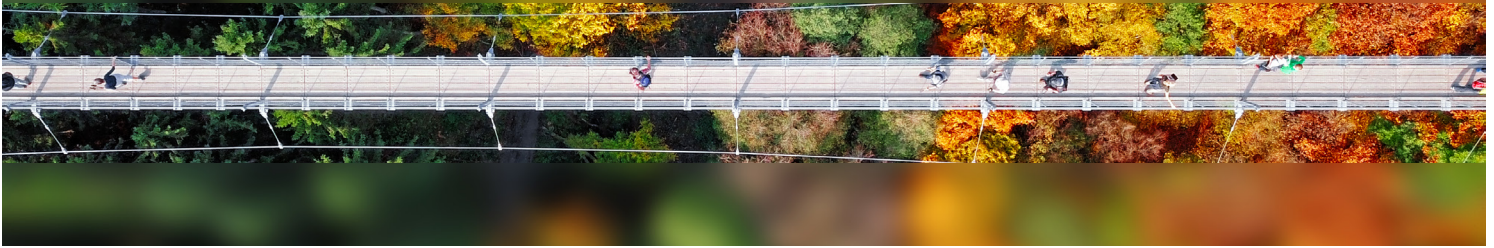


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SFDR AND TAXONOMY REGULATION: DOES MORE GUIDANCE MEAN MORE CLARITY?

Recently, the asset management industry has benefited from the release of documents intended to clarify provisions contained in Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (**SFDR**) and Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (**Taxonomy Regulation**). These texts do not introduce additional requirements, but aim to shed some light on the interpretation of SFDR and the Taxonomy Regulation in light of continued uncertainty.

In this briefing, we look at:

- the European Commission's [responses](#) to a series of questions submitted by the European Supervisory Authorities (**ESAs**) relating to the implementation of the SFDR and the Taxonomy Regulation, published by the ESAs on 25 May 2022;
- the [supervisory briefing](#) on sustainability risks and disclosures in the area of investment management published by ESMA on 31 May 2022 (**ESMA Supervisory Briefing**); and
- the [ESAs' clarifications](#) on the draft regulatory technical standards (**RTS**) under SFDR published on 2 June 2022 (**ESA Clarifications**).

ZOOMING IN ON THE EU COMMISSION'S RESPONSES TO THE ESAs' QUESTIONS

Application of the SFDR to Legacy Products

In its response, the Commission confirmed that it expects products that were in existence but which were no longer made available to investors as of 10 March 2021 (**Legacy Products**) to comply with (i) the SFDR Article 11 periodic reporting requirements; and (ii) the SFDR Article 10 website disclosure requirements. Note that the requirements of SFDR Article 10 and 11 are only applicable to products that have been categorised as Article 8 or Article 9.

The Commission has **not** confirmed that pre-contractual disclosures for Legacy Products will need to be updated.

The SFDR periodic reporting requirements are linked to the statements made in the pre-contractual disclosures for such products. In the case of a Legacy Product (for example, a closed-ended fund which had its final closing date prior to 10 March 2021), the pre-contractual disclosures will not have been made in accordance with SFDR.

Key elements

- Legacy products (i.e., products that were in existence but not made available to investors as of 10 March 2021) are required to report periodically if they have been categorised as Article 8 or 9 products.
- A financial market participant that does not consider 'principal adverse impact' at entity level may nonetheless create a product that pursues a reduction in negative externalities.
- When Article 8 and 9 products invest in companies, such companies must follow good governance practices.
- All Article 8 Products must disclose the information required by Article 6 of the Taxonomy Regulation.
- ESG-related terms in a fund's name and documentation must not be misleading and all information related to ESG across the fund's documentation and marketing material must be consistent.

Financial market participants (**FMPs**) will need to consider whether they have any Legacy Products that could be properly considered to be Article 8 or 9 products, and if so, consider how to address periodic reporting requirements in respect of such products.

Consideration of principal adverse impacts at product level

Another query posed by the ESAs related to the interrelationship between Articles 4 and 7 of the SFDR on the consideration of principal adverse impacts (**PAI**), at entity level and at product level. Specifically, the ESAs asked whether it is possible for a FMP to not consider PAI at entity level but nevertheless consider PAI under SFDR Article 7 for some of the financial products it manages and, if so, whether they could disclose this under SFDR Article 4.

In its response, the Commission confirmed that a FMP that is not subject to mandatory compliance with SFDR Article 4 and does not consider PAI at entity level (but publishes and maintains on its website clear reasons why it does not consider PAI) may create a product that seeks to reduce negative externalities by voluntarily considering PAI as part of their product disclosures under Article 6 and Article 11. However, such products should not form part of the entity level disclosures made by FMPs who have 'opted out' of SFDR Article 4.

This is a helpful clarification. It is clear from the wording of its response that the Commission has been seeking to address the fact that SFDR Article 7 clearly precludes product-level PAI disclosure for those that have 'opted out' under SFDR Article 4 and to give such FMPs comfort that they can still create products that seek to reduce principal adverse impacts by reference to the PAI regime, even if they are not able to opt into Article 7(1) SFDR formally for such products.

Good governance

A continuing area of uncertainty in terms of SFDR application has been whether products that invest in companies with a view to improving their good governance could still be categorised as Article 8 or Article 9 (which both require investee companies to follow good governance practices). The ESAs asked this question of the Commission directly, and in its response the Commission appeared to confirm that if an Article 8 or Article 9 product were to invest in a company that did not follow good governance practices, it would be in breach.

Application of Articles 5 and 6 of the Taxonomy Regulation

The last and probably most complex question from the ESAs relates to whether: (i) Article 8 products that promote environmental characteristics but do not commit to making sustainable investments with an environmental objective (also known in the industry as 'light green' or 'Article 8 light' products); and (ii) Article 9 products with a social objective that subsequently make sustainable investments with an environmental objective, have to comply with Articles 5 and 6 (as applicable) of the Taxonomy Regulation (i.e., report their Taxonomy alignment). The Commission's response was very detailed and the following paragraphs are intended as a summary of the key points to note.

In its answer, the Commission confirmed that it is “irrelevant” if a financial product commits to invest in sustainable investments with an environmental objective, and that all Article 8 products that promote environmental characteristics must comply with Article 6 of the Taxonomy Regulation in relation to their pre-contractual and periodic disclosures, based on an assessment of reliable data that investments will be (or have been) in economic activities that contribute to an environmental objective.

In addition, the Commission clarifies that where the investments made by a financial product during a reference period change over time and include investments in economic activities that contribute to an environmental objective, irrespective of commitments made in the pre-contractual disclosures, that change should be reflected in the pre-contractual documentation.

Likewise, the Commission confirmed that Article 9 products with a social objective that invest in sustainable investments with an environmental objective must comply with Article 5 of the Taxonomy Regulation.

In other words, it appears that compliance with Articles 5 and 6 of the Taxonomy Regulation is dependent on the actual investments made, not what is stated in a product’s pre-contractual disclosures.

This is a significant departure from how the industry had generally been interpreting the application of Articles 5 and 6 of the Taxonomy Regulation. FMPs may therefore need to urgently review their approach to Taxonomy compliance.

As part of its response to this question, although not raised by the ESAs, the Commission took the opportunity to address the issue of availability of data, which is a well-known challenge. In the response, the Commission stated that, if a FMP fails to collect data on the environmental objective(s) and on how and to what extent the investments are Taxonomy-aligned, the pre-contractual and periodic disclosures must indicate zero. The Commission also confirmed that it is not an option in this case to use narrative explanations on the lack of reliable data or to include negative justifications, such as explaining a lack of alignment by a lack of data. However, it did state that, in accordance with Recital 21 to the Taxonomy Regulation, in exceptional cases where a FMP is unable to obtain the relevant information to reliably determine an investment’s Taxonomy alignment (for example, because the relevant undertakings are not subject to the Taxonomy Regulation), that FMP can make complementary assessments and estimates based on information from other sources.

ZOOMING IN ON THE ESMA SUPERVISORY BRIEFING

The ESMA Supervisory Briefing is a non-binding document and its purpose is to provide guidance to national competent authorities (**NCA**s) in order to promote common supervisory approaches. However, its content may help FMPs anticipate the expectations of their supervising authorities on the implementation of SFDR and Taxonomy Regulation. We have highlighted a number of statements from the ESMA Supervisory Briefing below.

Key reminder

Articles 5 and 6 of the Taxonomy Regulation require pre-contractual and periodic disclosures to include:

- information on the environmental objective(s) set out in Article 9 of the Taxonomy Regulation to which the investment underlying the relevant financial product contributes; and
- a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation (i.e., their Taxonomy alignment).

Consistency of sustainability-related disclosures

The ESMA Supervisory Briefing recommends that NCAs check that the sustainability-related disclosures are consistent across the fund documentation and the marketing material.

Consideration of PAI by Article 9 products

NCAs could reasonably expect Article 9 products to consider PAI as referred to in SFDR Article 7 on the basis that Article 9 products should only be making sustainable investments, and this involves applying the ‘do no significant harm’ test (which requires the disclosure of how the PAI indicators have been taken into account). However, the ESMA Supervisory Briefing does state that such consideration is not mandatory.

Guidance on SFDR disclosures

Disclosure should:

- Not include boilerplate language with complex legal disclaimers or technical jargon that is difficult to understand;
- Avoid the repeated use of the same standard text across different funds;
- Limit use of cross-references or hyperlinks to where it is specifically required in the annexes of the SFDR Delegated Regulation; and
- Contain an indication of the SFDR article under which the fund is disclosing (without giving the impression that it is a label).

Fund names must not be misleading

‘ESG’, ‘green’, ‘sustainable’, ‘social’, ‘ethical’, ‘impact’ or any other ESG-related terms should only be used in the fund name when the evidence of sustainability characteristics are reflected fairly and consistently in the fund’s investment objectives and policy and its strategy, as described in the fund documentation.

Article 8 Products that do not make any sustainable investments are advised not to use the terms ‘sustainable’ or ‘sustainability’ in their name to avoid confusing investors.

Words such as ‘impact’ or ‘impact investing’ should only be used for funds whose investments are made with the intention to generate positive, measurable social and environmental impact.

Funds that are tracking an index should use ESG-related terms only if the index is itself ESG-focused.

Guidance for sustainable investment policy, objectives, and strategy

Sustainable objectives or characteristics should be clearly identified and general terms such as ‘the fund pursues ESG objectives’ without further explanation should be avoided.

It should be stated how the investment strategy is linked to the sustainable objectives.

Integration of sustainability risks by AIFMs

Last, the ESMA Supervisory Briefing contains a reminder that AIFMs – regardless of whether they offer sustainable funds – are required from 1 August 2022 to integrate sustainability risks in their portfolio and risk management processes and overall governance structure.

ZOOMING IN ON THE ESA CLARIFICATIONS

It is important to note that the ESA Clarifications relate to the text from the draft RTS contained in the Final Reports from [4 February 2021](#) and [22 October 2021](#) respectively, not the text from the [delegated regulation](#) adopted by the Commission in April 2022.

The ESA Clarifications focus on the following key areas of the Final Reports:

PAI disclosure

Uses of “sustainability indicators”

The ESA Clarifications confirm that the reference to “sustainability indicators” in the disclosures for financial products on the one hand, and the PAI indicators referred to in Article 4 SFDR (and Annex I of the draft RTS in the Final Reports) on the other, refer to different disclosures under the SFDR. However, the ESAs helpfully go on to explain that, in their view, it is possible to use the PAI indicators to measure the environmental or social characteristics, or the overall sustainable impact, of a financial product, and provide the below table to illustrate three possible uses of the PAI indicators at financial product level.

Use of PAI Indicators	Related main disclosure sections
<p>Disclosure of DNSH for sustainable investments under Article 2(17) SFDR: the use of PAI indicators is mandatory to demonstrate that an investment qualifies as a sustainable investment. The PAI indicators to be used are the ones in Table 1 of Annex 1 and any relevant indicators in Tables 2 and 3 of Annex I.</p> <p>The ESAs consider that using PAI indicators to fulfil the DNSH of SFDR does not require any PAI consideration at entity level pursuant to Article 4(1)(a), 4(3) or 4(4) SFDR.</p>	<p>Annex II/IV: “how do/did the sustainable investments that the financial product partially intends to make/made, not cause significant harm to any environmental or social sustainable investment objective?”</p> <p>Annex III/V: “how do/did sustainable investments not cause significant harm to any environmental or social sustainable investment objective?”</p>

Use of PAI Indicators	Related main disclosure sections
<p>Disclosure of PAI consideration under Article 7 SFDR: the disclosure of PAI consideration at product level is set out in Article 7 SFDR and is not further specified except for fields in the templates to provide the information required by that Article.</p>	<p>Annex II and III: “does this financial product consider PAI on sustainability factors?”</p> <p>Annex IV and V: “how did the financial product consider PAI on sustainability factors?”</p>
<p>Measurement of the attainment of environmental or social characteristics and the sustainability-related impact (Articles 10(1)(b), 11(1)(a) and 11(1)(b) SFDR): sustainability indicators used to measure the attainment of the environmental or social characteristics (for Article 8 SFDR financial products) or sustainable investment objective (e.g. the impact of the financial product for Article 9 SFDR products) may include PAI indicators. There is no direct link between sustainability indicators and PAI indicators.</p> <p>The ESAs clarify that the use of PAI indicators as sustainability indicators to measure the attainment of environmental or social characteristics or impact of the sustainable investments does not require any prior PAI consideration at entity level pursuant to Article 4 SFDR or PAI consideration at product level pursuant to Article 7 SFDR.</p>	<p>Annex II: “what sustainability indicators are used to measure the attainment of each of the environmental or social characteristics promoted by this financial product?” // “What are (...) and how does the sustainable investment contribute to such objectives?”</p> <p>Annex III: “what sustainability indicators are used to measure the attainment of each of the sustainable investment objective of this financial product?”</p> <p>Annex IV: “How did sustainability indicators perform?” // “What were (...) and how did the sustainable investment contribute to such objectives?”</p> <p>Annex V: “How did sustainability indicators perform?”</p>

Disclosures for direct and indirect investments in pre-contractual and periodic disclosures

The ESA Clarifications state that the relevant pre-contractual and periodic disclosures for Article 8 and Article 9 products could outline what share of the investments is held directly, and what share is held indirectly. Direct investments in investee companies are stated as including securities issued by the investee company (e.g., equities, corporate bonds, debt, and asset-backed securities). Indirect investments in investee companies are stated to encompass investment in funds, funds of funds or derivatives.

The ESA Clarifications go on to explain that FMPs should disclose the proportion of investments used to attain the environmental or social characteristics promoted (for

Article 8 products), or the sustainable investment objective (for Article 9 products), as well as the purpose of any remaining proportion of investments.

In relation to this remaining proportion of investments, the ESA Clarifications suggest that environmental or social safeguards could nonetheless be considered, and should be described so that investors obtain accurate information on the entire suite of investments made by the relevant financial product.

Financial product disclosure

The ESA Clarifications confirm that:

- Only economic activities that comply with Taxonomy Regulation Article 3 can count towards a financial product's Taxonomy-alignment.
- The requirement to disclose the "minimum proportion" of Taxonomy-aligned investments in pre-contractual disclosures is intended to be a binding commitment.
- If the commitment on the minimum proportion of Taxonomy-aligned investments made within the pre-contractual disclosures requires updating over the life of the product, such pre-contractual disclosures should be updated in accordance with sectoral legislation (e.g., AIFMD).
- The calculation of the Taxonomy-alignment of a financial product (A) that invests in another financial product (B) should be based on the market value of the proportion of Taxonomy-aligned investments of product (B).
- As regards periodic disclosures, the disclosure of the top holdings of a financial product requires the identification of the country in which the investment is made, or in which the investee company is headquartered, or where a financial product is domiciled (i.e., FMPs do not need to adopt a look-through approach).
- Periodic reports being drawn up in 2022 must comply with SFDR Article 11 irrespective of reference periods, and from 1 January 2023 such reports must comply with the additional RTS set out in the delegated regulation.

"Do not significantly harm" (DNSH) disclosures

The draft RTS set out disclosures for a financial product's sustainable investments' DNSH requirements. Essentially, FMPs have to disclose how a financial product's sustainable investments do not significantly harm any sustainable investment objective with reference to "how the indicators for adverse impacts in Table 1 of Annex I, and any relevant indicators in Tables 2 and 3 of Annex I, are taken into account".

The ESA Clarifications point out that this DNSH disclosure requirement is separate from the disclosures required under SFDR Articles 4 and 7, there is no link between them, and that they act independently. In other words, a financial product that makes sustainable investments must make DNSH disclosures, whereas the PAI disclosures at product-level referred to in SFDR Article 7 apply separately under that Article.

The ESAs acknowledge that the Final Reports did not specify how the PAI indicators should be used for the purposes of the DNSH disclosures. However, the ESA

Clarifications state that best practice could be to disclose DNSH for sustainable investments by extracting the indicators from Table 1 of Annex I, and any additional relevant indicators from Tables 2 and 3 of Annex I, and show the impact of the sustainable investment against those indicators, proving through appropriate values that the sustainable investments do not significantly harm any environmental or social objectives.

The ESA Clarifications also explains how the DNSH disclosure of the SFDR interacts with the DNSH requirements of the Taxonomy Regulation. The ESAs confirm that:

- The DNSH principle under the Taxonomy Regulation is separate from that under SFDR Article 2(17).
- When assessing whether an economic activity qualifies as environmentally sustainable, the Taxonomy Regulation sets out detailed DNSH activity-level criteria under Article 17 and in technical screening criteria contained in relevant Delegated Acts.
- By contrast, the SFDR sets out this principle for the purpose of assessing at the level of the investment whether it may qualify as sustainable.

What this means in practice is that, to qualify as a sustainable investment in the meaning of SFDR, an investment in a Taxonomy-aligned economic activity must also respect the DNSH principle in SFDR Article 2(17).

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