

Sustainable Finance: EU update December 2021

December 2021



Introduction



As the world watched world leaders and activists gather in Glasgow to discuss how to protect the climate at COP 26, the huge focus on encouraging the development of sustainable finance continues.

At the EU level, the implementation of the EU sustainable finance strategy continues at pace. Despite Brexit, UK firms need to keep an eye on EU developments particularly if they market into the EU or provide services in relation to EU products but also because the UK government has said it will draw on the EU approach as it introduces UK specific measures as part of the UK road map to sustainable investing.

In this article, we provide an update to our [March](#) article on the EU sustainable finance disclosure rules and other EU developments in this area.

For an update on the sustainable investment regime in the UK following the recent publication by the FCA of its discussion paper on its Sustainability Disclosure regime, please see our article [here](#).

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EU sustainable finance developments since March 2021

This article will focus on developments to the EU's key sustainable finance legislation Regulation 2019/2088 on sustainability-related disclosures in the financial sector (**SFDR**), the upcoming implementation of additional disclosure requirements in Regulation 2020/852 (**Taxonomy Regulation**), and the practical issues for those subject to these requirements.



SFDR developments since March 2021

As set out in our [March](#) article, the SFDR is a significant part of the EU’s legislative approach to increasing the sustainability of the financial sector. It applies to firms that are “**financial market participants**” or “**financial advisers**” and applies to a wide range of products. A summary of how SFDR applies is set out in the table below.

Who does SFDR apply to?		
Financial Market Participants (FMPs)	Financial Advisers (FAs)	
Typical examples include investment firms that provide portfolio management, fund managers and credit institutions that provide portfolio management.	Typical examples include credit institutions, certain insurance intermediaries, investment firms, AIFMs and UCITS management companies that provide investment advice.	
What does SFDR apply to?		
Funds	Portfolios	Other products
UCITS and AIFs, qualifying venture funds.	Portfolios managed under MiFID II.	Certain insurance products, pension schemes.



Implementation of SFDR – where are we now?

While most of the level one obligations set out in the SFDR came into force on 10 March 2021, there were a number of questions regarding its application as set out in a [letter](#) in January 2021 from the chair of the European Supervisory Authorities (**ESAs**) to the European Commission. The European Commission published a [response](#) to the ESA letter in July 2021 (as [corrected](#) in November 2021). A summary of the key issues and the Commission’s response is set out below. It is worth noting that despite the guidance, the industry continues to have some concerns with SFDR implementation.

Concerns raised (January 2021)	EU response (July 2021)	Outstanding industry concerns
Does the SFDR apply to non-EU AIFMs and sub-threshold AIFMs?	The SFDR entity and product requirements apply to sub-threshold AIFMs. Additionally, where a third country AIFM enters the market of a Member State by the relevant National Private Placement Regime, that AIFM must ensure compliance with SFDR, including financial product related provisions.	
Article 4(4) SFDR requires that, from 30 June 2021, “financial market participants which are parent undertakings of a large group as referred to in Article 3(7) of Directive 2013/34/EU5 exceeding on the balance sheet date of the group, on a consolidated basis, the criterion of the average number of 500 employees during the financial year shall publish and maintain on their websites a statement on their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors” Does the calculation of the 500-employee threshold for principal adverse impact (PAIs) reporting on parent undertakings of a large group apply to both EU and non-EU entities within the group?	When calculating the 500-employee criterion in Article 4 of the SFDR, FMPs and FAs need to include employees of any parent and / or subsidiary undertakings regardless of whether they are established inside or outside of the EU.	
If the FMP meets the 500-employee criterion, whether the PAIs due diligence statement should include impacts of the parent undertaking only or must it include the impacts of the group at a consolidated level?	The EU confirmed that under Article 4(4) parent undertakings should publish their PAIs due diligence statement at the entity level, ie at the parent undertaking level.	Clarity is also being sought on whether PAIs due diligence statement for relevant FMPs should also include the impacts at group level, as well as at parent undertaking level.
Article 8 aims to enhance transparency on products “ promoting environmental or social characteristics” in pre-contractual disclosures. It applies: “Where a financial product promotes , among other characteristics, environmental or social characteristics, or a combination of those characteristics”. What does “promotion” mean in the context of an Article 8 (light green) product which promotes environmental or social characteristics?	Article 8 and Article 9 products are two distinct product categories. “Promotion” for the purposes of an Article 8 (light green) product has a wide meaning. For example, it would include direct and indirect claims and general ambitions stated in various publications (marketing communications, use of product names, factsheets and so on), regardless of the form used (electronic or otherwise).	Further clarification required, for example whether complying with national legislation is enough to bring a product within Article 8 scope.

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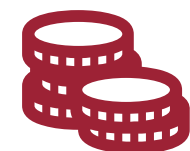


Implementation of SFDR – where are we now? (cont'd)

While most of the level one obligations set out in the SFDR came into force on 10 March 2021, there were a number of questions regarding its application as set out in a [letter](#) in January 2021 from the chair of the European Supervisory Authorities (**ESAs**) to the European Commission. The European Commission published a [response](#) to the ESA letter in July 2021 (as [corrected](#) in November 2021). A summary of the key issues and the Commission’s response is set out below. It is worth noting that despite the guidance, the industry continues to have some concerns with SFDR implementation.

Concerns raised (January 2021)	EU response (July 2021)	Outstanding industry concerns
<p>Article 9(1) and (2) SFDR apply: “Where a financial product has sustainable investment as its objective”. Article 9(3) applies “where a financial product has a reduction in carbon emissions as its objective”.</p> <p>What range of investments is open to a product classified as an Article 9 (“dark green”) product? Are Article 9 products only able to invest in sustainable investments as defined in Article 2 SFDR?</p>	<p>An Article 9 (“dark green”) financial product may invest in a wide range of underlying assets if these qualify as “sustainable investments” as defined in the SFDR.</p> <p>An Article 9 product may, in order to meet particular rules, also include other investments for certain specific purposes such as hedging or liquidity so long as these are in line with the sustainable investment objective.</p> <p>If the product cannot meet these investment criteria it may still be able to meet the Article 8 criteria.</p>	<p>Further clarification on what constitutes “sustainable investment” and whether an Article 9 product needs to be 100% invested in sustainable investments (save for ancillary purposes).</p> <p>Whether analysis for ascertaining sustainability should be carried out at entity level or at the level of the economic activity underlying the entity.</p>
<p>In relation to MiFID portfolios or other tailored financial products, do the SFDR disclosure requirements apply at the level of the portfolio only, or whether they can apply at the level of standardised portfolio solutions?</p> <p>If they do apply at the portfolio level, how is it possible to maintain client confidentiality obligations in view of disclosures required, such as the website disclosures in Article 10?</p>	<p>Disclosure obligations do apply to discretionary portfolios and client mandates as there is no distinction in the SFDR as to whether the products are tailored to end investors or not.</p> <p>Website disclosures for these products are therefore required but where a firm makes use of standardised product solutions, transparency of those solutions might be a way for complying with the website disclosure requirements.</p>	<p>Firms are considering the practical implications of meeting the SFDR disclosure obligations while complying with confidentiality obligations.</p>

Outstanding issues and delays to the Level 2 SFDR and Taxonomy implementing measures



As can be seen above, there remain outstanding issues regarding the interpretation of SFDR level 1 provisions. In addition to these concerns, firms have had to deal with delays to the publication and implementation of the SFDR level 2 measures which will set out detailed requirements as to how they can meet their SFDR obligations.

An original draft SFDR RTS was published in April 2020. However, it was so controversial that its implementation was delayed, and a revised SFDR RTS was subsequently published in February 2021. Then in March 2021, the ESAs issued a [consultation paper](#) on the content, methodologies and presentation of taxonomy-related sustainability disclosures, including draft regulatory technical standards (the **Taxonomy RTS**). The Taxonomy Regulation interacts with the SFDR; in particular, imposing disclosure requirements on SFDR Article 8, Article 9 and Article 6 products (which are products which do not integrate any kind of sustainability into the investment process) As the Taxonomy RTS does in part amend the SFDR RTS, the two need to be read together.

Given the difficulties with the SFDR RTS, the Commission initially confirmed in a July 2021 [letter](#) that the application of the SFDR RTS would be delayed to 1 July 2022. In addition to the delayed implementation of the SFDR RTS, the Commission confirmed that it intended to bundle the SFDR RTS with certain Taxonomy Regulation RTS which amend the SFDR RTS that deal with disclosure requirements for taxonomy aligned products. The Commission's aim is to avoid duplication and minimise complexity in this area by creating a single rulebook for RTS on these sustainability disclosures under the SFDR and the Taxonomy Regulation.

These bundled RTS were due to be implemented together on 1 July 2022, but in a [letter](#) dated 29 November 2021 the Commission confirmed that implementation of the bundled RTS would be further delayed until 1 January 2023. A consolidated version of the draft SFDR RTS was made available in October 2021, in section 5 of the [joint final report](#) from the ESAs.



The revised final draft RTS in the October report do make some changes to the previous final draft SFDR RTS. Key points to note include:

- pre-contractual and periodic disclosures obligations for taxonomy aligned products that identify the environmental objectives to which the product contributes and show how and to what extent the product's investments are aligned with the EU taxonomy.
- removal of the derogation from the “do no significant harm” (**DNSH**) principle for taxonomy aligned sustainable investments. As a result, the DNSH-related rules will be applied to all sustainable investments, including taxonomy-aligned investments.
- the SFDR RTS have been amended to reflect that the mandatory templates for the pre-contractual and periodic disclosures included in the Annexes should identify whether sustainable investments are environmental or social and for environmentally sustainable investments, whether the investments are taxonomy-aligned.
- the pre-contractual disclosures for Article 8 and Article 9 SFDR products have been amended to include not only information on whether, but also on how, a financial product considers principal adverse impacts on sustainability factors.

The Commission was due to consider the final report together with the bundled RTS within three months and to publish the finalised bundled RTS. However, due to the length and technical detail in the bundled RTS, the Commission confirmed in the 29 November letter that it would take more than three months to consider the bundled RTS and to publish the final versions. This was part of the reason for the additional delay to the implementation of the bundled RTS until 1 January 2023.

It is worth noting however that the Commission continues to expect in scope firms to provide the first detailed reporting on the principle adverse impact indicators by 30 June 2023 for the reference period 1 January 2022 until 31 December 2022. In effect this implies a retrospective application of the relevant RTS as the principle adverse impact indicators are detailed in the RTS which are now not due to come into force until 1 January 2023.

For further information on disclosure obligations under the SFDR, please refer to our guide to sustainability-related disclosures under the EU's SFDR.

Taxonomy Regulation



The Taxonomy Regulation establishes an EU-wide classification system (or taxonomy) to identify which economic activities can be considered environmentally sustainable. It is an important part of the EU's sustainable finance plan and is designed to set out clearly whether a company, product, fund manager is actually "green" under a common EU-wide definition of what constitutes a "green" product. The aim is to enable investors to evaluate the sustainability credentials of their investments more easily.

As mentioned above, the Taxonomy Regulation interacts with the SFDR insofar as it imposes additional disclosure obligations on certain SFDR Article 8 products ("light-green" products) and SFDR Article 9 products ("dark-green" products), if that product invests in an economic activity that contributes to one of the six environmental objectives defined in the Taxonomy Regulation.

Taxonomy Regulation environmental objectives	Expected implementation date
Climate change mitigation	1 January 2022
Climate change adaptation	1 January 2022
The sustainable use and protection of water and marine resources	1 January 2023
The transition to a circular economy	1 January 2023
Pollution prevention and control	1 January 2023
The protection and restoration of biodiversity and ecosystems	1 January 2023

If an Article 8 or Article 9 product invests in an economic activity that meets one of these objectives, the Taxonomy Regulation imposes additional disclosures including for example:

- information on the environmental objective or environmental objectives to which the investment underlying the financial product contributes; and
- a description of how and to what extent those underlying investments are themselves invested in environmentally sustainable economic activities, including specifying the share of investments in environmentally sustainable economic activities.

The relevant Article 8 or Article 9 product must also comply with the following criteria as set out in Article 3 of the Taxonomy Regulation:

- it does not significantly harm any environmental objectives
- it complies with minimum safeguards
- it complies with technical screening criteria

Currently, there are two relevant implementation dates for the Taxonomy Regulation level 1 disclosures: the climate change mitigation and adaptation objectives are currently due to be implemented on 1 January 2022; with the remaining objectives due to be implemented on 1 January 2023.

However, as mentioned above, the relevant Taxonomy Regulation RTS implementation date has effectively been moved to 1 January 2023 as they are being bundled with the SFDR RTS. Therefore, the Taxonomy Regulation level 1 obligations regarding climate change mitigation and adaptation will currently apply before the Taxonomy Regulation level 2 standards have been finalised. This will be particularly challenging for firms as the relevant level 2 regulations include the prescribed templates for pre-contractual disclosures and periodic reports.



Practical considerations for the industry as a result of the delays

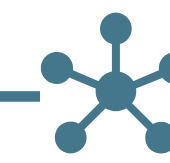
While it is laudable that the Commission wants to minimise complexity and duplication in relation to sustainability disclosures by providing a single rulebook and bundling the relevant SFDR RTS and Taxonomy Regulation RTS as a single delegated act, it presents a significant headache for those affected.

Unless the Commission also delays the implementation of the Taxonomy Regulation level 1 obligations to 1 January 2023 or confirms that there will be regulatory forbearance until that date, entities subject to the requirements will have to consider how best to meet their obligations. Options include complying with the level 1 obligations on a principles basis from January 2022 and revising the disclosure if necessary when the RTS are in force. It may be worth considering including a statement that explains the situation to investors in the relevant disclosure. It is also possible that, as with the SFDR, the Commission will ask National Competent Authorities to encourage firms to consider the relevant draft RTS when making the level 1 disclosures, even though those disclosures will not yet be finalised or in force. Further, as a result of these delays, firms may be required to carry out additional updates to disclosure documents throughout the year.

This is a complex area, and each firm will need to make its own decision on how best to comply depending on its specific circumstances. If you would like tailored advice, please get in touch with us.

EU's Renewed Sustainable Finance Strategy

In July 2021, the Commission also published its [Renewed Sustainable Finance Strategy](#) (RSFS). The RSFS follows up on the Commission's 2018 Sustainable Finance Action Plan, under which the SFDR and the Taxonomy Regulation were proposed. The RSFS sets out how the Commission intends to continue improving the financing of sustainable economic activities. In the RSFS, the Commission proposes initiatives in four different areas: climate transition finance, inclusiveness, resilience, and contribution of the financial system to sustainability goals and the international perspective. The Commission intends to report on the strategy's implementation by the end of 2023.



Integration of sustainability principles into other EU financial services legislation

Delegated Regulations and Directives integrating sustainability into MiFID 2, AIFMD and UCITS Directive were published in the Official Journal in August 2021. The delegated legislation is designed to supplement the requirements set out in the SFDR and the Taxonomy Regulation and are intended to integrate sustainability factors in the relevant legislative regimes.

Relevant Legislation	Key points
MIFID 2	<p>Integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, including, for example, considering the client's sustainability preferences when assessing suitability.</p> <p>Integration of sustainability factors into product governance obligations for investment firms when manufacturing financial instruments, including, for example, considering sustainability related objectives when identifying the target market for the instrument.</p> <p>Inclusion of sustainability risks within the firm's risk management policy.</p>
AIFMD	<p>Integration of the sustainability risks into certain organisational and operating requirements for AIFMs, including, for example, the selection and ongoing monitoring of investments in line with its due diligence obligations.</p> <p>Integration of sustainability factors into the AIFM's governance obligations, including, for example, ensuring that the AIFM's senior management is responsible for the integration of sustainability risks in its investment policy for each AIF.</p> <p>Inclusion of sustainability risks within the AIFM's risk management policy.</p>
UCITS	<p>Integration of the sustainability risks into certain organisational and operating requirements for management companies, including, for example, the selection and ongoing monitoring of investments in line with its due diligence obligations.</p> <p>Integration of sustainability factors into the management company's governance obligations, including, for example, ensuring that its senior management is responsible for the integration of sustainability risks in its investment policy for each UCITS.</p> <p>Inclusion of sustainability risks within the UCITS management company's risk management policy.</p>

Most of the delegated legislation applies from August 2022 apart from the AIFMD amending directive. Member States have until 22 August 2022 to adopt measures to implement the AIFMD amending directive, which must apply by 22 November 2022.



What's next in 2022?

The EU work on its sustainable finance action plan continues apace and we set out below a summary of key upcoming dates.

Date	Action point
30 December 2021	SFDR – ESAs to prepare draft technical disclosures to investors in relation to social and governance matters.
1 January 2023	Taxonomy Regulation - Commission to publish a report about the provisions required for extending the scope of the Taxonomy Regulation beyond environmentally sustainable economic activities.
1 June 2022	Taxonomy Regulation - ESAs to prepare draft technical standards in relation to activities that contributes to environmental objectives other than climate change mitigation and adaptation.
August 2022	Level 2 amendments to UCITS directive AIFMD, MIFID, Solvency II and IDD to integrate sustainability factors begin to apply.
30 December 2022	SFDR - product level disclosures on principal adverse impacts begin to apply.
1 January 2023	Taxonomy Regulation - current application date for disclosures in relation to environmental factors including climate change adaptation and climate change mitigation.
1 January 2023	SFDR RTS - delayed applications of the on the content, methodologies, and presentation of sustainability-related disclosures due to apply.

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