SLAUGHTER AND MAY/

# THE TIDE COMES IN: AN UPDATE ON THE SFDR AND THE TAXONOMY REGULATION

Governance, Sustainability & Society – Part of the Horizon Scanning series

## Introduction

**"ESG standards coalesce as EU launches new era of greenwashing prevention"**

(*FT.com Moral Money, 10 March 2021*)

While 10 March 2021 probably came and went without much impression on the public consciousness, it was a key date for EU asset managers as many of the operative provisions of Disclosure Regulation (EU) 2019/2088 (otherwise known as the sustainable finance disclosure regulation or "SFDR") started to apply. Some commentators herald this to be a "game changer" and a "new era" in the prevention of greenwashing; others are more circumspect but nonetheless agree that the new rules mark a significant milestone in EU's attempts to police the growing area of sustainable investing as it seeks to achieve its stated aim of re-orienting capital flows into a more sustainable economy.

### The Sustainable Finance Disclosure Regulation and the Taxonomy Regulation

As set out in our previous publication, the SFDR imposes a host of transparency obligations on financial market participants and financial advisors, including asset managers, requiring both entity-level and product-level disclosures on a number of elements:

- how sustainability risks are integrated into their investment decision-making process;
- the consideration of "principal adverse impacts" on "sustainability factors"; and
- various product-level disclosures to substantiate a product's ESG credentials, in particular if they have sustainable investment as a specific objective ("**Article 9 products**") or are promoted as having ESG characteristics ("**Article 8 products**").

The Taxonomy Regulation establishes a classification system setting out the criteria to determine whether a particular economic activity constitutes an "environmentally sustainable" activity. By having a common classification system by which investors can more easily assess a product's ESG credentials, the EU is seeking to minimise greenwashing and ensure that products are properly labelled as sustainable.

In its current form, the Taxonomy Regulation sets out six environmental objectives (climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems) and the criteria by which an economic activity makes a "substantial contribution" to those objectives and accordingly qualifies as "environmentally sustainable". The activity qualifies if it:

- contributes substantially to one or more of these economic objectives;
- does not significantly harm any of the environmental objectives;
- is carried out in compliance with certain minimum safeguards (i.e. in accordance with OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights); and
- complies with technical screening criteria that have been established by the Commission.

The EU is seeking to extend the classification system beyond environmental objectives to encompass social matters as well.

Many firms have, in compliance with the SFDR, already published their responsible investment policies setting how they have integrated sustainability and ESG risks across their investment chain in advance of the 10 March deadline. However, the harder work is just beginning as firms start to grapple with preparing the more detailed Level 2 disclosures in respect of reference periods commencing in 2022 as well as myriad other pre-contractual and periodic reporting disclosures at product level.

## Where are we now?

**"[The SFDR is] Vague, imprecise, open for interpretation - and probably knowingly so."**
*(David Czupryna, head of ESG development, Candriam)*

### What applies and when

While the Level 1 requirements of SFDR apply from 10 March 2021, the Joint European Supervisory Authorities (ESAs) tasked with preparing the Regulatory Technical Standards (RTSs) relating to the content, methodologies and format of certain disclosures required under the SFDR only published its final report on the draft RTSs on 2 February 2021. These will be finalised and adopted by way of a Commission Delegated Regulation (the SFDR Level 2 Regulation). Given the detail of the draft RTSs as set out in the initial consultation published in April 2020 and the length of time taken for the ESAs to finalise the RTSs in light of the responses, it should come as no surprise that the application of the Level 2 requirements has been delayed. The date of application has now been clarified in a joint supervisory statement by the ESAs. As long trailed by the European Commission in communications with a number of national industry bodies, the RTS provisions will apply from 1 January 2022. This means:

- The first reference period commences on 1 January 2022. As the initial Impact Statement only requires disclosure of certain non-reference period information, the earliest detailed information relating to principal adverse impacts to be disclosed in an Impact Statement in accordance with the RTS would not be made until 2023 in respect of a reference period from 1 January 2022 to 31 December 2022.
- Periodic reports required under Article 11(2) of the SFDR that are issued from 1 January 2022 must be drawn up in compliance with those requirements.

The ESAs have also recommended that the draft RTS be used as a reference when applying the provisions of the SFDR in the interim period between the application of SFDR and the application of the RTS at a later date.

The initial draft RTS proposed up to 50 quantitative indicators on which firms must report when assessing their principal adverse impacts. In its final form, the number of "mandatory indicators" has been reduced from the original 32 to 18 (14 for investee companies, 2 for sovereigns and 2 for real estate). Many indicators relating to social ("S") matters, for example, those relating to human trafficking, have been dropped and classified as additional (optional) indicators instead. On one hand, this has led to some criticism that the indicators have been severely weakened. On the other, the sheer granular detail of the indicators set out in the original consultation means that some industry pushback was perhaps inevitable - and, as many firms noted, the lack of relevant data from investee companies themselves meant that it was practically difficult for asset managers to be able to report in such granular detail.

In November 2020, the Commission published the draft text of the Level 2 delegated regulation supplementing the Taxonomy Regulation which sets out the technical screening criteria for determining the conditions under which a specific economic activity qualifies as contributing substantially to the first two of the six environmental objectives ("climate change mitigation" and "climate change adaptation") (the Taxonomy Climate Delegated Act). The delegated regulation also establishes, for each relevant environmental objective, technical screening criteria for determining whether that economic activity causes no significant harm to one or more of those environmental objectives. Political agreement was reached on the text on 21 April 2021, although the Commission has delayed its assessment on whether natural gas and nuclear energy activities can be included as transitional activities under the Taxonomy.

The ESAs have, on 17 March 2021, also published their joint consultation paper on Taxonomy-related sustainability disclosures (Taxonomy Disclosure RTS). The Taxonomy Regulation amends the SFDR to require additional disclosures based on the Taxonomy Regulation in the relevant pre-contractual documentation and periodic reports of financial products which promote environmental characteristics (in the case of an Article 8 product) or invest in an economic activity that contributes to an environmental objective (in the case of an Article 9 product).

Rather than introduce a completely new ruleset, the ESAs are proposing in their consultation paper to take the approach of amending the SFDR Delegated Regulation in order to expand the disclosures required to reflect the provisions of the Taxonomy Regulation. In particular, it is proposed that the Annexes to the SFDR Delegated Regulation be updated to include new provisions which set out the required pre-contractual disclosures and periodic reports to reflect the additional information required.

Broadly, the expanded disclosures aim to demonstrate *the extent* to which and *how* a financial product is aligned with activities that are classified as environmentally sustainable under the EU Taxonomy.

- **"The extent"**: The ESAs propose that the "extent" to which economic activities invested in qualify as environmentally sustainable should be shown as a graphical representation of the share of taxonomy-compliant investments of the financial product, showing the taxonomy-aligned investments as a weighted average of all investments.
- **"How"**: In order to disclose "how" investments underlying the financial product are made in economic activities that qualify as environmentally sustainable, the ESAs take the view that it is sufficient to state that the activities financed comply with the four criteria set out in Article 3 of the Taxonomy Regulation (see box above). However, firms must also disclose whether that statement has been assessed by a third party.

### Product disclosures: Additional requirements under the Taxonomy Regulation

The draft Taxonomy Disclosure RTS sets out the form and content of the expanded disclosures which must be included in relevant documentation of Article 8 and Article 9 products. Additional information required in pre-contractual documentation for such products include, among other things, the following:

- A pie chart providing graphical representation of the minimum taxonomy alignment of investments;
- where the product invests in economic activities that are not environmentally sustainable economic activities, a clear explanation of the reasons for doing so; and
- a description of the investments underlying the product that are in environmentally sustainable economic activities.

In relation to periodic reports, in addition to the information required for pre-contractual documentation as set out above, further information that must be provided include:

- A breakdown, expressed as a percentage of all investments of the financial product, of the proportion of investments in activities enabling other activities to make a substantial contribution to an environmental objective or supporting a transition to a climate-neutral economy
- a historical comparison of the taxonomy alignment of the investments of the reference period with previous reference periods.

## Scope of application to UK and non-EU asset managers

Although the SFDR came into force prior to 31 December 2020, the main obligations only apply after the end of the Brexit transition period. That being the case, the relevant obligations did not automatically form part of UK domestic law as part of the on-shoring process and therefore have no direct application in the UK. Similarly, while the overarching framework of the Taxonomy Regulation (in terms of definitions and the establishment of the environmental objectives and relevant criteria) came into force prior to 31 December 2020 and was on-shored, the substantive disclosure provisions (Articles 4 to 8) have not, and will not, be on-shored. UK and other non-EU asset managers may therefore wonder about the scope of the regulations and the extent to which they apply to them.

The territorial scope of the SFDR as drafted is ambiguous. Unfortunately, there has been little by way of clarification in this respect. The Regulation is stated to apply to "Alternative Investment Fund Managers" (AIFMs) and "MiFID investment firms" as both terms are defined in the AIFMD and MiFID II. However, the definitions set out in those directives are "activity based" without territorial scope – at face value, any firm which fits those definitions would be within scope, even if they are third country (non-EU) asset managers - although on a technical reading it may, for example, be possible to argue that "third country firms" are

separately defined within MiFID II and are therefore meant to be excluded. In the absence of explicit regulatory guidance, most have taken a fairly common-sense approach by considering the extent to which any activity undertaken by the relevant asset manager falls within the EU regulatory perimeter. Following this approach, if a non-EU firm's marketing activities in the EU are subject to an EU regulatory framework, then the products being marketed should also fall within scope of the SFDR and a firm will be required to make the relevant product level disclosures in respect of those products. Most, for example, take the view that a non-EU AIFM marketing an AIF via national private placement regimes under the AIFMD would be required to comply with product disclosures.

Delegation arrangements may also mean UK firms are affected, even if not directly. To take an obvious example: if an EEA AIFM delegates its portfolio management to a UK firm, it may require the help of the UK firm in order for it to comply with the SFDR.

### Other issues

There remain various other technical issues that arise from the wording of the SFDR which are not resolved by the publication of the final report – the ESAs have themselves acknowledged many of these issues and raised them in a letter to the Commission (published January 2021) asking for further clarification:

- The "one size fits all" requirements relating to product level pre-contractual disclosures are difficult to implement in circumstances where there are different types of disclosure documents for the different products, ranging from short form KIIDs (the length and form of which are prescribed) to long form information memoranda or prospectuses.
- It remains unclear what it means for a product to "promote" ESG characteristics and therefore be classified as an Article 8 product, with all its attendant requirements. Does this require an active marketing of the product as having ESG characteristics, or is it sufficient that the product does have an ESG-type feature? Does the application of an exclusion screen (for example, an exclusionary strategy that excludes all tobacco companies) mean that the product is promoting ESG characteristics even if not explicitly marketed as such?
- The focus in Article 9 is on having "sustainable investment" as an objective – in other words, products which specifically focus on achieving a sustainability goal. However, the line between an Article 8 product and an Article 9 product remains blurred, and a product may very well be classified as both an Article 8 and an Article 9 product. Arguably, all products offered, for example, by an "impact investment" manager fall within Article 9 as, by definition, their entire investment approach involves seeking to create a positive social or environmental impact alongside financial returns. This appears to be the approach taken by certain impact investing firms such as Triodos which states that "*all of its funds… have sustainable investments as their objective as set out in Article 9 of SFDR*."
- Indeed, there is not always a clear line between Article 8/9 products and other financial products. This may be significant as other disclosure requirements (including negative statements) may apply, with certain disclosures being required in respect of all financial products whether or not they promote environmental objectives.
- It is unclear how to apply the SFDR product rules to portfolios and dedicated funds.
- The regulation obliges the actual "financial market participant" or "financial advisor" to make relevant website disclosures but it is unclear whether group-wide disclosures are sufficient for these purposes – although in practice, it is likely that an organisation will adopt group-wide policies.

## What have we seen so far?

### Entity-level disclosures by non-EU firms

In relation to entity-level disclosures, at this early stage, the market has seen a number of different approaches, usually depending on the EU footprint of the firm in question. Some have voluntarily opted in and made disclosures in line with the SFDR, and of course, many large asset management firms would include, within their group, EU subsidiaries to which the regulation directly applies. In practice, given that many firms operate group-wide policies, it is likely that entity-level disclosure requirements would be made in respect of all entities, including UK entities, within the group. Indeed, UK-based and global asset managers including the likes of Schroders, Aviva Investors and Fidelity International have all published disclosures in line with SFDR.

### Integration of sustainability risks

As noted, many firms have published disclosures relating to the integration of sustainability risks in line with Article 3 and 6 of the SFDR. Given that only the Level 1 requirements apply at this stage, it is perhaps

only to be expected that disclosures at this stage have largely focused on high level policies and procedures. Most firms have provided a description on how they have integrated sustainability risks – for example, by setting out the various steps they take to assess such risks before making any investment decisions. These may include a description of their approach to ESG due diligence and what key governance areas they assess, engagement of third parties to undertake specialist due diligence on, for example, environmental issues, and the checking of relevant ESG ratings from rating agencies.

To an extent, these (particularly entity level disclosures) are necessarily generic and high level at this stage, although it is still somewhat disappointing that to date, many disclosures have provided very little by way of colour, even at the product-specific level. For example, in relation to the disclosures on the results of the assessment of the likely impacts of sustainability risks on returns of financial products (as required under Article 6(1)(b) and 6(2)(b) of the SFDR), a disclosure along the line that "*sustainability risks may… have a negative impact on the value, and therefore returns and performance of the [relevant] product*" (as made by a number of asset managers) could hardly be said to be illuminating.

## Principal adverse impacts

The concept of "principal adverse impacts" which focuses on "the impacts of investment decisions and advice that result in negative effects on sustainability factors" incorporates the concept of double materiality by requiring asset managers to consider the impact of their capital allocation and investment decisions on sustainability factors, and not just risks posed by ESG issues on the value of their investments.

As firms are required to consider principal adverse impacts only on a "comply or explain" basis, pending finalisation and the delay in the application of the RTS against which those impacts must be measured, a number have opted out, at least initially, of the requirements relating to "principal adverse impacts". Of these, many have cited the "lack of readily available data" and consequently, their practical inability to obtain and/or measure all the data which they would be required by the SFDR to report as their reason for opting out.

Commentators have pointed out that the proposed indicators are not based on any existing or widely accepted non-financial reporting standard. Unless and until there are standardised reporting obligations on investee companies by reference to the same or equivalent data set, asset managers would have to satisfy their disclosure obligations on the basis of limited data of variable quality. The issue becomes especially acute in respect of funds which invest on a global basis or in private unlisted companies. Many small and medium sized companies, in particular, are not yet in a position to readily track or provide the required data. It is therefore unsurprising that a substantial number of firms which have opted out of reporting on principal adverse impacts are managers of private funds which invest in asset classes such as unquoted securities in companies. In addition, many firms have also already developed their own proprietary set of key performance indicators to measure performance across their products and it remains to be seen the extent to which these can be re-purposed to allow them to report against the requirements of the SFDR.

Respondents to the ESAs' initial consultation on the draft RTSs have also expressed the need for the Commission to align the introduction of the various legislative proposals and allow a phased approach to the application of the various disclosure requirements. In particular, the application of asset managers' disclosure obligations should be co-ordinated with amendments to the Non-Financial Reporting Directive (NFRD) requiring companies within scope to disclose the extent to which their economic activities are taxonomy-aligned. There are existing difficulties with the SFDR not being entirely aligned with the Taxonomy Regulation, with each introducing overlapping and similar concepts which are not referenced to each other (for example, the reference to the "do not significantly harm" concept in the SFDR does not cross-refer to the concept as defined in the Taxonomy Regulation although they are clearly meant to be linked).

Nonetheless, asset managers beyond a certain size have no ability to opt out and must comply by 30 June 2021. In any event, the technical difficulties in implementing these disclosure requirements have not necessarily led to the market adopting a blanket approach of delaying compliance or opting not to comply. Many firms have, in fact, opted to consider the principal adverse impacts of their investment decisions and have set out their policies in respect of those impacts – perhaps taking the view that they can and will refine their approach in relation to disclosing against the granular metrics over time as both practice and availability of data mature.

## What now?

Although some may consider the initial disclosures underwhelming, it should be acknowledged that this is in the context of the fact that ESG and non-financial reporting remain an evolving field. At this initial stage, judgment should perhaps be reserved given that detailed disclosures against the quantitative indicators will not be published for some time yet – the usefulness or otherwise of the SFDR requirements can only be properly assessed at a later stage as the SFDR Delegated Regulation and other Level 2 requirements start to apply.

The EU cannot be criticised for lack of ambition in this respect, and certainly the UK is monitoring the EU regulatory initiatives as it considers whether and how it would implement its own set of rules in this area. It will be interesting to see how the UK develops its approach – industry bodies such as the Financial Markets Law Committee have pointed out the risks of divergence which may result in asset managers having to comply with overlapping but separate and parallel disclosure regimes. Given that the overarching framework of the Taxonomy Regulation has been on-shored, it has been suggested that the UK adopt a complementary approach using the EU framework, although with the possibility of enhancing the Level 2 requirements, where appropriate, to contribute to the development of global best practice. Nonetheless, with much work already underway by firms to establish appropriate systems and methodologies, perhaps what is most required by firms at this stage is clarity from the UK government and regulators.

In terms of availability of data from investee companies and alignment of that data with requirements under the SFDR and the Taxonomy, the Commission has recently announced a proposal for a Corporate Sustainability Reporting Directive (CSRD) which expands the NFRD requirements and also extends reporting requirements to large companies (whether or not listed) and to listed SMEs. The Commission has acknowledged the need for alignment between the various pieces of EU legislation and is seeking to ensure that, under the CSRD proposal, reporting standards would include indicators that correspond to the indicators contained in the SFDR and Taxonomy Regulation.

Nonetheless, while the standardisation of disclosure requirements among asset managers is a laudable aim given the very real risks of greenwashing, the technical difficulties arising from the ambiguous drafting of the regulations and, more significantly, in putting together an agreed set of data points and indicators suggest that there remains a wider debate about how best to implement a disclosure framework that serves multi-faceted purposes of preventing greenwashing, providing useful and accessible information to end users, as well as driving change in corporate behaviour.

The complex nature of the task can be seen in the fierce debate surrounding the proposed technical screening criteria in the Taxonomy Climate Delegated Act on whether certain activities, such as the use of gas and nuclear, may be included as transitional activities and accordingly labelled as contributing to one of the environmental objectives under the Taxonomy. Almost inevitably, this debate has taken on a political hue as different Member States push to accommodate certain industries within the Taxonomy. Already, a group of scientists and experts appointed to the EU Platform on Sustainable Finance has written an open letter criticizing the Taxonomy Climate Delegated Act, claiming that the criteria relating to forestry, bioenergy are not based on conclusive scientific evidence as envisaged under the Taxonomy Regulation, and that the initial November 2020 draft has been significantly weakened as a result. Five environmental non-governmental organisations have since walked out of the EU Platform following publication of the politically agreed text.

Against this backdrop, there is also the risk that an overly prescriptive approach focused on granular quantitative indicators and fixed templates may in fact produce confusing and complicated disclosures which are ultimately of little use to end users - in particular to retail investors. This may be counterproductive to the stated aim of preventing greenwashing. Certainly, some have argued for a more principles-based approach (advocated, for example, by the SEC), which is not based on one set of prescriptive metrics but which would simply require an asset manager to explain, within its own context, what it means that it invests on a sustainable basis, how it uses the term "ESG", the weighting it gives to different "E", "S" or "G" issues, etc.

More fundamentally, the point is often, and rightly, made that disclosure is not an end in itself. While there is probably some truth to the adage that "What gets measured gets managed", others have commented on the limits of disclosure as a driver to substantive change. The risk for both asset managers and their investee companies is that simply undertaking to provide increased and improved reporting becomes conflated with having made actual progress in addressing ESG issues.

**"..the focus on reporting may actually be an obstacle to progress—consuming bandwidth, exaggerating gains, and distracting from the very real need for changes in mindsets, regulation, and corporate behaviour."**

*(Kenneth Pucker, Harvard Business Review)*

The regulatory push towards transparency should instead be seen as part of a wider trajectory within the investment ecosystem to re-orient capital towards sustainable investments and towards a mindset that takes into account wider stakeholder and societal interests. Large asset managers like BlackRock and Schroders – which wield considerable influence - have made clear that their clients (the ultimate investors and asset owners) are increasingly demanding that businesses be run on a more sustainable basis. By extension, they would be putting pressure on investee companies along the same lines. Schroders has already requested that all FTSE350 companies produce and publish detailed, costed, net zero transition plans in 2021 while committing to undertake the same process themselves. Market-led initiatives, including voluntary disclosures, rather than regulation, may well prove to be the more significant catalyst that leads to behavioural change amongst corporates.

Nonetheless, regulatory action is still necessary and inevitable. For one, regulatory action is required to introduce some form of consistency of standards and, perhaps more importantly, to assess whether asset management firms' practices match their disclosures. It is therefore unlikely that there will be any let up in the regulatory tide. With the initial work of disclosing their policies out of the way, firms must now undertake the harder work of preparing to report against the detailed RTSs at entity and product level for the applicable reference period, as well as to make the detailed disclosures on the extent of alignment between the relevant products and the Taxonomy. Undoubtedly, many firms – including non-EU firms – should be taking (or continuing to take) practical steps in preparation, including:

- To the extent a firm considers principal adverse impacts to be relevant to a product, reviewing the final RTSs relating to the disclosure of principal adverse impacts and considering the indicators that are relevant across different products and asset classes.
- Reviewing the technical screening criteria as they get finalised and considering methodology to calculate extent to which investments is aligned with the Taxonomy in respect of each relevant product.
- Identifying data points and whether information is available from investee companies.
- In the absence of direct information from investee companies, considering how to deal with data gaps – this may include sourcing data from third party data sources such as ESG rating agencies. This may require further assessment of the methodology, and quality, of data gathered from third parties.
- Reviewing pre-contractual documentation (KIIDs and prospectuses) with a view to updating and incorporating the relevant disclosures.
- Assessing "on the ground" practice to ensure it is in line with disclosures.

However, these should not be a substitute for actual engagement by asset managers with client investors to properly explain their approach to embedding the often complex matrix of various ESG factors within their investment decisions – and then to demonstrate how they are actually applying their policies in practice and the outcomes of their activities in this regard.

If you would like to discuss any of the issues highlighted in this publication or any other legal or regulatory matter, please do contact us or speak to your usual Slaughter and May contact.

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