Sustainable Finance Disclosure Regulation, Simplified

Compliance regulation is rarely, if ever, simple. However, below are the salient points of the Sustainable Finance Disclosure Regulation (SFDR), which can prompt more informed questions and promote better-directed conversations that may help the boards and C-level executives of firms that are defined as financial market participants prepare for the fast-approaching disclosure deadline.

WHAT IS SFDR?

SFDR is a European Union (EU) regulation focused on financial market participants (FMPs)—an umbrella term for firms that fall within several financial services industries, including private as well as public companies. The regulation has been introduced to improve transparency in the markets for sustainable investment products while increasing transparency around sustainability claims made by FMPs. It is a decided step in the direction of corporate accountability while aiming to circumvent greenwashing. The regulation imposes comprehensive sustainability disclosure requirements covering a broad range of environmental, social, and governance (ESG) metrics at both the entity and product levels.

While SFDR does not directly apply to the US financial market, there are instances in which US firms are expected to comply. SFDR encompasses a broad range of entities and products beyond the investment management industry, including insurance and banking.

Furthermore, recent analysis by S&P Global found that "more than $3 trillion worth of parent firms based outside the EU will be considering how their EU subsidiaries can begin to measure, monitor, and disclose on ESG performance of investment products in line with SFDR. These firms are both public and private, representing a shift from the historic focus on just publicly listed companies and funds."

US firms affected by SFDR include the following:

- All listed companies
- Large companies that meet at least two of the following conditions:
  - Balance sheet total greater than €20 million
  - Net revenue greater than €40 million
  - An average number of employees greater than 250 during the fiscal year

The compliance deadline is June 30, 2023; after that, reporting becomes an annual requirement with June 30 as the deadline each year. Beginning with the June 30, 2024, report, it must include a year-to-year comparison between the reference periods, eventually covering five reference periods once the fifth reference period has been reached.

Additionally, the regulation requires that three statements must be published to the company's website in such a manner that they are easy to find, access, and understand. The required statements are the following:

- The sustainability risk policy: how sustainability risks are considered in the company's investment decisions
- The principal adverse impact: how the firm's investments affect a range of sustainability factors
- The sustainability risk remuneration policy: how sustainability risks factor into the company's compensation policy

HOW DO WE GET STARTED?

Assemble the right team from the start. With any compliance effort, cross-departmental communication, cooperation, and collaboration are critical, as is a cross-functional team. If you find you have a skills gap internally, seek those skills externally.

Below are some thoughts on how to prepare for your SFDR compliance journey:

- Determine if your organization is within the defined scope of the regulation.
- Understand the reporting requirements and deadlines.
- Invest in the right professional support up front to avoid wasting time and other resources.
- Start your SFDR reporting process in time.
- Build a compliance process road map; maintain the documentation along with rationales.
- Gauge scope and level of effort for both the near the long term:
  - Do a needs assessment of both the data required for the disclosures and the resources necessary to access the data.
  - Identify the data you will need to provide adequate proof of your organization's ESG measures and where they can be accessed.
  - Determine method of access: direct (information gathered directly from portfolio companies) or indirect (third-party data).
  - Access the data you need from your portfolio companies.
  - Decide and define a data governance approach, including how and where this data will be stored and updated, and who will have access.
  - Formalize the reporting process and assign a permanent team.

The framework above is not exhaustive. Many compliance exercises are arduous, but the results—beyond simply obeying the reporting requirements—can provide significant insights that can help your company make more informed decisions to pave the way to competitive advantage and truly sustainable growth. D

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