

Update and FAQs – SFDR and Taxonomy Regulation

June 2022

1. Speed read

As the start date looms for the Level 2 requirements under SFDR and the product disclosure regime in the Taxonomy Regulation, firms are progressing their implementation projects. This bulletin provides an update on recent ESMA, ESA and European Commission pronouncements, as well as giving practical guidance on key points.

2. How did we get here?

The Sustainable Finance Disclosure Regulation 2019/2088 (**SFDR**) was adopted on 27 November 2019 – it began to apply in a phased way from 10 March 2021.¹

The **Taxonomy Regulation** entered into force on 12 July 2020, and is formally known as Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment.² Among other things, it introduces a detailed product disclosure regime for products in scope of SFDR, via both directly applicable requirements and amendments

to SFDR. It also began to apply in a phased way, beginning on 1 January 2022.

Under SFDR and the Taxonomy Regulation, the European Supervisory Authorities (**ESAs**) were mandated to develop Level 2 requirements or Regulatory Technical Standards (**RTS**). After a protracted process and many delays, these have been bundled into a single RTS which is hopefully now in final form.

3. Final RTS or level 2 requirements

On 6 April 2022, the European Commission announced that it has adopted a final version of the RTS. In particular:

- the final text of the RTS and an explanatory memorandum;³
- Annex 1 – containing the template principal adverse sustainability impacts statement;⁴
- Annex 2 and Annex 3 – containing the template pre-contractual disclosures for products falling under Article 8 and Article 9 of SFDR;⁵

– Annex 4 and Annex 5 – containing the template periodic disclosures for Article 8 and Article 9 products.⁶

Technically speaking, the RTS is now subject to a three-month objection period by the European Parliament and Council (extendable by three months on request). Assuming that expires with no objection, the RTS will be published in the Official Journal and enter into force on the twentieth day following publication.

The RTS is intended to apply on/from 1 January 2023.

What were the differences between the draft RTS and the final version?

A lot of firms in the industry were assuming (or hoping) that the most recent draft RTS was virtually final, so they could proceed with their implementation projects in reliance on this. In fact, the final RTS includes a number of changes. Sifting through these one by one, they are mostly points of form rather than substance – with text moved around and deletions of what could have been considered duplication. Whether this was time and effort well spent is debatable.

The upshot is that the final version often leaves key requirements to be made via the templates and drafting notes in the templates, rather than telling firms what to do via substantive clauses in the body of the RTS.

There are some points of substance in the changes (albeit far and few between); eg Article 54 of the RTS now explains how sector exposures are defined. Recital 15 also now states as follows, although the meaning is unclear: “(15) *While financial products that have sustainable investment as their objective should make sustainable investments only, such products can to some extent make other investments where they are required to do so **under sector specific rules**...*”

1 <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>

2 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852>

3 [https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_1_EN_ACT_part1_v6%20\(1\).pdf](https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_1_EN_ACT_part1_v6%20(1).pdf)

4 https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_1_EN_annexe_acte_autonome_part1_v6.pdf

5 https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_2_EN_annexe_acte_autonome_cp_part1_v5.pdf and https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_3_EN_annexe_acte_autonome_cp_part1_v5.pdf

6 https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_4_EN_annexe_acte_autonome_cp_part1_v5.pdf and https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_5_EN_annexe_acte_autonome_cp_part1_v5.pdf

4. How should I fill in the templates?

Annex 4 and Annex 5 – containing the template for Article 8 and Article 9 are in fact now fairly close – looking at them side by side, you will see a lot of overlap in the content.

Some important steps

- A first key step is to convert the templates into word format. Speak to your usual A&O contact if you wish for a hand with this. In doing this, make sure the diagrams are capable of being amended – eg for some products you will need all the boxes; in other cases, you may need to take some out. You must also be able to change to insert relevant numbers in the boxes.
- The second step is to decide if your product is/will be Article 8 vs Article 9.
- If Article 8, you must then decide if it will be a regular Article 8, or what the industry calls an “Article 8+”:
 - This is the case if you are making a commitment on a minimum level of sustainable investments in the product.
 - Where you make that commitment, for that portion of the product, you basically provide very similar disclosures to those you would make if the whole product was an Article 9 product, making **only** sustainable investments.
- If your product is a regular Article 8 product, however, none of that is relevant. What this means in practice, is that you need to strip out all the questions in the Article 8 template that essentially become redundant in this scenario.
- Speak to your usual A&O contact if you wish to see a mock-up of the template for this.
- Note that this “stripping out” process also involves stripping out virtually all rows and questions relating to the taxonomy – with one or two exceptions, these mostly fall away. Again, speak to your usual A&O contact if you would like our full reasoning on this.

Key points

- **Challenges** – Some of the disclosures can be challenging to make sense of in certain circumstances. Eg it is not straightforward to come up with indicators for a product that says it is Article 8 because of a negative exclusion policy. Similarly, it is not straightforward to identify indicators for a product that says it is Article 8 because of its approach to engagement. In our view, firms must do their best to come up with something sensible, but recognise that it is not clear what regulators will wish to see and so it may be necessary to update the pre-contractual disclosure when this becomes clearer.
- **Use of the templates for new funds** – Some of the disclosures are not straightforward to come up with for new funds – eg a newly launched fund that has cash but (as yet) no actual investments. In the absence of regulatory guidance on this, We suggest taking a conservative approach – let us know if you wish for further advice on this.
- **Legacy products** – It is unclear whether firms with legacy products (eg funds closed to new investments before 10 March 2021) are caught by the pre-contractual disclosure requirements under SFDR, where they would otherwise fall within Article 8. Similarly, it is unclear whether products closed to new investments before 1 January 2023 must prepare a disclosure using the template RTS, which only begins to apply from this date. At a minimum:
 - it is clear that periodic disclosures must still be prepared for such products; and
 - there is an argument that it may still be necessary to prepare the pre-contractual template disclosure so as to post it on the firm’s website. This is in view of the wording of the SFDR website disclosure requirement (Article 10).⁷ See also the following from the European Commission (emphasis added):
*“As regards situations of existing investors and where a financial product is no longer made available to end investors as of 10 March 2021 and a financial market participant draws up for such product a periodic report referred to in Article 11(2) of Regulation (EU) 2019/2088 after that date, the periodic report must comply with the requirements laid down in Article 11(1) of that Regulation. **Such financial products must also comply with the rules on transparency of the promotion of environmental or social characteristics and of sustainable investment objectives on websites enshrined in Article 10... of [SFDR].**”⁸*

⁷ “Financial market participants shall publish and maintain on their websites the following information for each financial product referred to in Article 8... and Article 9 ...: (c) the information referred to in Articles 8 and 9 ...”

⁸ https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf

– **Binding vs non-binding and greenwashing issues** –

Views in the market differ on this. We have also seen different approaches in different asset classes, and possibly also a hardening of the approach over time as regulators are being more vocal about their greenwashing concerns.

Going forward, it may become challenging for a firm to rely on non-binding characteristics of a product to justify that product being classified as falling under Article 8. Eg features of a product that are discretionary or subject to caveats, limitations, exceptions etc. In our view, it may therefore be preferable for a firm to consider ensuring any characteristics relied on for Article 8 purposes are fairly “hard wired” into the product – eg for a fund, mandated in its investment objectives etc.

For example, ESMA has cited the following as potential instances of greenwashing:

“... the marketing documentation focuses on exclusion policies [ie negative screening] which do not per se result in selecting a fully sustainable eligible investment universe, or an ESG integration strategy is presented but no commitment is made to use ESG considerations in the investment decision-making. This is a problem affecting both institutional investors and retail investors. The latter increases the risk of misinformation, mis-pricing and mis-selling...”⁹

ESMA has also noted the following:¹⁰

“... Recital 11 of the SFDR Delegated Regulation, with regards to funds disclosing under Article 8 SFDR, notes that disclosure of criteria for the selection of underlying assets should be limited to those criteria that are binding on the fund manager in the investment decisionmaking process. ... Recital 16 of the SFDR Delegated Regulation warns against the greenwashing risks where funds apply “non-binding” exclusion strategies.”; and

“A sustainable investment policy and/or objectives should be included in the fund documentation and the fund should be managed according to it.”

The Dutch regulator has also said that it expects: *“... classification of funds in this [Article 8] category to be substantiated by a specific statement of the particular ecological or social characteristics that are promoted and that these characteristics will be represented in the investment policy of the fund concerned.”*

Obviously not relevant to SFDR, but the FCA also appears to align on the more general point: *“where a fund claims to pursue ESG/sustainability characteristics, themes or outcomes, these should be appropriately reflected in the fund’s objectives and/or policy.” [and] “A fund’s ESG/ sustainability focus should be reflected consistently in its design, delivery and disclosure. A fund’s focus on ESG/ sustainability should be reflected consistently in its name, stated objectives, its documented investment policy and strategy, and its holdings.”*

We appreciate, however, that this issue is complex – if you would like further advice, please speak with your usual A&O contact.

- **PAI product level disclosures** – Article 7 of SFDR does not prescribe the content for these; nor does the RTS. In theory, this leaves firms with flexibility as to the approach they wish to take. In our view, it is not necessarily helpful to an ordinary investor to see pages of detail here – rather, a shorter and more focused disclosure may be preferable. It is not clear, however, what regulators will wish to see. For more on this, see below.

⁹ https://www.esma.europa.eu/sites/default/files/library/esma30-379-1051_sustainable_finance_roadmap.pdf

¹⁰ https://www.esma.europa.eu/sites/default/files/library/esma34-45-1427_supervisory_briefing_on_sustainability_risks_and_disclosures.pdf
<https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorized-esg-sustainable-investment-funds.pdf>



5. What materials should I look at if i have a question or can't work out what the templates require?

We have three practical suggestions:

(1) You can look to see if any of the following contain the answer. See also our cheat sheet below:

- European Commission Q&A July 2021¹¹
- European Commission Q&A 17 May 2022¹²
- ESA Joint Supervisory Statement 25 February 2021¹³
- ESA Updated Joint Supervisory Statement 24 March 2022¹⁴
- ESA Clarifications on RTS 2 June 2022¹⁵
- ESMA Supervisory briefing – Sustainability risks and disclosures in the area of investment management 31 May 2022¹⁶

In our view, the ESMA Sustainable Finance Roadmap 2022-2024 also provides a useful steer on certain points – eg views on what might be considered greenwashing.¹⁷

(2) You can look at the previous drafts of the RTS and templates. In our experience, the ESAs and the European Commission have remained largely “on track” in terms of their views on key points and issues of interpretation:

- First main consultation – 23 April 2020¹⁸
- Final report – 2 February 2021¹⁹
- First main consultation on taxonomy related disclosures – 15 March 2021²⁰
- Final report – 22 October 2021²¹
- Final versions – announced 6 April 2022 (for links see below).

(3) Certain industry associations have published guidance for members on key points. Some also have regular calls with members to talk about points of interpretation that are coming up and to gauge industry best practice that is emerging. Where possible, you may wish to plug into this sort of thing. If you are a member of a relevant body, you may also ask for notes of previous calls in case there's a helpful discussion on the issue you are grappling with.

11 https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1323237.pdf and https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf. See also the small amends made by https://www.esma.europa.eu/sites/default/files/library/c_2021_8620_f1_amendment_to_internal_decision_en.pdf

12 https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf and https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf

13 https://www.esa.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20disclosure%20under%20SFDR/963544/JC%202021%2006%20Joint%20ESAs%20supervisory%20statement%20-%20SFDR.pdf

14 https://www.esa.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20disclosure%20under%20SFDR/1028649/JC%202022%2012%20-%20Updated%20supervisory%20statement%20on%20the%20application%20of%20the%20SFDR.pdf

15 https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf

16 https://www.esma.europa.eu/sites/default/files/library/esma34-45-1427_supervisory_briefing_on_sustainability_risks_and_disclosures.pdf

17 https://www.esma.europa.eu/sites/default/files/library/esma30-379-1051_sustainable_finance_roadmap.pdf

18 https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf and (for the draft Annex) <https://www.esma.europa.eu/press-news/consultations/joint-esa-consultation-esg-disclosures>

19 https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

20 https://www.esma.europa.eu/sites/default/files/library/jc_2021_22_-_joint_consultation_paper_on_taxonomy-related_sustainability_disclosures.pdf

21 https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf

Cheat sheet

Key materials	What does it cover?
<p>European Commission Q&A July 2021²²</p>	<ul style="list-style-type: none"> - Application of SFDR to non-EU AIFMs and small/registered AIFMs - 500 employee threshold for compulsory PAI reporting and groups - Whether Article 9 products can only invest in sustainable investments - When Article 9 products may make “other” investments - Whether these “other” investments must meet minimum environmental or sustainable safeguards - Whether carbon reduction Article 9 products must track an EU Climate Transition Benchmark (EU CTB) or EU Paris-aligned Benchmark (EU PAB), where they exist <i>[although note – we have questions as to how this guidance should be read. Please speak to your usual A&O contact if you wish for further advice on this]</i> - Questions of interpretation of Article 8 and how products should be classified under SFDR (ie “where the line should be drawn” as regards Article 6 vs Article 8) - Integration of sustainability risk and impact on SFDR classification - Meaning of the term “promotion” in Article 8 SFDR and what a firm should consider when classifying products under SFDR - Relevance of binding vs non-binding characteristics of a product - How a product’s name may affect its SFDR classification - How a negative exclusion may affect a product’s SFDR classification (eg no tobacco) - How a characteristic that is not advertised may affect a product’s SFDR classification - How a local law obligation may affect a product’s SFDR classification (eg no investments in cluster munitions) - Link between SFDR obligations and greenwashing risk – ie conveying a false impression, or providing misleading information about how a financial product is performing in terms of ESG sustainability - How to make website disclosure under SFDR in relation to portfolios

²² https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1323237.pdf and https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf
 See also the small amends made by https://www.esma.europa.eu/sites/default/files/library/c_2021_8620_f1_amendment_to_internal_decision_en.pdf



Key materials	What does it cover?
<p>European Commission Q&A 17 May 2022²³</p>	<ul style="list-style-type: none"> – PAI regime – can a firm “opt out” at an entity level but still have products for which PAI is considered (including Article 9 products)? – If so, what SFDR disclosures are required – Timing for disclosures by advisers under Article 6(2) SFDR – Application of SFDR to advisers that provide advice on products out of scope of SFDR – PAI regime for advisers, including application of the regime to advisers that provide advice on products out of scope of SFDR – How to interpret certain references in SFDR to employees – eg full time, part time, owner managers etc – How SFDR applies to legacy products – eg new vs existing products, products no longer available to new investors, etc – What “good governance” means for Article 8 and 9 products – How to interpret SFDR references to “good governance” in the context of government bonds – What you should do, in terms of taxonomy disclosures, when you cannot get reliable data – When you should say “zero” – Whether/when you can supplement such a disclosure with narrative explanations and risks arising from this – What sources of information you can use in “exceptional cases” for the purposes of taxonomy disclosures – and what else you should say in your disclosure in these circumstances – When an Article 8 SFDR product must make disclosures under the Taxonomy Regulation – Also, when an Article 8 SFDR product must make periodic disclosures under the Taxonomy Regulation – ie when the obligation to include taxonomy information in periodic reports is triggered – When a pre-contractual disclosure must be updated to reflect changes over time in a product’s lifetime – When an Article 9 product with a social objective must make disclosures under the Taxonomy Regulation <p><i>[But note – the guidance on the taxonomy regime is often difficult to make sense of. Please speak to your usual A&O contact if you wish for further advice on this]</i></p> <p>Helpfully, the Q&A also notes the following:</p> <p><i>“The purpose of Articles 5 and 6 of [Taxonomy] Regulation (EU) 2020/852 is to incentivise a behavioural change in the whole value chain, including delivery of sound information on sustainability performance on underlying investments.”</i></p> <p><i>“Financial market participants may only disclose such information for the purposes of disclosures under Articles 5 and 6 of [the Taxonomy Regulation] for which they have reliable data, otherwise they would risk, where relevant, infringing [SFDR] and [the Taxonomy Regulation], sector specific rules, incurring liability, or avoidance of contracts under national law.”</i></p> <p>In our view, these are very useful takeaway points to bear in mind when looking at the regulation.</p>

23 https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf and <https://www.esma.europa.eu/document/ec-qa-sustainability-related-disclosures>



Key materials	What does it cover?
<p>ESA Supervisory Statement 25 February 2021²⁴</p> <p>ESA Updated Supervisory Statement 24 March 2022²⁵</p>	<ul style="list-style-type: none"> – Timing as to when different SFDR and taxonomy obligations begin to apply and how – In particular, how you report using the PAI template as at 1 January 2023 – When information on “reference periods” must begin to be included in those disclosures, and what the first reference period will comprise – Supervisory expectations in relation to disclosures before 1 January 2022 (ie when the RTS comes into effect) – Including what clarification can or should be provided during that interim period – eg re sources of information – How firms should interpret the periodic reporting requirements – between 10 March 2021 and 1 January 2023, and from 1 January 2023 onwards <p>A key takeaway point is that periodic reports issued in 2023 under the RTS must include information captured for 2022, before the RTS was actually finalised or in force</p>
<p>ESA Clarifications on RTS 2 June 2022²⁶</p>	<ul style="list-style-type: none"> – Confirmation that sustainability indicators and PAI indicators are two different things <p>A useful takeaway: <i>“There is no direct link between sustainability indicators and PAI indicators.”</i></p> <ul style="list-style-type: none"> – When/how (if a firm wishes) PAI indicators may be used to measure the success of a product in achieving its environmental or social objectives, or having a sustainable impact – Examples as to when/how the PAI indicators could be used in relation to other “strands” of SFDR – eg “do not significantly harm” (DNSH) disclosures <p>Two key takeaways: <i>“the use of PAI indicators is mandatory to demonstrate that an investment qualifies as a sustainable investment”</i> and <i>“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... SFDR.”</i></p> <ul style="list-style-type: none"> – Guidance on PAI calculation methodology in the context of periodic disclosures of financial products – “Look through” to be applied for indirect investments when calculating PAI (eg funds, fund of funds and derivatives), or when investing in a holding company or SPV – What to do where (on a “look through approach”) information in an underlying asset is not available <p>A useful takeaway: <i>“Where such information is not available, in order to be able to fulfil the disclosure requirement for those investments, the RTS provided that the section should also contain details of the best efforts used to obtain the information either directly from investee companies, or by carrying out additional research, cooperating with third party data providers or external experts or making reasonable assumptions.”</i></p> <ul style="list-style-type: none"> – Guidance on making pre-contractual and periodic disclosures, where a product makes indirect investments – What “environmental and social safeguards” are recommended or required for residual investments in an Article 8 or 9 product – and what should be disclosed on this and why <p>A useful takeaway: <i>“... financial products that have sustainable investment as an objective should only make sustainable investments. However, disclosures are still required on the amount and purpose of any remaining assets to demonstrate how those do not prevent the financial product from attaining its sustainable investment objective.”</i></p> <ul style="list-style-type: none"> – Detailed guidance on PAI indicators in the PAI reporting template – How to interpret the taxonomy requirements where a product makes different investments over time – Guidance re using capital expenditure or operating expenditure disclosures vs turnover of non-financial investees for the calculation of the taxonomy-alignment of financial products

24 https://www.esa.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20disclosure%20under%20SFDR/963544/JC%202021%2006%20Joint%20ESAs%20supervisory%20statement%20-%20SFDR.pdf

25 https://www.esa.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20disclosure%20under%20SFDR/1028649/JC%202022%2012%20-%20Updated%20supervisory%20statement%20on%20the%20application%20of%20the%20SFDR.pdf

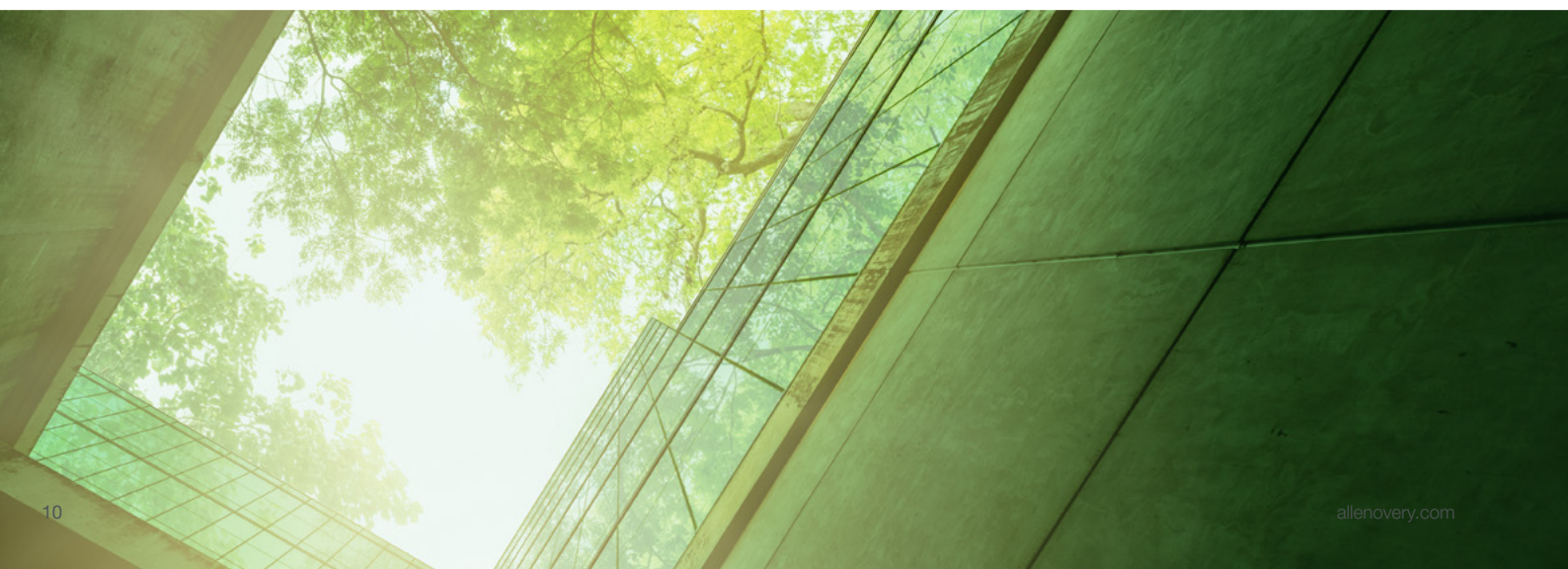
26 https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf

Key materials	What does it cover?
<p>ESA Clarifications on RTS 2 June 2022</p>	<ul style="list-style-type: none"> – When pre-contractual disclosures could or should be amended over the life of a product – Guidance on periodic disclosures – Guidance on taxonomy disclosures – eg “minimum proportion” of taxonomy-aligned investments in pre-contractual disclosures, and what should be included in periodic disclosures – Guidance on the issue of binding vs non-binding objectives and commitments <p>A useful takeaway: <i>“The ESAs consider that the commitments on the “minimum proportion” of Taxonomy-aligned investments are intended to be binding commitments to ensure transparency to end investors on the taxonomy ambitions of the financial product. In that respect, as for any other binding commitment included in the precontractual information, penalties for failing to respect such commitments are set out in the sectoral legislation referred to in Article 6(3) SFDR.”</i></p> <ul style="list-style-type: none"> – Guidance on how to calculate taxonomy numbers when one financial product invests in another financial product, including how to apply a “look-through” approach – Guidance on DNSH disclosures and product level PAI disclosures <p>Two useful takeaways: <i>“For the avoidance of doubt, there is no direct link between the two types of disclosures, which apply independently. A financial product making sustainable investments must make DNSH disclosures, whereas the PAI disclosures at financial product level referred to in Article 7 SFDR apply separately under that Article.”</i></p> <p>And;</p> <p><i>“The ESAs acknowledge that their final reports did not specify exactly how the PAI indicators should be used for the purpose of the DNSH disclosures for sustainable investments in the RTS or the financial product disclosures. However, best practice could be to disclose DNSH for sustainable investment by extracting the indicators from Table 1 of Annex I, and any additional relevant indicators from Table 2 and 3 of Annex I, and show the impact of the sustainable investments against those indicators, proving through appropriate values (eg where feasible in compliance with the Climate Delegated Act and the Complementary Climate Delegated Act) that the sustainable investments do not significantly harm any environmental or social objectives.”</i></p> <ul style="list-style-type: none"> – Guidance on DNSH disclosure under SFDR vs Taxonomy Regulation <p>A useful takeaway: <i>“The DNSH principle under TR is not applied in the same way as it is under... the SFDR. When assessing whether an economic activity qualifies as environmentally sustainable, the TR sets out detailed DNSH activity level criteria under Article 17 TR and in technical screening criteria... In contrast, the SFDR sets out this principle for the purpose of assessing at the level of the investment which may qualify as sustainable... [and] 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 as set out in Article 2(17) SFDR.”</i></p> <ul style="list-style-type: none"> – Guidance as to when firm should show that investments are aligned with OECD guidelines and/or UN Guiding Principles, including the International Bill of Human Rights. <p>A useful takeaway: <i>“The objective of this provision is to bring the DNSH disclosures under SFDR in line with the minimum safeguards in Article 18 TR.”</i></p>



Key materials	What does it cover?
<p>ESMA Sustainable Finance Roadmap 2022-2024²⁷</p>	<p>Some key takeaways:</p> <ul style="list-style-type: none"> – Data gaps – ESMA recognises a number of problems on the legislative side in relation to ESG – this includes timing issues, such as the “misalignment” between the dates for various directives, meaning data gaps. It states that: <i>“Investors and supervisors in the EU... have to cope with the current sub-optimal status of sustainability reporting still for some years.”</i> It is hoped, however, that there will be some regulatory forbearance in the interim. – Interpretation issues – ESMA recognises the different interpretations taken of SFDR and suggests work to ensure a <i>“consistent application of the EU rulebook through convergence tools such as Q&As and Guidelines”</i>. It also suggests work on <i>“clarifying definitions and disclosure obligations for sustainability products”</i>, among other things. <p>This would be much welcomed by the market, which has suffered from a lack of regulatory guidance.</p> <ul style="list-style-type: none"> – Greenwashing – Judging from the roadmap, we can expect this will be one of the most significant priorities of ESMA for the coming three years. As noted above, ESMA also cites the following as potential instances of greenwashing: <i>“... the marketing documentation focuses on exclusion policies [ie negative screening] which do not per se result in selecting a fully sustainable eligible investment universe, or an ESG integration strategy is presented but no commitment is made to use ESG considerations in the investment decision-making. This is a problem affecting both institutional investors and retail investors. The latter increases the risk of misinformation, mis-pricing and mis-selling...”</i> – Future work – ESMA notes where it will conduct further work or feed into work planned by the European Commission <ul style="list-style-type: none"> – (2022) Contribute to EC’s work on minimum sustainability criteria for SFDR Article 8 products, or a combination of criteria for financial products that disclose under Article 8 of the SFDR – (2022) Review the RTS to clarify: PAI indicators; and PAI on social and employee matters, human rights, anti-corruption and anti-bribery – (2022-2024) Flag to the EC any need to amend/clarify/interpret Level 1 and Level 2 such as for SFDR, Taxonomy Regulation, UCITS Directive or AIFMD – (2022-2024) Contribute to consistent implementation of new requirements applicable to asset managers (eg SFDR/Taxonomy Regulations): <ul style="list-style-type: none"> – National Conduct Authorities (NCAs) to share supervisory cases to promote effective and consistent supervision – Develop ESMA guidance to NCAs and/or the market to ensure effective and consistent application of rules as needed – Maintain up to date/develop new supervisory briefings – (2022-2024) Survey landscape of EU/national ecolabels – (2023-2024) Undertake a Coordinated Supervisory Action (CSA) on sustainability disclosures – (2022-2024) Analyse disclosures under Articles 8 and 9 of SFDR in the investment management sector to support supervisory convergence efforts and the identification of greenwashing cases – (2022-2024) Assess data availability and quality for asset managers

27 https://www.esma.europa.eu/sites/default/files/library/esma30-379-1051_sustainable_finance_roadmap.pdf



Key materials	What does it cover?
<p>ESMA</p> <p>Supervisory briefing</p> <p>Sustainability risks and disclosures in the area of investment management</p> <p>31 May 2022²⁸</p>	<p>Some key takeaways:</p> <ul style="list-style-type: none"> – Proportionate and risk based approach – ESMA encourages local regulators to take a risk-based approach and “to be proportionate in their supervision”: <p><i>“The extent of information sought, and the frequency and intensity of supervisory engagement should consider elements such as the type of assets the fund manager intends to invest in, the complexity of the investment policy and strategy of the fund and the type of investors in the investment fund. The engagement should also be commensurate with the risks identified.”</i></p> <p>No doubt, these points will be welcomed by the industry.</p> <ul style="list-style-type: none"> – Greenwashing – As noted above, ESMA makes some observations about greenwashing risks that firms may wish to take on board in their product governance and other internal processes: <p><i>“Recital 11 of the SFDR Delegated Regulation, with regards to funds disclosing under Article 8 SFDR, notes that disclosure of criteria for the selection of underlying assets should be limited to those criteria that are binding on the fund manager in the investment decisionmaking process... Recital 16 of the SFDR Delegated Regulation warns against the greenwashing risks where funds apply “non-binding” exclusion strategies.”</i></p> <p>In our view, this indicates a “direction of travel” on this issue among regulatory bodies more generally.</p> <ul style="list-style-type: none"> – Checklists – ESMA recommends certain points for a local regulator’s checklist, in terms of compliance with key requirements for SFDR and taxonomy related disclosures (pre-contractual, periodic and website). These items may helpfully be copied/pasted into a firm’s product governance policies and procedures. – PAI product level disclosures – ESMA suggests as follows, although this may be controversial in the industry, as it may increase the length and complexity of product disclosures by some margin: <p><i>“It is worth noting that NCAs could reasonably expect that products disclosing under Article 9 SFDR would disclose the Principal Adverse Impacts of investment decisions referred to in Article 7 SFDR, even though it is not mandatory, due to the requirements of DNSH disclosures for sustainable investments in the SFDR Delegated Regulation which require the disclosure of how the indicators for adverse impacts in Annex I of the SFDR Delegated Regulation have been taken into account and because Article 9 SFDR products should only make sustainable investments”.</i></p> <ul style="list-style-type: none"> – Consistency across fund docs and marketing materials – ESMA flags that there should be consistency on this front, focusing on: “- The way the sustainability-related disclosures are presented; – The fund’s name; – The investment objective and policy; and – The investment strategy.” <p>Again, this is a useful checklist for a firm’s product governance policies and procedures.</p> <ul style="list-style-type: none"> – Key points to bear in mind when making ESG related disclosures – ESMA provides a useful “shopping list” of key points here, eg: <ul style="list-style-type: none"> – Although possibly more relevant for retail products – no boilerplate language with complex disclaimers, nor technical jargon – The repeated use of the same or similar text across different funds is a red flag for supervisors – No cross references and hyper-links, except where prescribed – eg one of the RTS templates has a question “Where can I find more product specific information online?” – “Sustainability-related disclosures should be made in a manner that ensures that investors are not required to search for the relevant information, or otherwise obscure the disclosures in the volume of general information provided. Any link to other information should be to the exact place where the relevant information may be found. Any hyperlinks should be maintained over time to ensure that investors do not find broken links where information is no longer available” – Fund documents should disclose the SFDR classification – “and if relevant, the TR”, although it is not clear what this means.

28 https://www.esma.europa.eu/sites/default/files/library/esma34-45-1427_supervisory_briefing_on_sustainability_risks_and_disclosures.pdf

Key materials	What does it cover?
<p>ESMA</p> <p>Supervisory briefing</p> <p>Sustainability risks and disclosures in the area of investment management 31 May 2022</p>	<p>– “Rules of the road” when naming a fund – ESMA provides useful pointers here, to address greenwashing risk, eg:</p> <p><i>“Funds’ names should not be misleading, as the disclosure of sustainability characteristics should be commensurate with the effective application of those characteristics to the fund. The use of terms such as “ESG”, “green”, “sustainable”, “social”, “ethical”, “impact” or any other ESG-related terms should be used only when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the fund’s investment objectives and policy and its strategy as described in the relevant fund documentation. [Local regulators] may raise questions and challenge the use of such terms in the fund’s name if it is perceived as misleading when compared to the actual investment objectives and strategy. For instance, a weak level of application of a fund’s sustainable characteristic or objective to its assets may be a risk indicator warranting further investigation and may lead, in case of a fund that does not demonstrate binding sustainability characteristics focused on a specific sustainability theme or pillar, to reject the use of such a specific theme or pillar in its name.”</i></p> <p>The word “sustainable” or “sustainability” should be used only by (1) funds disclosing under Article 9 SFDR, OR (2) funds disclosing under Article 8 SFDR which in part invest in economic activities that contribute to environmental or social objectives OR (3) funds disclosing under Article 5 TR.</p> <p>Words like “impact”, “impact investing” or similar should be used only by funds whose investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return.</p> <p>In terms of good and poor practice:</p> <ul style="list-style-type: none"> – <i>“A “climate impact” fund investing in companies with business in activities focused on enabling the adaptation to, or mitigation of, climate change can refer to the impact in its name;</i> – <i>A “sustainable water” fund investing in sustainable companies which supply to the value chain of water or which offer products or technologies which are more water efficient than others in their category can refer to this in its name;</i> – <i>A “sustainable energy” fund having a non-specific investment policy not supported by a strategy aiming to invest in sustainable energy companies engaged in alternative energy and energy technologies should not be allowed to use such specific terms in its name; and</i> – <i>An index-tracking fund that applies an exclusion policy which only excludes a small number of securities, or where the holdings are not materially different from a similar non-ESG index should not use ESG-related terms in its name.”</i> <p>– Rules of the road for investment policies etc – Again, ESMA provides useful pointers here, to address greenwashing risk, eg:</p> <p><i>“A sustainable investment policy and/or objectives should be included in the fund documentation and the fund should be managed according to it.”</i></p> <p><i>“The sustainable objectives or characteristics should be clearly identified and expressions such as “the fund pursues ESG objectives in general” without any further specification should be avoided. In case of environmental objectives, a way to clearly identify those objectives is if they are referred to in Article 9 [of the Taxonomy Regulation].”</i></p> <p><i>“The sustainable investment policy and objectives must clearly reflect any claims made in the fund documentation and marketing materials suggesting ESG or sustainability characteristics, themes or outcomes.”</i></p> <p><i>“The strategy should be clearly identified in the relevant fund documentation. As reference, [local regulators] should rely on a non-exhaustive list of sustainability strategies (ie best in class, thematic, ESG integration, ESG engagement, impact investing, exclusions). It should also clearly state how the strategy is linked to the formulated sustainable objectives or characteristics and how it helps to achieves this.”</i></p> <p><i>“For a strategy to be clearly identified at least some of the following nonexhaustive key elements should be disclosed: – Investment universe (including limits and thresholds); – Screening criteria applied; – Specific ESG characteristics/themes or non-financial impacts pursued; – Use of benchmark/indices and relative expected tracking error (if applicable); or – Stewardship approach.”</i></p>

Key materials	What does it cover?
<p>ESMA</p> <p>Supervisory briefing</p> <p>Sustainability risks and disclosures in the area of investment management</p> <p>31 May 2022</p>	<ul style="list-style-type: none"> – Depositaries – ESMA considers that “<i>depositaries should include all ESG-related investment restrictions in the monitoring of the compliance of the instructions coming from the management company or the investment manager.</i>” – ESG risk management – ESMA considers it likely that large managers will have sophisticated tools in place, whereas small and medium sized managers may “<i>struggle to comply with these new rules</i>”. It is suggested this will be a supervisory priority – sample checks on websites are also suggested, alongside questionnaires, with both a desk-based and on-site approach recommended. It also suggests that all fund managers should conduct a review of their relevant policies and procedures on a periodic basis.

7. Next steps



If you have any questions about the topics in this bulletin, or about ESG more generally, please get in touch with your usual A&O contact.