



# SFDR IMPACTS ON FINANCIAL MARKET PARTICIPANTS

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# SFDR IMPACTS ON FINANCIAL MARKET PARTICIPANTS

The Regulatory Technical Standards (RTS) on Sustainable Finance Disclosure Regulation (SFDR) require that financial market participants give qualitative and quantitative information disclosure on their website, in pre-contractual documents and inside periodic reports regarding their investment strategy, their ESG risk management policy for each product in their offering portfolio.

Reply, thanks to its expertise on ESG-related issues, can support financial market participants in updating company policy and in the various stages of regulation implementation.

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# SFDR REQUIREMENTS

The European Supervisory Authorities (ESAs) have developed the Regulatory Technical Standards (RTS) on Sustainable Finance Disclosure Regulation (SFDR); these RTS require that financial market participants give high level of disclosure requirements.

# SCOPE OF SFDR: PARTECIPANTS IN FINANCIAL MARKETS

The RTS on SFDR are applied to **financial market participants including financial advisors**. These entities should meet the regulatory requirements in the European Union to the extent that they market financial products, for financial market participants, and they provide investment and / or insurance advice, for financial advisors.



Market participants include all those categories having relationships with retail customers, in particular those listed below.

## BANKS

Intermediaries that provide advice on investments and financial products by operating through:

- professional investors;
- retail investors.

## INSURANCE

Brokers or insurance firms providing advice on Insurance-based Investment Products (IBIP).

## INVESTMENT FIRMS

Investment companies include:

- Alternative Investment Firms;
- Asset Management companies Undertakings for Collective Investment in Transferable Securities (UCITS);
- Providers of pension products;
- Alternative Investment Funds (AIF) providing investment advice.

## OTHERS

Other participants and intermediaries in the financial markets that have a functional role in investment decisions.



# TRANSPARENCY AND POLICY DISCLOSURE

The RTS provides specific requirements on the content, methodology and presentation of information regarding sustainability indicators and they are even more specific for the disclosure on Principal Adverse Impact (PAI) in relation to environment, including climate, impacts, social and employee issues, human rights compliance, anti-corruption and anti-collusion.

In particular, SFDR RTS require high level of transparency and disclosure, regarding availability on policy regarding Sustainability and ESG Factors, too.



# TRANSPARENCY

The RTS specify the details of the product information that has to be disclosed by the financial market participant on their website, in pre-contractual information (e.g. Key Information Document (KID) for packaged retail investment and insurance-based investments products) and inside periodic reports.



## WEBSITE

An entity's website shall contain information to describe the environmental or social characteristics of financial products or the sustainable investment, including the data and the methodologies used.



## PRE-CONTRACTUAL DOCUMENTS

The Key Information Document (KID) and other pre-contractual documents shall contain information on how a product with environmental or social characteristics meets those characteristics. Additionally, if an index has been designated as a reference benchmark, whether and how that index is consistent with those characteristics.



## PERIODIC REPORTS

Financial market participants are required to disclose in the periodic reports information on how sustainability risks are integrated in their investment selection processes.

Figure 1 Transparency - SFDR Disclosure

## WEBSITE PRODUCT DISCLOSURE

The RTS for product website disclosures sets out the details of the content and presentation of information on products that should be disclosed on the website by the financial market participant. The RTS sets out where and how the financial market participant needs to publish the information on the website, including the need to publish a two-page summary. The RTS also includes a list of items to be included in the disclosure, focusing on the methodology employed, the data sources used, and any screening criteria employed.



Figure 2 Website Product Disclosure

The website product disclosure shall include the sections listed below.

### SUMMARY

Shall contain a summary of the information that relates to the financial product with a maximum length of two A4-sized pieces of paper. Moreover, this section shall be provided in at least:

- one of the official languages of the home Member State and, where different and

where the financial product is marketed in more than one Member State, in an additional language customary in the sphere of international finance;

- where the financial product is marketed in a host Member State, one of the official languages of that host Member State.

### DO NOT SIGNIFICANTLY HARM

The section shall contain an explanation of how the investments of the financial product do not significantly harm any of the sustainable investment objectives, including:

- how the indicators for adverse impacts and any relevant indicators are taken into account;
- whether the sustainable investment is aligned with the Organisation for Economic Cooperation and Development (OECD) guidelines for multinational enterprises and the UN Guiding Principles on Business and Human Rights.

### INVESTMENT STRATEGY

The section shall contain:

- a description of the investment strategy;
- a description of the policy to assess good governance practices of the investee companies, including with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

### PROPORTION OF INVESTMENTS

The section shall distinguish between direct exposures in investee entities and all other types of exposures to those entities.

### SUSTAINABLE INVESTMENT OBJECTIVE

The section shall contain an explanation of what is the sustainable investment objective of this financial product:

- products promoting environmental or social characteristics;
- products with sustainable investment objectives.

### MONITORING OF SUSTAINABLE INVESTMENT OBJECTIVES

The section shall contain a description of how the sustainable investment objectives and the sustainability indicators are monitored throughout the lifecycle of the financial product and the related internal or external control mechanisms

### METHODOLOGIES

The section shall contain a description of the following characteristics:

- a description of the engagement policies implemented where engagement is part of the environmental or social investment strategy, including any management procedures applicable to sustainability-related controversies in investee companies;
- a description of how the index designated as a reference benchmark is aligned with the environmental or social characteristics promoted by the financial product, including the input data, the methodologies used to select that data, the rebalancing methodologies and how the index is calculated.

### DUE DILIGENCE

The section shall contain a description of the due diligence carried out on the underlying assets of the financial product to identify, prevent, mitigate, and address adverse impacts, including the internal and external controls on that due diligence.

**LIMITATIONS TO METHODOLOGIES AND DATA**

The section shall contain a description of the following points:

- any limitations to the methodologies and the data sources;
- how such limitations do not affect the attainment of the sustainable investment objective;
- the actions taken to address such limitations.

**DATA SOURCES AND PROCESSING**

The section shall contain a description of the following themes on data:

- The data sources used to attain the sustainable investment objective of the financial product;
- The measures taken to ensure data quality;
- How data is processed;
- The proportion of data that is estimated.

**PRE-CONTRACTUAL PRODUCT DISCLOSURE**

Financial market participants shall include a statement at the beginning of pre-contractual product disclosure to explain whether the financial product intends to make any sustainable investments and whether an index has been designated as a reference benchmark for the purpose of attaining environmental or social characteristics promoted by the financial product.

In particular, information requirements should ensure that an appropriate level of information is provided on the financial product overall. End investors should be provided with a summary list of the sustainability-related underlying investment options and a clear indication of where sustainability-related information on them can be found.

That list should ensure that the underlying investment options are appropriately categorised

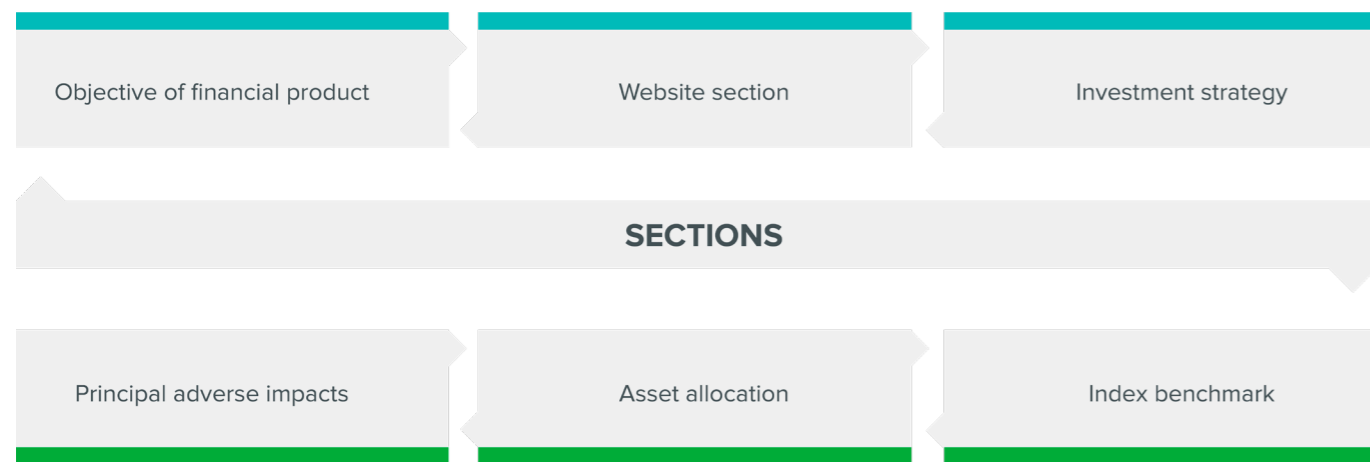


Figure 3 Pre-contractual Product Disclosure

The pre-contractual product disclosure includes the sections listed below.

**OBJECTIVE OF FINANCIAL PRODUCTS**

This section shall:

- disclose a minimum set of standardized and comparable relevant quantitative and qualitative indicators to show how each financial product meets the environmental or social characteristics that it promotes or the sustainable investment objective(s);
- avoid greenwashing, that is, the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards.

**WEBSITE SECTION**

Website reference section for financial products that promote environmental or social characteristics. The section shall contain the following statement: “More product-specific information can be found on the website”.

**INVESTMENT STRATEGY**

The section shall contain the following information:

- description of investment strategy adopted;
- how the strategy is implemented in the investment process on a continuous basis;
- a short description of the policy used to assess good governance practices of the investee companies;

- a reference to the website containing further details on the investment strategy.

**INDEX BENCHMARK**

Where an index is designated as a reference benchmark for the purpose of attaining environmental or social characteristics promoted by the financial product, the statement shall contain the following information:

- an explanation of how the reference benchmark is continuously aligned with each of the environmental or social characteristics promoted by the financial product and with the investment strategy;
- an explanation of how the designated index differs from a relevant broad market index;
- an indication of where the methodology used for the calculation of the designated index can be found.

**ASSET ALLOCATION**

The section shall contain an explanation of the investments in the financial product with the following information:

- the minimum proportion of the investments of the financial product used to attain the environmental or social characteristics promoted by the financial product;
- the purpose of the remaining proportion of the investments, including a description of any minimum environmental or social safeguards.

Where the financial product commits to making one or more sustainable investments, this section should also include:

- a description of how the sustainable investments contribute to a sustainable investment objective and do not significantly harm any of the sustainable investment objectives;
- whether the sustainable investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights;

Where the financial product uses derivatives to attain the environmental or social characteristics promoted by the

financial product, a description of how the use of those derivatives attains those characteristics.

**PRINCIPAL ADVERSE IMPACTS**

Identification of the principal adverse impacts consideration section for financial products promoting environmental or social characteristics. The section shall explain whether the financial product promotes environmental or social characteristics by considering principal adverse impacts on sustainability factors as referred to in the description of policies to identify and prioritise principal adverse sustainability impacts section (see Article 7 of RTS on SFDR).

**FOCUS ON PRINCIPAL ADVERSE IMPACTS**

The RTS include a mandatory reporting template to use for the statement on considering principal adverse impacts of investment decisions on sustainability factors. The disclosure is not limited to the indicators, as other more narratives elements form an equally important part of the reporting. The disclosure for financial market participants also includes reporting items on a summary, policies on the identification of principal adverse impacts, actions taken and planned to mitigate the principal adverse impacts, adherence to international standards and a historical comparison covering at least five previous reference periods.

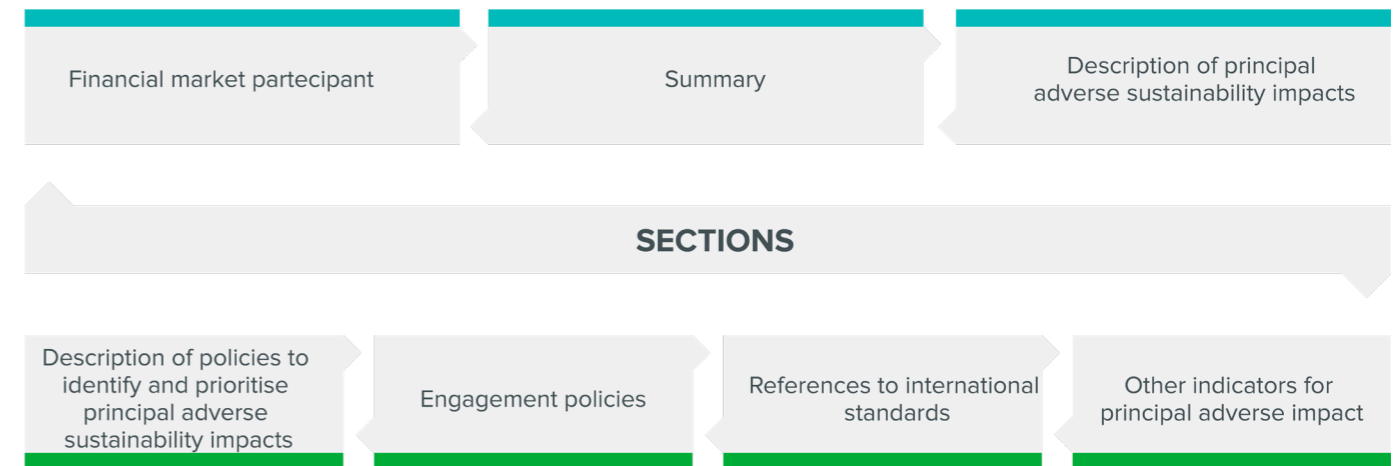


Figure 4 Principal adverse impact reports

The section related to the principal adverse impacts includes the information listed below.

**FINANCIAL MARKET PARTICIPANTS**

The section shall contain the name and, where available, LEI code of the financial market participants.

**SUMMARY**

The section referred shall contain the following information:

- the name of the financial market participant to which the adverse sustainability impacts statement relates;

- the fact that principal adverse impacts on sustainability factors are considered;
- the reference period of the statement;
- a summary of the principal adverse impacts statement of a maximum length of two sides of A4-sized paper when printed.

The section shall be written at least the following languages:

- one of the official languages of the home Member State of the financial market participant and, where different, in an additional language customary in the sphere of international finance; and

- if a financial product of the financial market participant is marketed in a host Member State, one of the official languages of that host Member State.

### DESCRIPTION OF PRINCIPAL ADVERSE IMPACTS

The section shall contain the following elements:

- a description for the reference period of adverse impacts of investment decisions of the financial market participant on sustainability factors that qualify as principal;
- a description of the actions taken during the reference period and actions planned or targets set by the financial market participant for the next reference period to avoid or reduce the principal adverse impacts identified.

Moreover, the assessment shall be based on at least the average of four calculations made by the financial market participant on 31st March, 30th June, 30th September and 31st December during the reference period.

**If the financial market participant has provided a description of adverse impacts on sustainability factors for a previous reference period, the statement shall contain a historical comparison of the current reference period with the previous reference period provided in accordance with those paragraphs and shall **continue to include further historical comparisons within that statement for at least five previous reference periods****

### OTHER INDICATORS FOR PRINCIPAL ADVERSE IMPACT

The section shall contain:

- Information on the principal adverse sustainability impact/s referred to in the standard format;
- Information on any other adverse sustainability impacts used to identify and assess additional principal adverse impacts on a sustainability factor referred to in the standard format.

### REFERENCES TO INTERNATIONAL STANDARDS

The section shall contain a description of the adherence of the financial market participant to responsible business conduct codes and internationally recognised standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement.

The description shall contain:

- the adverse impact indicators used in the assessment of principal adverse sustainability impacts referred to measure that adherence or alignment;
- the methodology and data used to measure that adherence or alignment, including a description of the scope of coverage, data sources and how the methodology forecasts the future performance of investee companies;
- where a forward-looking climate scenario is used, an identification of that scenario, including the name and provider of the scenario and when it was designed;

- where a forward-looking climate scenario is not used, an explanation of why forward-looking climate scenarios are not considered to be relevant by the financial market participant.

### ENGAGEMENT POLICIES

The section shall contain:

- where applicable, brief summaries of engagement policies in accordance with EU Directive<sup>1</sup>;
- brief summaries of any other engagement policies relating to reducing principal adverse impacts.

The brief summary shall include a description of the indicators for adverse impacts considered in those policies and how those policies adapt where there is no reduction of the principal adverse impacts over more than one reference period.

### DESCRIPTION OF POLICIES TO IDENTIFY AND PRIORITIZE THE PRINCIPAL ADVERSE IMPACTS

The section shall contain a description of the policies of the financial market participant on the assessment process to identify and prioritise principal adverse impacts on sustainability factors and of how those policies are maintained and how they are applied, including at least the following information:

- the date of approval of the policies by the governing body of the financial market participant;
- the allocation of responsibility for the implementation of the policies within organisational strategies and procedures;
- a description of the methodologies to select the indicators to identify and assess the principal adverse impacts and, in particular, how those methodologies take into account the probability of occurrence and severity of adverse impacts, including their potentially irremediable character;
- an explanation of any associated margin of error within those methodologies;
- a description of the data sources used.

Where information relating to any of the indicators used is not readily available, the section shall contain also details of the best efforts used to obtain the information either directly from investee companies, or by carrying out additional research, cooperating with third party data providers or external experts or making reasonable assumptions.

<sup>1</sup> Article 3g of Directive 2007/36/EC of the European Parliament and of the Council



## PERIODIC REPORTS PRODUCT DISCLOSURE

To ensure a clear overview of the investments of the financial product, financial market participants should provide in the periodic reports on the impacts of the top investments of the financial product. Periodic reports product disclosure and underlines how relevant products met their environmental or social characteristics and the overall sustainability-related impact of products with sustainable investment objectives, including those with an index designated as a reference benchmark.



Figure 5 Periodic reports product disclosure

This section includes the information reported below.

### ENVIRONMENTAL/SOCIAL CHARACTERISTICS PROMOTED

The section shall contain the following elements:

- description of the environmental or social characteristics promoted by the financial product;

- a list of the sustainability indicators used to measure the attainment of each of the environmental or social characteristics promoted by the financial product.

### NO SIGNIFICANT HARM

The section shall contain the following elements:

- how the indicators for adverse impacts were taken into account;
- whether any investments were excluded due to their significant harm to the sustainable investment objectives.

### TOP INVESTMENTS OF THE FINANCIAL PRODUCT

The section shall contain the following indications:

- information on the impacts of the top investments of the financial product;
- a list of the 25 investments constituting on average the greatest proportion of investments of the financial product during the reference period, including the sector and location of those investments.

### ACTIONS TAKEN TO ATTAIN ENVIRONMENTAL OR SOCIAL CHARACTERISTICS

The actions taken within the reference period to attain the environmental or social characteristics promoted by the financial product, including shareholder engagement.

### PROPORTION OF SUSTAINABILITY-RELATED INVESTMENTS

The section shall contain the following information:

- total investments that are sustainable investments and, where relevant, the subdivision of those sustainable investments between environmental or social objectives;
- total investments other than those in the point before, that contribute to the attainment of the environmental or social characteristics promoted by the financial product.

### SUSTAINABLE PERFORMANCE OF THE INDEX DESIGNATED AS A BENCHMARK

The section shall contain the following comparative information:

- comparison of the performance during the reference period of the financial product with regard to the indicators measuring the sustainability factors of the index referred to in point;
- comparison of the performance during the reference period of the financial product with regard to a relevant broad market index.

For templates related to the main negative impacts on sustainability, and templates for pre-contractual disclosure and periodic reports, visit the [Final Report on draft Regulatory Technical Standards](#) produced by the [European Security and Markets Authority](#), pages 52 to 98.

# POLICY

The RTS requires also that financial market participants disclose due diligence policies, including investment strategies, and their ESG risk appetite framework for each product in their offering portfolio.



**DUE DILIGENCE POLICY**

It focuses on assessing the ESG risks and opportunities of the proposed investment in order to allow the participants to make an informed decision considering:

- ESG factors;
- the company’s and manager’s capacity to address risks and capitalise on opportunities.



**RISK APPETITE FRAMEWORK**

This disclosure relates to the following themes:

- identification of the types of risk that financial market participant are willing to take on and set the risk objectives, any tolerance thresholds for each products under both normal and stress conditions;
- the escalation process to follow if any limits, tolerance thresholds and the operating limits are normally broken down.

Figure 6 Policy - SFDR Disclosure



# DUE DILIGENCE POLICY

The due diligence (we call it also “DD” hereinafter) policy shall include a statement on describing its due diligence policy in respect of the principal adverse impact of investment decisions regarding the sustainability factors such as:

- climate and other environment-related adverse impacts;
- social and employee matters, respect for human rights, anti-corruption and anti-bribery matters adverse impacts.

The final goal to the due diligence policy is to prepare reports related to Record of ESG DD process, ESG action plan(s), ESG DD report, including a summary of findings.

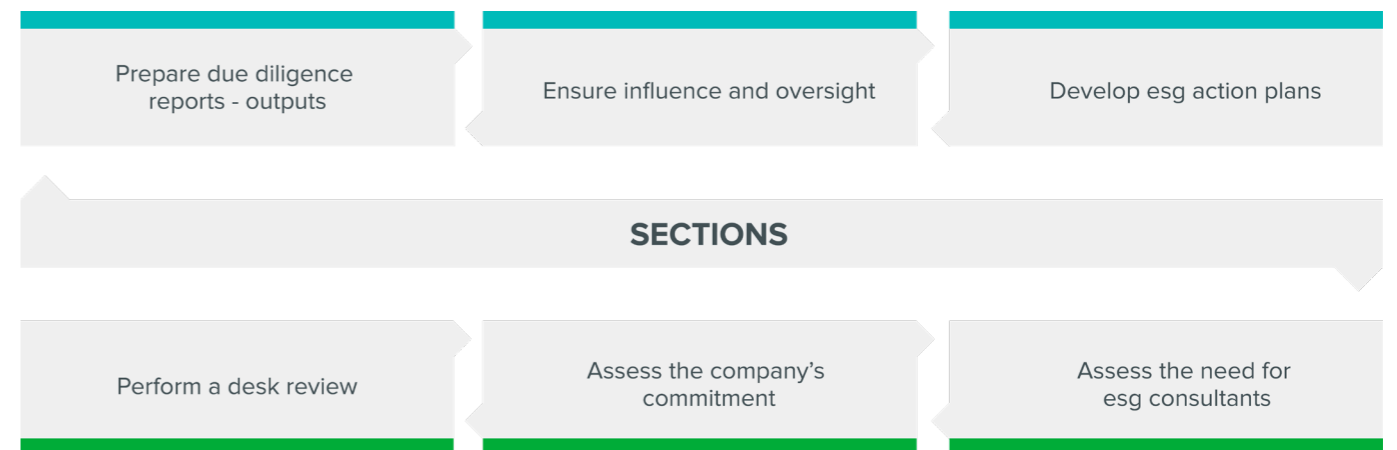


Figure 7 Due Diligence policy section

## PREPARE DUE DILIGENCE REPORTS – OUTPUTS

The final reports shall include:

- a summary of findings;
- a record of ESG DD process;
- ESG action plans;
- ESG DD report.

## ENSURE INFLUENCE AND OVERSIGHT

Managers need to ensure they will have sufficient influence and oversight once the investment is made, so that the company operates in accordance with the relevant standards and implements agreed action plans.

The level of oversight required will depend on several factors including the level of risks/impacts, resources required on ESG management, the company’s Commitment, Capacity and Track Record (also “CCTR” in the following) and the leverage that the fund manager will have over the company.

**DEVELOP ESG ACTION PLANS**

The DD process requires to develop an ESG action plan, that addresses ESG improvement in order to:

- bring the company into compliance with the fund’s ESG policy requirements and standards;
- capitalise on ESG opportunities.

**ASSESS THE NEED FOR ESG CONSULTANTS**

Managers may need to engage consultants to assist them with the due diligence. If this is the case, fund managers will still need to conduct their own due diligence.

**ASSESS THE COMPANY’S COMMITMENT**

The DD policy should include an assessment of company commitments in order to:

- ensure that the company will have the necessary resources to operate in accordance with the applicable standards and to implement any ESG action plans;
- define company commitment, capacity and track record (CCTR) as they are leading indicators of the company’s ability to achieve and maintain compliance with the applicable standards and expected performance.

**PERFORM A DESK REVIEW**

RTS on SFDR require to collect and review documentation, including publicly available information and documents requested from the company inside the DD process. This will enable the company to identify how well key risks and impacts are being managed, whether there are any concerns with the fund’s ESG Policy, and whether the company has capitalised on any ESG opportunities.

**RISK APPETITE FRAMEWORK**

In our opinion, ESG risks should be considered both inside traditional financial risk (idiosyncratic risk, market risk, liquidity risk, etc.), traditional non-financial risk (strategic risk, reputational risk) and as stand-alone risk. Moreover, RTS on SFR requires the disclosure of the framework regarding ESG Risk Management.

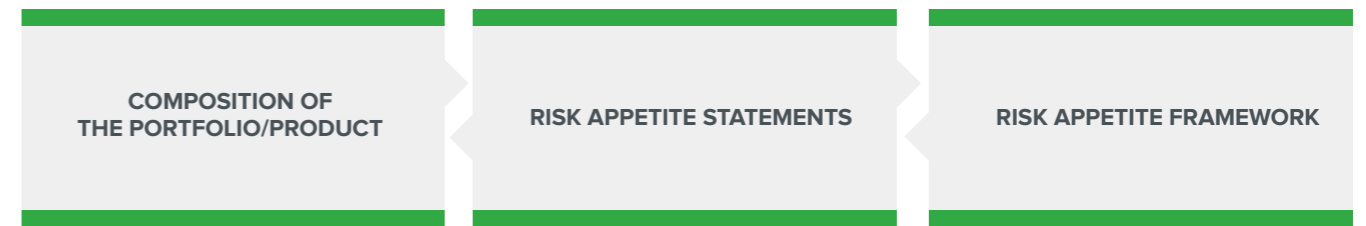


Figure 8 Risk Appetite Framework disclosure

In our opinion, financial markets participants (banks, insurance, asset management companies, etc.) should include ESG risk in their risk appetite framework, too.

**RISK APPETITE STATEMENTS**

Risk appetite statements incorporating ESG risks would then cascade down to group entities, business lines and units, in close interaction with the implementation of the business strategy.

**RISK APPETITE FRAMEWORK**

Integrate the value in term of risk appetite, risk tolerance and risk capacity considering ESG risk both as impact inside each risk and as stand-alone value for non-financial risk (e.g. strategic, reputational) and for financial risk (e.g. idiosyncratic risk, market risk, liquidity risk, etc.) regarding clients’ product portfolio.

**COMPOSITION OF THE PORTFOLIO/ PRODUCT**

Change the composition of the portfolio and product in line with the institution’s ESG risk-related strategic objectives and/or limits including its concentration and diversification objectives in relation to business lines, geographies, economic sectors and products is important also from an ESG risks perspective.

# DATA: NEW DATASET NEEDED

The first step to comply with the SFDRs' RTS is identifying the new set of ESG input data needed to calculate financial risk metrics, and, in the case of raw data, a curing mechanism.

We report in the figure hereinafter a sample of the new data set needed to calculate new ESG indicators and risk metrics.

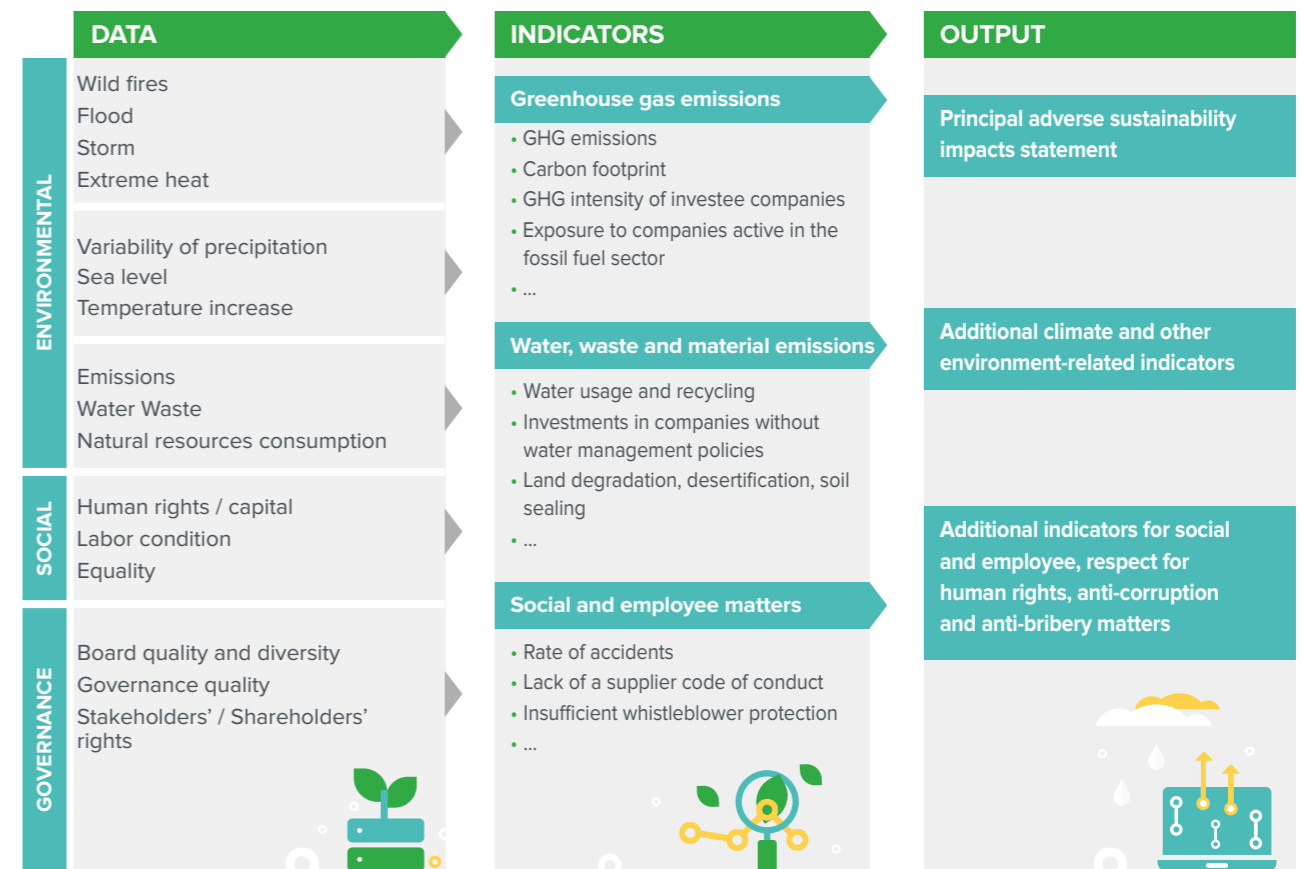


Figura 9 New dataset



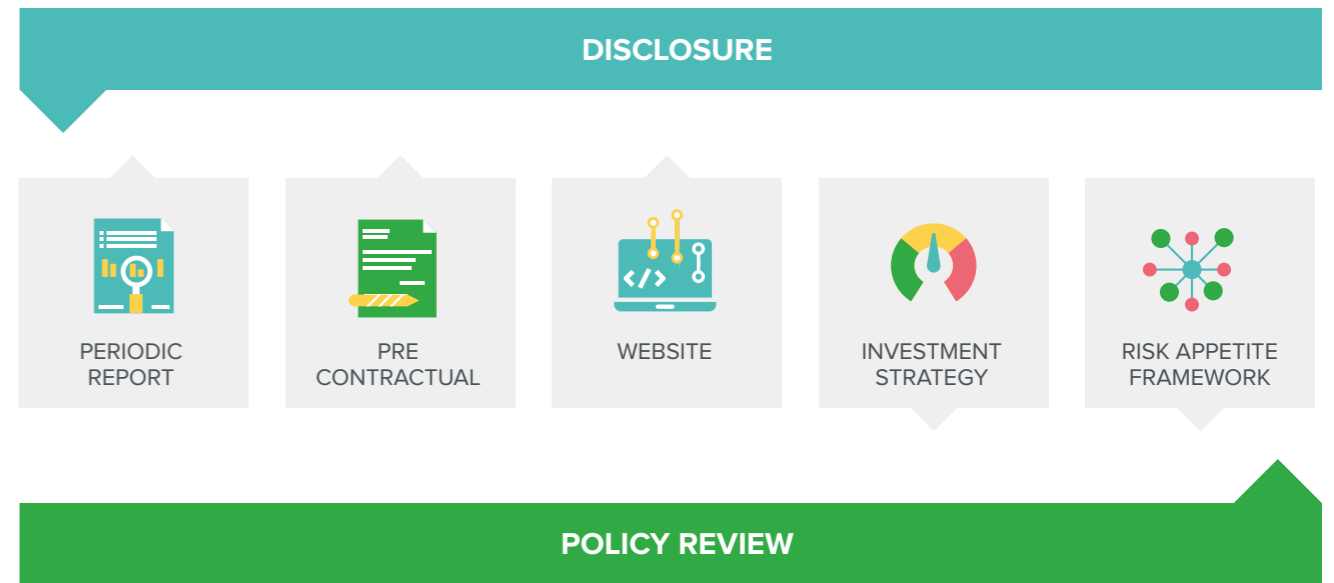
Today, part of this data is publicly available in the non-financial statement (or sustainability report) of the various companies. In fact, all companies with more than 500 employees (reduced to 250 from 2023 with the new Corporate Sustainability Directive Regulation), with assets of more than 20 million euros or a turnover of more than 40 million euros, are obliged to draw up the above-mentioned non-financial statement<sup>2</sup>.

Therefore, as no database is yet available, it is crucial to highlight that this new data may require innovative technology, such as artificial intelligence or language processing, to be captured and stored in a database. Thus, the energy impact and the consequent CO2 emissions that could result from the use of such technologies should also be assessed, if the energy does not come from renewable sources.

<sup>2</sup> This directive also defines a set of standard metrics for all Non-Financial Statements

# HOW REPLY CAN HELP?

Reply can support financial market participants (Bank, SGR, Asset Management companies, Insurance, etc.) both in the policy update and in the implementation of the disclosure, based on the expertise acquired and on Reply's team of subject matter experts.



## RISK APPETITE FRAMEWORK

Reply can support you in integrating the Risk Appetite Framework by including also ESG Risk indicators, thresholds and limits.

## INVESTMENT STRATEGY

Reply can support you in the Due Diligence finalized to the inclusion of ESG Factors into investment strategy.

## WEBSITE

Reply can support you in implementing the template and information to be publicly disclosed.

## PERIODIC REPORT

Reply can support you in the definition and implementation of periodic report metrics on products portfolios, that have to be reported to your clients.

## PRE-CONTRACTUAL DISCLOSURE

Reply can support you in implementing information and metrics, that are required to be disclosed to clients before signing the contract.