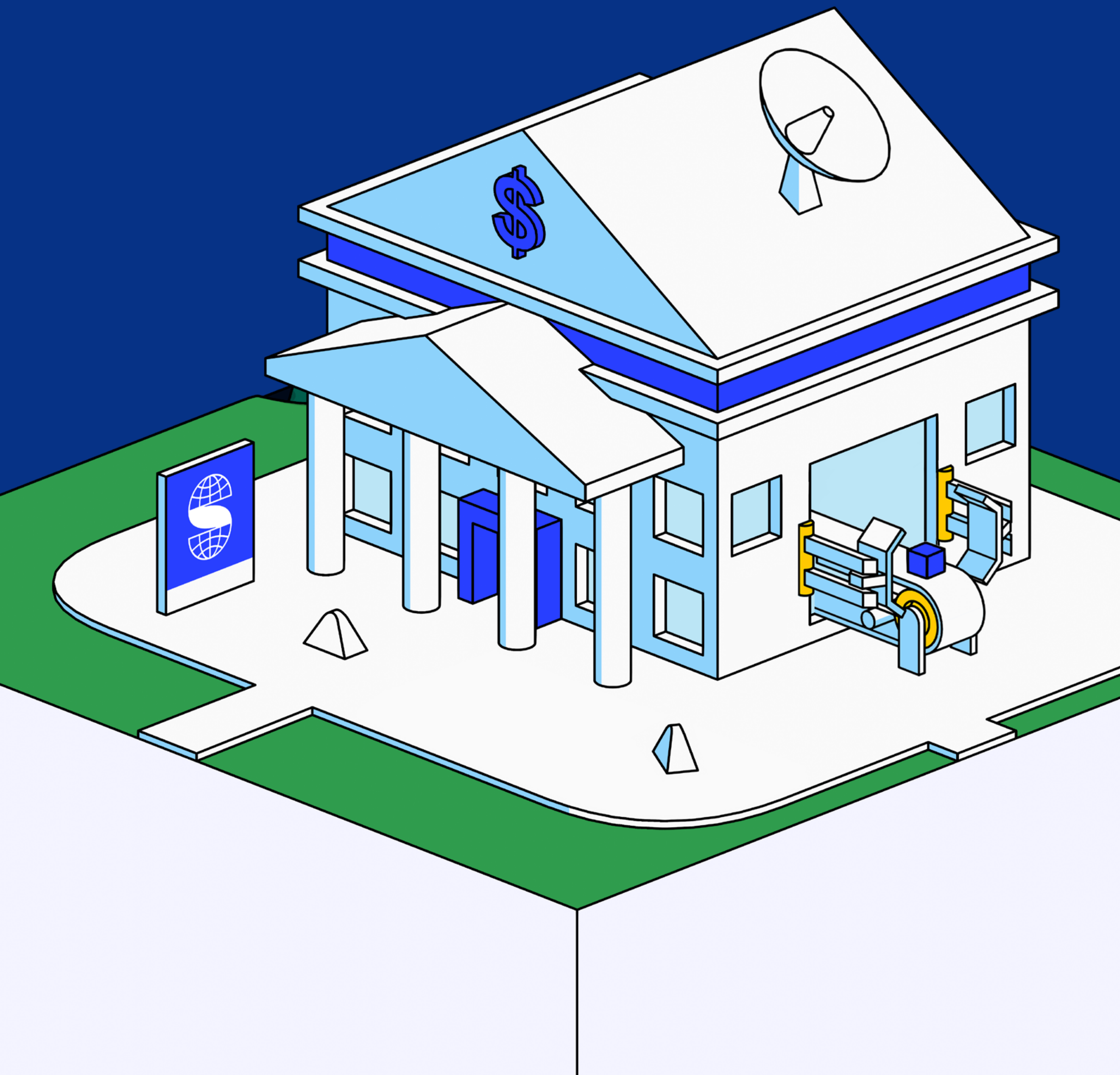
Your Guide to SFDR Compliance

Guide

SFDR Compliance



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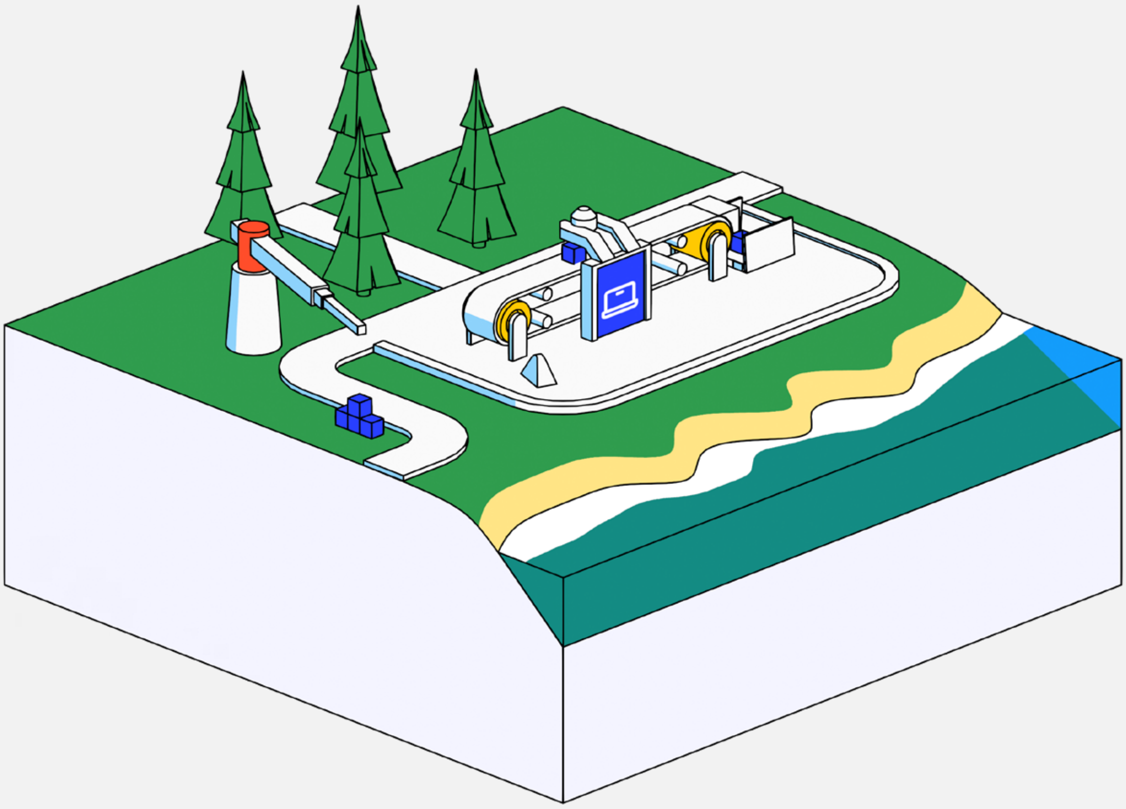


Introduction

Navigating the complexities of the Sustainable Finance Disclosure Regulation (SFDR) may seem like a daunting task, but it doesn't need to be. This comprehensive guide from Sweep is here to help you at every step of the journey to achieving full SFDR compliance. From understanding the regulatory requirements through data collection, all the way to reporting – we'll equip you with the knowledge and tools needed to become a compliance champion.

Financial Market Participants (FMPs)

Financial market participants are organizations, or entities that engage in various activities within financial markets. They can include investors, traders, banks, insurance companies, pension funds, asset managers, brokers, and other financial institutions.

What exactly is the SFDR?

The SFDR is a regulatory framework introduced by the European Union (EU) to enhance transparency and promote sustainable finance.

The framework aims to address the growing demand for environmental, social, and governance (ESG) information from investors and align investment activities with sustainable objectives. It sets out disclosure obligations for financial market participants (FMPs) regarding their integration of ESG factors into investment decisions. It also addresses the adverse impacts of their investment choices on sustainability.

By complying with SFDR, organizations can demonstrate their commitment to sustainability, meet investor expectations, and contribute to the transition towards a low carbon economy.

Introduction

Who does it apply to?

The SFDR applies to various entities within the European Union (EU), including:

- Asset and Fund Managers
  This includes investment management companies, portfolio managers, and alternative investment fund managers (AIFMs) who manage funds within the EU.
- Investment Firms
  This category covers various entities providing investment services, such as investment advisors, brokers, and securities dealers.
- Insurance Companies
  Insurance undertakings that offer insurance-based investment products (IBIPs) are subject to the SFDR requirements.
- Pension Providers
  Occupational pension funds and institutions for occupational retirement provision fall under the scope of SFDR.
- Financial Advisors
  Individuals or entities providing investment advice or insurance advice regarding IBIPs are also subject to SFDR.

Outside the EU

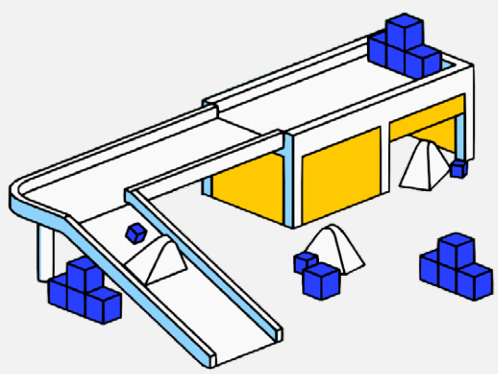
It's important to note that the SFDR applies to investment managers and advisors who market their products within the European Union, regardless of their geographical location.

Private Equity and Non-listed companies

Private equity firms are covered by the SFDR and need to assess and disclose the environmental, social, and governance (ESG) risks and impacts of their investments, along with their strategies for managing those risks.

Non-listed companies, especially those offering investment products or services, are also subject to SFDR requirements regarding ESG disclosure and reporting.

Adhering to the SFDR not only helps PE and non-listed companies meet regulatory obligations but also enhances transparency, fosters investor confidence, and supports the transition towards a more sustainable financial system.



Your SFDR Compliance Journey

The journey towards full SFDR compliance involves a few key steps. Below, we outline each of them in order.

Understand the scope

It's important to familiarize yourself with the SFDR disclosure requirements and determine if your organization falls within its scope based on your role as a financial market participant.

Your journey to SFDR Compliance

1. Understanding how SFDR affects you
2. Data collection
3. Data aggregation and standardization
4. Reporting
5. Informed decision-making

Data collection

Data collection is the first crucial aspect of SFDR compliance, requiring financial market participants to gather and manage relevant information on sustainability risks, adverse impacts, and environmental, social, and governance (ESG) indicators.

What data do you need for SFDR Compliance?

Sustainability Risk Indicators
Information on potential risks arising from environmental factors (e.g., climate change), social factors (e.g., labor rights), and governance factors (e.g., board structure) that may have an impact on investment performance.

Principal Adverse Impacts (PAIs)

PAIs refer to significant negative effects that can arise from certain activities or decisions. These are typically associated with environmental, social, or governance (ESG) factors and can have adverse effects on stakeholders, communities, or the overall sustainability of an organization. Identifying and addressing PAIs is crucial for responsible and sustainable business practices.

Principal Adverse Impact (PAI) Data

Data related to the adverse impacts of investment decisions on sustainability factors, including metrics and indicators to quantify and assess these impacts.

Portfolio-level Data

Information on the ESG characteristics and sustainability goals of investment portfolios, including the proportion of assets aligned with specific environmental or social objectives.

Data on Investment Products

Details on the environmental or social characteristics of investment products and their alignment with sustainability objectives, as well as any associated methodologies or third-party certifications.

What are some of the common challenges of collecting this data from across your investment portfolio?

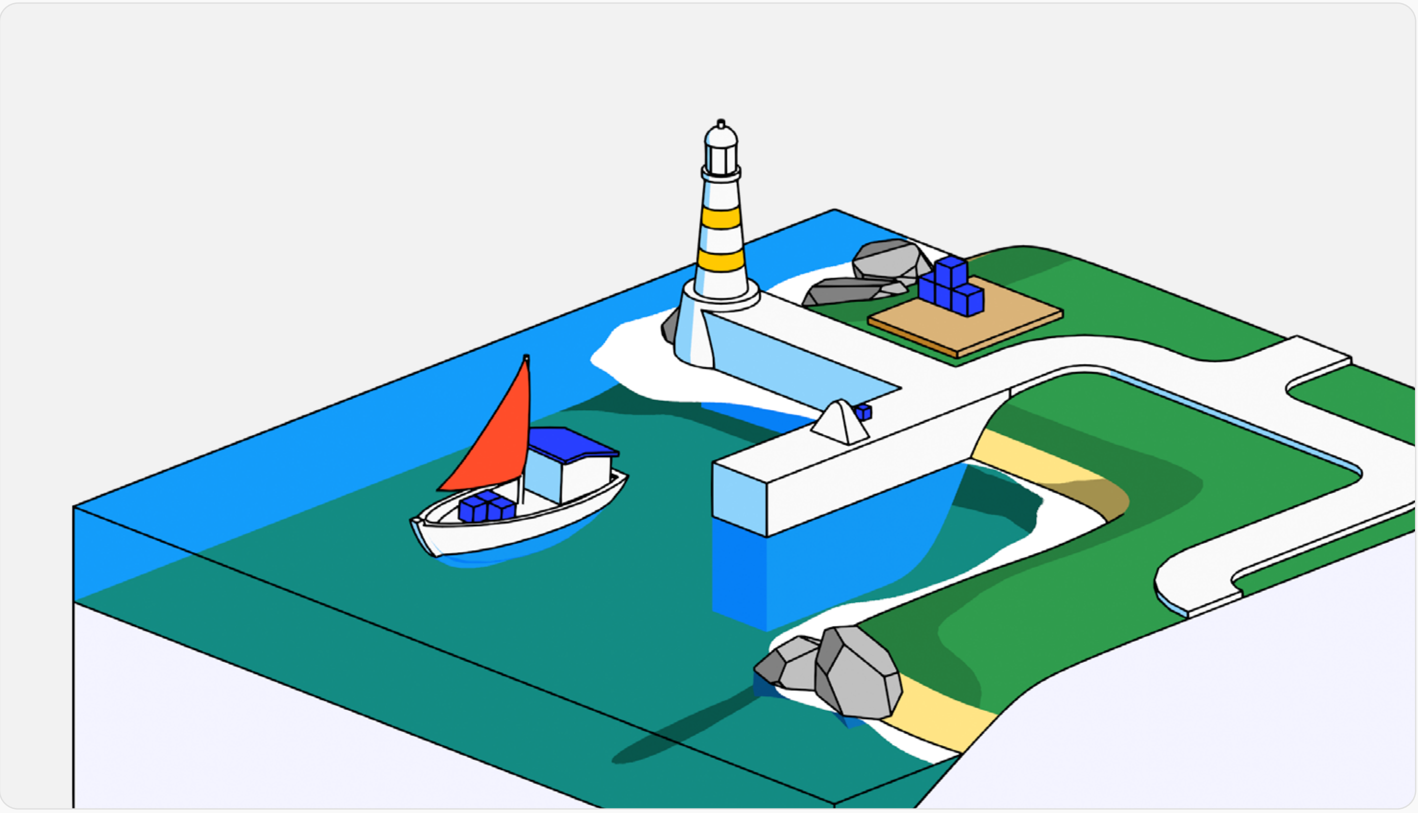
Collecting data from across an investment portfolio for SFDR compliance can pose several challenges, including:

Data availability

Accessing reliable and standardized data on sustainability factors, adverse impacts, and ESG indicators can be a challenge, especially when the data is not readily available or consistently reported by investee companies or third-party sources.

Data quality and consistency

Ensuring the quality and consistency of the collected data can be tricky due to variations in reporting methodologies, data sources, and the lack of standardized frameworks. Inconsistencies or incomplete data can hinder accurate analysis and reporting.



Data integration

Integrating data from multiple sources and formats into a centralized system or platform can be complex and time-consuming. It may require establishing data pipelines, overcoming compatibility issues, and addressing data cleansing and normalization challenges.

Data verification and assurance

Validating the accuracy and reliability of the collected data can be challenging, as it may involve verifying data sources, engaging with investee companies, or conducting independent audits to ensure the information is trustworthy.

Great power and great responsibility

According to The Carbon Disclosure Project's (CDP)'s Time to Green Finance report, financed emissions are 700 times greater than the average financial organization's own emissions. This is why collaboration is key to driving an effective climate strategy. As investors, private equity firms have the power to influence the behaviors of companies, and by extension, entire industries.

3 Data Challenges specific to PE

Sustainability is critical in private equity (PE) investments, yet accessing and leveraging Principles Adverse Impacts (PAI) data remains challenging due to:

Limited data availability

PE companies aren't obliged to disclose sustainability data, resulting in limited and often incomplete information. Accessibility is further restricted by potential barriers, hindering a comprehensive evaluation of a company's sustainability profile.

Non-standardization of data

The lack of uniform metrics across the PE sector makes comparing sustainability data difficult. Companies use varying methods to calculate their adverse impacts, causing inconsistency in benchmarking and tracking sustainability performance across investments and asset classes.

Use of proxies and PAI calculation methods

As PE firms resort to proxy data to fill in the gaps, the need arises for expertise to choose reliable indicators. Additionally, new methods for calculating PAI are in the early stages and lack validation and standardization. They need further refinement and industry-wide agreement to ensure they fairly represent a company's sustainability impacts.

Recognizing and addressing these issues is vital for the PE sector's advancement in sustainable investment practices.

Staff training on the SFDR

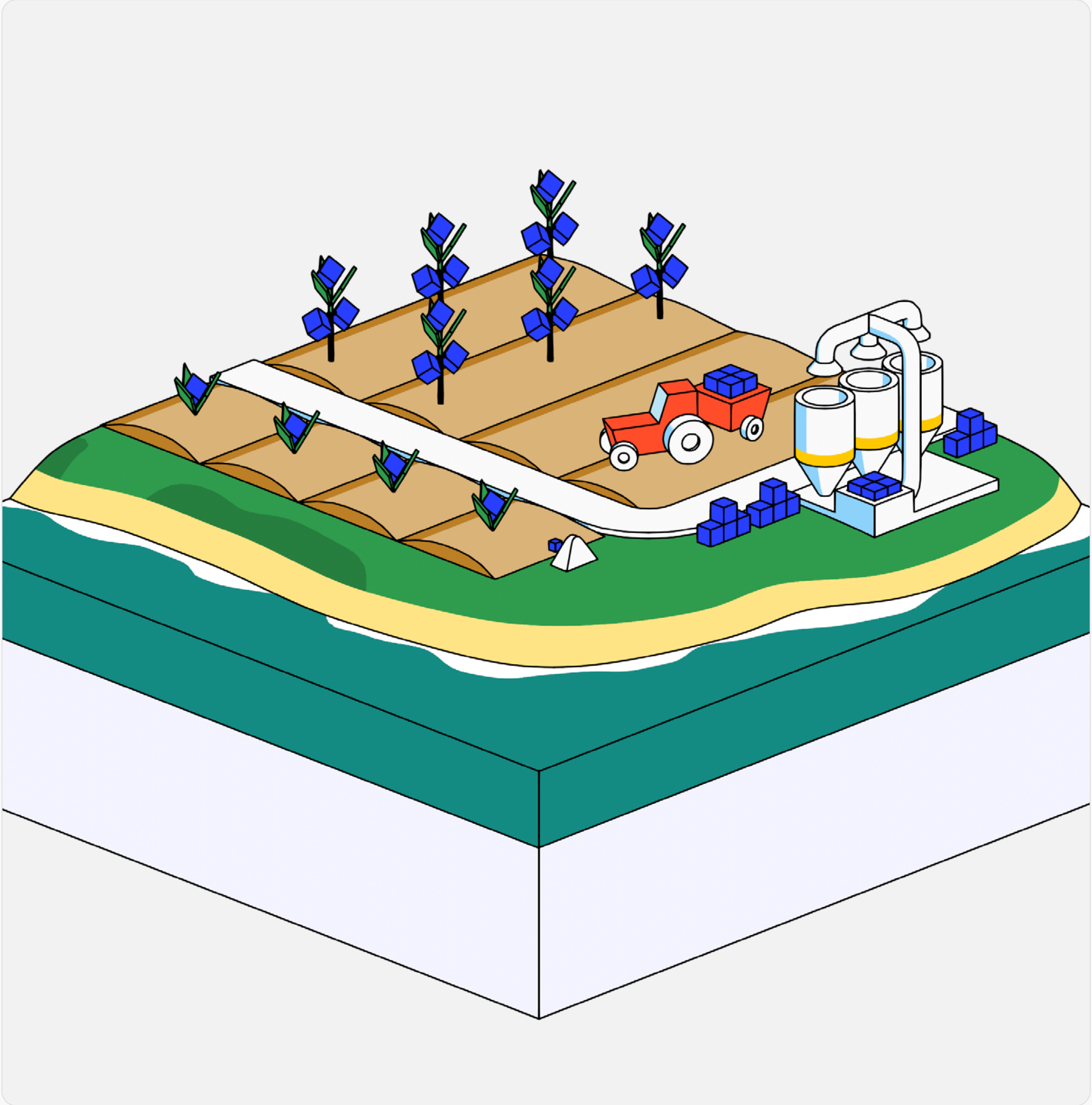
It's important to conduct training programs to enhance staff awareness and understanding of SFDR obligations, ensuring that relevant employees are equipped with the knowledge and skills needed for compliance.

How ESG software can help with data collection

Software providers simplify data collection for SFDR by offering streamlined processes that automate tasks, organize data, and provide analysis.

They provide data templates designed specifically for SFDR reporting, making it easier for financial market participants (FMPs) to capture the required information accurately and consistently.

The software also includes data validation checks, minimizing errors and ensuring the completeness and accuracy of the collected data. This saves valuable time for FMPs by reducing manual efforts and provides better insights for informed decision-making.



SFDR Indicator Coverage

SFDR indicators cover a wide range of criteria, including greenhouse gas emissions, energy efficiency, resource usage, biodiversity impact, labor standards, and corporate governance practices.

Data aggregation

After collecting validated sustainability data from your investee companies, you need to aggregate it at the portfolio level using the methodology outlined in the SFDR, which we'll explain below.

SFDR indicators

The SFDR regulation includes a set of indicators that FMPs need to report on. These indicators are meant to assess the environmental, social, and governance (ESG) impacts of their investment portfolios.

There are a total of 64 indicators, out of which 18 are mandatory. FMPs must report on these 18 mandatory indicators. The mandatory indicators are divided into two main groups: 9 indicators related to the environment and 6 indicators related to social aspects, employee rights, human rights, and anti-corruption measures.

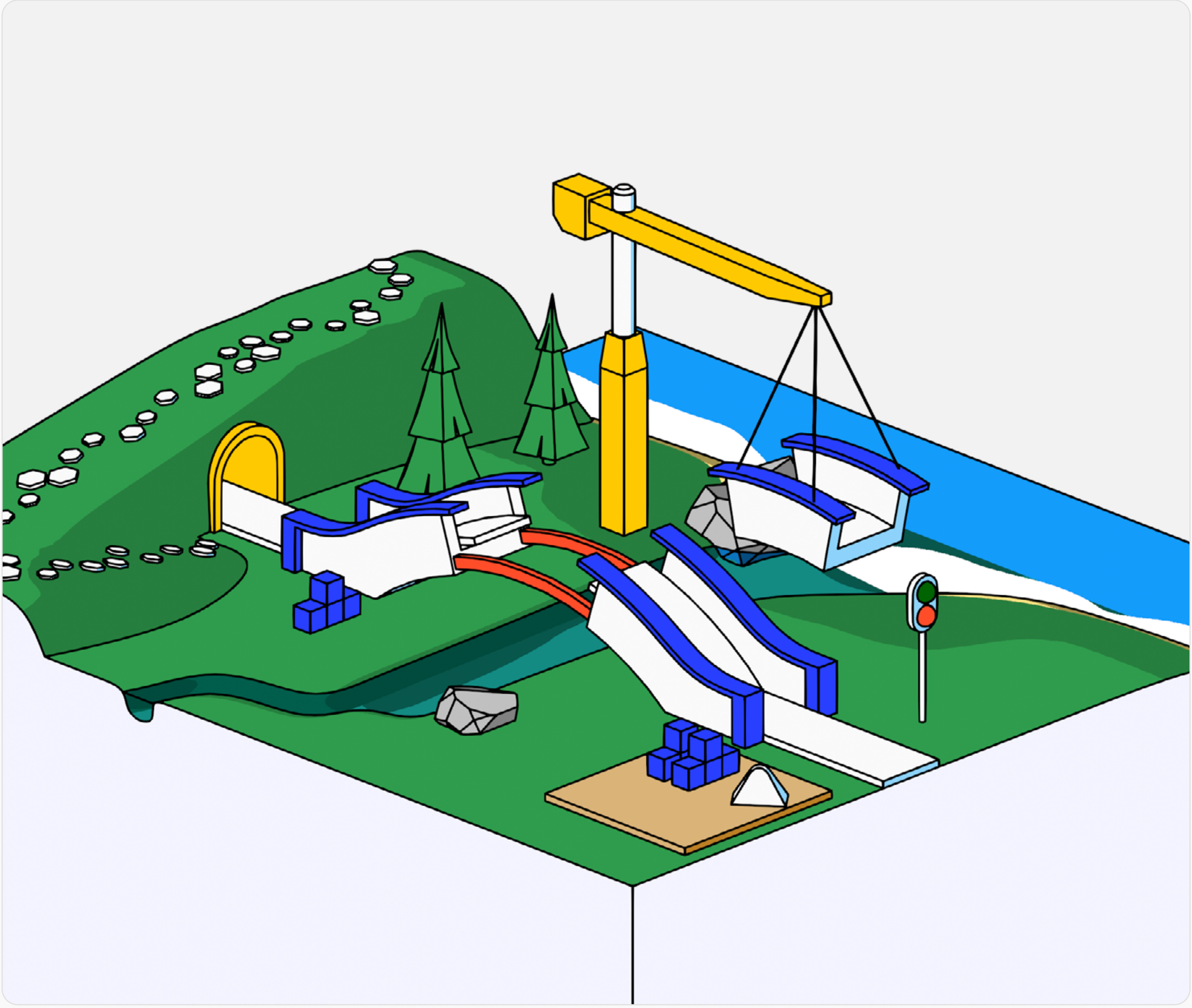
Additionally, FMPs need to choose and report on at least 1 out of 22 optional environmental indicators and 1 out of 24 optional social indicators. This means they have some flexibility in selecting additional indicators from these categories.

Example of the calculation of one PAI indicator

$$\frac{\sum_{n}^{i}\left(\frac{\text{current value of investment}_i}{\text{investee company's enterprise value}_i} \times \text{investee company's Scope 1, 2 and 3 GHG emissions}_i\right)}{\text{current value of all investments (€M)}}$$

Source: European Commission SFDR Annex 1

- Current value of investment
  The EUR value of the FMP's investment in the company.
- Investee company's enterprise value
  The total value of the company, including market capitalization of common stock, preferred equity, and book value of debt and minorities' interests (excluding cash).
- Investee company's scope 1, 2, and 3 GHG emissions
  Examples of "non-financial" data. Note that Scope 1 and 2 are emissions from owned sources, meaning that data is much easier to obtain. Scope 3 emissions, covering the entire value chain, can be more challenging to calculate.
- Current value of all investments (€M)
  The EUR value of all FMP investments.



How ESG software can help with data aggregation

Once you have collected validated sustainability data from your investee companies, software platforms can offer you **streamlined solutions to help you aggregate the data at the portfolio level, following the SFDR methodology.**

These software tools are designed to simplify the complex process of handling the numerous SFDR indicators. In effect, they save you time, help you minimize errors, and provide you with accurate insights for informed decision-making based on ESG impacts.

Reporting

The next step is to report and communicate your data in a comprehensible format to all your key stakeholders. The SFDR mandates financial organizations to disclose PAI information in pre-contractual documents, periodic reports, and on their websites. Ensure compliance with these requirements by preparing clear and transparent reports and disclosures.

Pre-contractual documents

When engaging with potential investors, provide them with relevant information about your approach to sustainability, including how you consider PAI indicators. This can be in the form of brochures, prospectuses, or other pre-contractual documents. Clearly communicate your sustainability objectives, methodology, and the key PAI indicators you consider.

Streamlining auditing and reporting

Some software providers enable you to significantly reduce audit preparation time with automated controls, and give easy access to supporting documentation.

Periodic reports

Include PAI information in your periodic reports, such as annual or semi-annual reports, that provide updates on your portfolio's sustainability performance. Describe how the aggregated PAI data has been used to assess the sustainability impact of your investments and any actions taken based on the findings. Provide insights into the progress made towards sustainability goals and the challenges faced.

Website disclosure

Make the aggregated PAI data easily accessible on your organization's website. Create a dedicated section that outlines your sustainability approach, methodologies, and results. Present the aggregated PAI data in a user-friendly and transparent manner, using visualizations, charts, or tables to enhance understanding.

How can you make your reporting more transparent?

Provide additional context to aid interpretation and understanding of the PAI data. Explain any limitations, assumptions, or uncertainties associated with the data or methodologies used. Include information about the scope of data collection, such as the percentage of companies covered in your portfolio or any exclusions. This context helps investors and stakeholders make informed judgments about your sustainability performance.

How ESG software can help with SFDR reporting

Software plays a crucial role in facilitating SFDR reporting by **providing functionalities to generate comprehensive reports based on the aggregated data.** It also allows for customization and flexibility, enabling you to tailor reports to your specific needs.

Tracking progress

Some SFDR tools give you a live overview of your SFDR compliance progress to help you ensure that you're 100% compliant with the mandatory metrics.

Using your data to guide decision-making

The data that you've gathered for SFDR compliance, can also bring you a range of benefits when it comes to decision-making.

Investment decisions

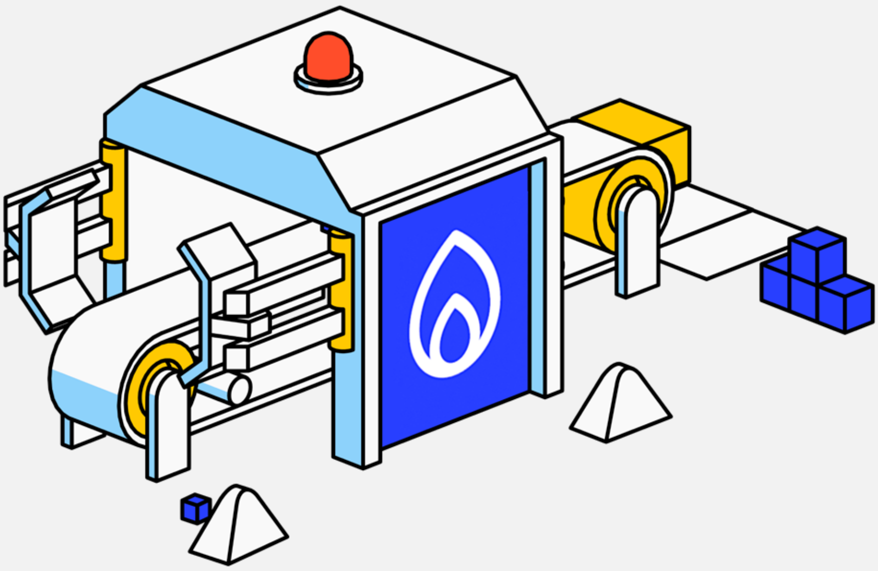
Evaluate the aggregated PAI data to assess the overall sustainability performance of your portfolio. Identify areas where improvements can be made, such as reducing exposure to investments with significant adverse impacts or reallocating resources towards more sustainable investments. The SFDR data can help align your investment strategy with sustainability objectives and regulatory expectations.

Collaboration

Share PAI data with your portfolio companies, along with your expectations for improved sustainability performance. Discuss potential actions and initiatives to address adverse impacts and enhance sustainability practices. This engagement can drive positive change and encourage companies to align their practices with sustainable principles.

Monitoring performance

Regularly monitor and track your PAI data to evaluate the effectiveness of your sustainability initiatives and investment decisions. Use it to identify which portfolio companies may need additional support with aspects of their ESG strategy. Analyze trends, compare performance across different periods, and assess the impact of changes in your investment portfolio – and then take action accordingly.



Use Sweep to become an SFDR Compliance Champion

Sweep gives you all the tools you need to succeed when it comes to SFDR compliance:

- providing a comprehensive and centralized platform for collecting, managing, and analyzing the data necessary for SFDR reporting.
- automating data validation and verification processes.
- automating calculations based on SFDR indicators.
- streamlining SFDR reporting.
- Incorporating regulatory updates, ensuring that you stay up-to-date with evolving SFDR requirements.

Sweep also brings detailed carbon calculation into the ESG software landscape.

Find out more

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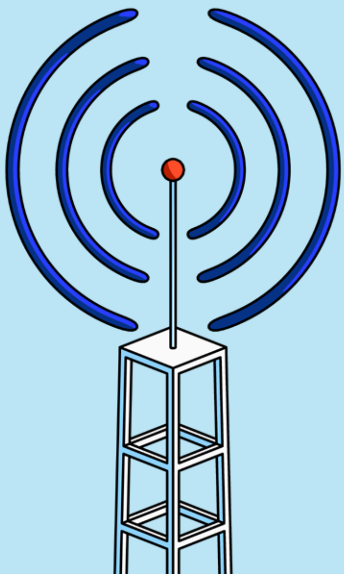

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