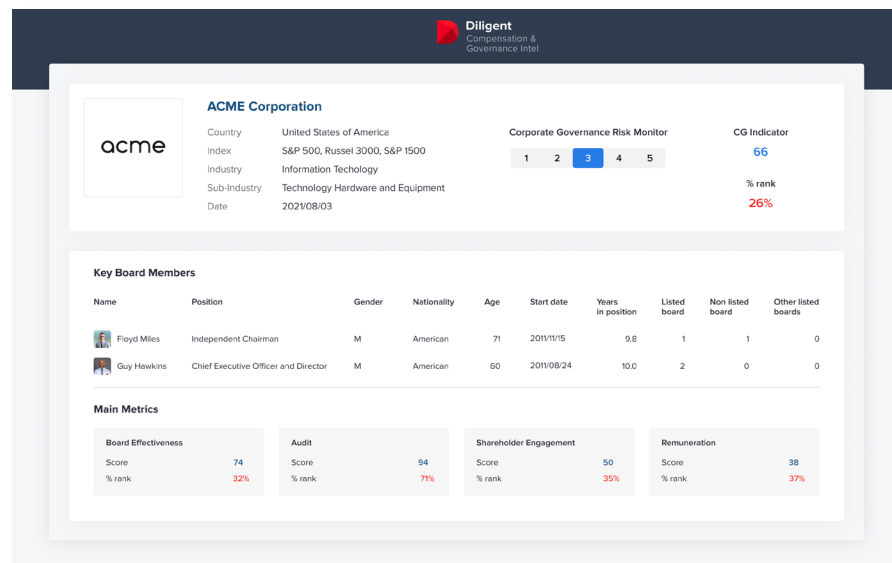
**June 30, 2023:** Firms will need to disclose detailed indicators for PAIs for the period from July 2022 to December 2022.

The SFDR platform is redefining not only how financial services companies record and measure the impact that their investments have on the world, but the very definition of sustainable investing itself. Although currently limited to the EU, this type of regulatory structure is very likely to find its way to other countries in the near future, making the adoption and incorporation of sustainability-related tracking and reporting tools critical to long-term compliance. By taking the above steps to address these new regulations, organisations will be better prepared to meet today's demands for sustainable finance and whatever comes next.

## Conclusion:

Diligent's Compensation & Governance Intel solution provides you with the data to drive your organisation forward. It has extensive standardised data to support due diligence of the "G" in ESG, including assessing pay for the performance of executives, director performance and board composition.

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## About Diligent Corporation

Diligent is the leading governance, risk and compliance (GRC) SaaS provider, serving more than 1 million users from over 25,000 organisations around the globe. Our modern GRC platform ensures boards, executives and other leaders have a holistic, integrated view of audit, risk, information security, ethics and compliance across the organisation. Diligent brings technology, insights and confidence to leaders so they can build more effective, equitable and successful organisations.