SFDR Level 2: FAQ on ESA finalised measures

November 2021

The Sustainable Finance juggernaut continued at pace last month with the publication of regulatory technical standards (**RTS**) for compliance with the SFDR rules that will come into effect on 1 January 2022. Although the application of the RTS is expected to be delayed beyond the SFDR rules' effective date of 1 January 2022, the reprieve for impacted entities is likely to be limited as an expected application date of 1 July 2022 has already been indicated by the European Commission.

The following FAQ on this latest addition to the increasingly vast and complex Sustainable Finance regime is intended to assist fund management companies (**FMCs**) prepare for compliance with the upcoming SFDR deadline of 1 January 2022 and the anticipated deadline of 1 July 2022 for compliance with the RTS.

FAQ 1: WHAT'S BEEN PUBLISHED?

On 22 October 2021, the European Supervisory Authorities (**ESA**) published final RTS (**October RTS**) for compliance with the SFDR rules, effective 1 January 2022, that require a cross-section of green funds to disclose whether and to what extent asset allocation strategies use the Taxonomy's classification system (**SFDR Taxonomy-related rules**).

The October RTS will now be combined with those published in February 2021 for compliance with SFDR rules applicable since March 2021 (**February RTS**) before being adopted by the Commission as a single Level 2 delegated regulation (**SFDR Level 2**).

While the October RTS are slated to come into effect on 1 January 2022, the Commission noted in July this year that it will not be possible to finalise SFDR Level 2 in time for this date and expects the application date of SFDR Level 2 will be delayed until 1 July 2022. As was the case prior to the SFDR compliance deadline last March, FMCs must now prepare to comply with the SFDR Taxonomy-related rules by 1 January 2022 absent final and adopted SFDR Level 2 measures.

The timeline below highlights key dates in the SFDR and SFDR Level 2 implementation process.

FAQ 2: WHO IS IMPACTED BY THE OCTOBER RTS?

The October RTS principally impact FMCs of Article 8 and 9 funds with environmental strategies or objectives that invest in SFDR-defined sustainable investments (**Sustainable Investments**) with environmental objectives i.e., those in scope of the SFDR Taxonomy-related rules. The decision tree in our October briefing can assist in scoping these rules and is available here. However, as the October RTS also amend the February RTS, being the standards for compliance with SFDR other than the Taxonomy-related rules, they are also likely to impact the wider category of Article 8 & 9 funds (see FAQ 4 below).

FAQ 3: WHAT IS THE IMPACT OF THE OCTOBER RTS?

The SFDR Taxonomy-related rules require transparency of the extent to which asset allocation strategies of in-scope funds use the Taxonomy through the disclosure of target/actual levels of investment in Taxonomy compliant or aligned activities i.e., activities which meet the environmental standard under the Taxonomy.

The October RTS set out the approach for compliance with these rules by (i) prescribing the methodology for calculating the level of investment in Taxonomy-aligned activities, and (ii) mandating the use of prescriptive and detailed templates for the prospectus disclosure of a fund's (binding) Taxonomy-aligned investment targets and financial report disclosure of the actual levels of Taxonomy-aligned investments in the relevant period.

i) Taxonomy-alignment calculation methodology

An investment (or portion thereof) can be classified as aligned with the Taxonomy if the underlying investee company or issuer discloses a share of its activities (or the activities it funds, in the case of financial companies) as Taxonomy-aligned. Therefore, the Taxonomy-alignment calculation methodology is based on the market value of an investment weighted by the Taxonomy-aligned share of the underlying company's activities. By way of simple example, the Taxonomy-aligned portion of an equity investment of €10k in an underlying company which discloses 10% of its activities as Taxonomy aligned will be €1,000. The degree to which eligible investments are aligned with the Taxonomy can range from 0%, for example in the case of equity investments in underlying companies with no Taxonomy-aligned activities, to 100%, for example in the case of green bonds issued under the soon-to-be available EU green bond standard (**EU GBS**). The Taxonomy-alignment of the fund portfolio is the aggregate of the Taxonomy-aligned portion of each investment expressed as a percentage of AUM.

Investments eligible for assessment

The Taxonomy-alignment calculation methodology limits the types of investments which are eligible for assessment to corporate debt and equity securities, green bonds issued under the soon-to-be available EU GBS, other debt securities where proceeds are used for Taxonomy-aligned activities, infrastructure, real estate, securitisation assets, and investments in other Article 8 & 9 funds with Taxonomy-aligned investments. Derivatives are specifically excluded from the Taxonomy-alignment assessment (other than as part of the AUM) but netting of long and short positions in eligible investments is required in accordance with the methodology set down by the Short Selling Regulation. Sovereign exposures proved a controversial exclusion from the list of eligible investments in the consultation version of the RTS and to address issues raised, the

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October RTS allow funds with sovereign exposures to include two Taxonomy-alignment calculations and representations, one including and one excluding sovereign exposures.

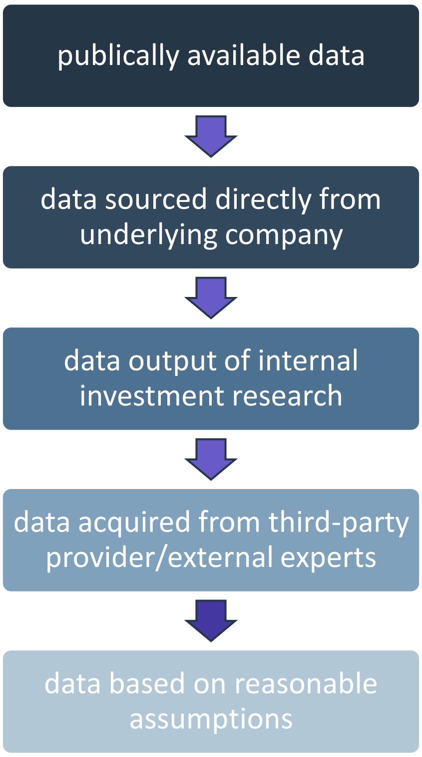
Taxonomy-alignment of underlying companies & impact of delay to Taxonomy disclosure rules for underlying companies

In calculating the Taxonomy-alignment of an investment, FMCs must use the Taxonomy disclosures of underlying companies to determine the weighting (i.e., the 10% figure in the example above) of the eligible investment. However, as highlighted by the ESA to the Commission, the delayed application of the Taxonomy disclosure rules for underlying companies and issuers to January 2023 for non-financial underlying companies and January 2024 for financial companies means that FMCs will be "*without access to any Taxonomy-aligned information on underlying investee companies"* from when they must begin making their own Taxonomy-alignment disclosures, first under SFDR Taxonomy-related rules on 1 January 2022 and then under SFDR Level 2 on the anticipated date of 1 July 2022. The delayed application of the Taxonomy rules for underlying companies was confirmed by the Commission in draft Taxonomy delegated legislation which provides for the disclosure by underlying companies of the share of Taxonomy-eligible (as distinct from Taxonomy-aligned) activities in the period from January 2022 to the delayed application date. The potential for a delay on similar terms for FMCs has, however, been ruled out by the ESA due to the risk of "*cliff effects"* following the "*switching back to [Taxonomy-aligned] investment disclosures"* from the, likely far higher level of, Taxonomy-eligible levels that would be disclosed under such a phase-in of the SFDR Taxonomy-related rules.

Data gaps

The October RTS do however provide for the scenario where Taxonomy disclosures of underlying companies are either not yet available or unlikely to become available because the underlying company is not subject to the Taxonomy (e.g., non-EU investee companies). In these scenarios, FMCs must source equivalent data and the October RTS provide for reliance in this regard on third party data providers. A data waterfall is set out in the October RTS which prioritises publicly reported data followed by privately obtained data sourced either directly from the underlying companies or third parties.

In light of the delayed application of Taxonomy disclosure rules for underlying companies and unless a fund's holdings are in companies voluntarily making Taxonomy disclosures, it is likely that neither public nor directly sourced data will be available in time for the anticipated SFDR Level 2 deadline of 1 July 2022 or indeed the SFDR deadline of 1 January 2022. To ensure they are in a position to comply with the SFDR Taxonomy-related rules, FMCs must therefore establish third-party sources for the data necessary to calculate the Taxonomy-alignment of in-scope funds' portfolios until such time as the Taxonomy disclosure rules for underlying companies come into effect in January 2023/2024.



October RTS Data Waterfall

While the Commission has acknowledged the impact of the delay to Taxonomy reporting by underlying companies, it suggests FMCs can utilise underlying companies' sustainability reporting under the Non-Financial Reporting Directive/equivalent regimes and to the extent such data is not available, Taxonomy-aligned targets and actual levels of Taxonomy-aligned investments may initially be reported as zero by FMCs. Given the commercially unpalatable nature of zero-alignment disclosures, the European Fund and Asset Management and Association (**EFAMA**) is engaging directly with the Commission in relation to possible alternative interim solutions (e.g., prospectus disclaimers) in the period until underlying companies' obligations to report on the share of Taxonomy-aligned activities come into effect in full in January 2024. However, to date no solution has been agreed with the Commission.

ii) Mandatory disclosure templates

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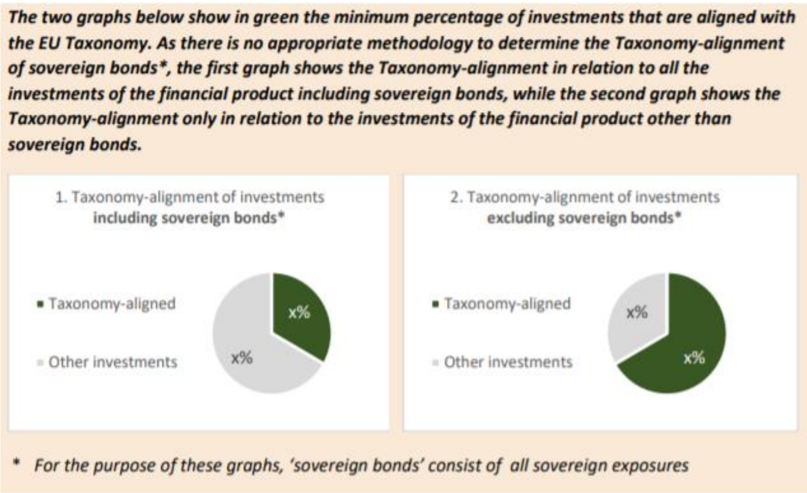
The February RTS mandate use of prescriptive templates for compliance with the prospectus and financial report disclosures required under the SFDR product-level rules. The October RTS amend the February RTS templates to provide for disclosures required to comply with the SFDR Taxonomy-related rules. Once both RTS have been finalised and adopted in composite form as SFDR Level 2, FMCs with Article 8 & 9 funds will be required to publish the relevant template as an annex to the relevant fund's prospectus/supplement and financial report. Notably, however, and irrespective of the timing of the application of the October RTS, FMCs have an obligation from 1 January 2022 to make prospectus and financial report disclosure of the percentage of Taxonomy-aligned investments in portfolios of in-scope funds under the SFDR Taxonomy-related rules. See here for further details of FMCs' 1 January 2022 disclosure obligations.

Prescribed form of Taxonomy-alignment disclosure



Extract from October RTS mandatory prospectus template

The level of Taxonomy-aligned investments in a fund portfolio is required to be disclosed as a percentage of AUM and represented in pie-chart form as shown in the extract from the prospectus template depicted here.

As noted above, the compromise for disclosing any sovereign exposures as Taxonomy-aligned in the absence of an appropriate calculation methodology is to allow disclosure of two pie charts, one including any sovereign exposures and the other excluding such exposures.

A breakdown of Taxonomy-aligned investments between enabling and transitional activities must also be included along with confirmation of whether the Taxonomy-alignment of underlying companies/issuers activities will be (in the case of prospectus disclosure) or has been (in the case of financial report disclosure) independently verified.

FAQ 4: HOW DO THE OCTOBER RTS AMEND THE FEBRUARY RTS FOR SFDR?

In addition to compliance standards for the SFDR Taxonomy-related rules, the October RTS also amend the February RTS for SFDR. The following will be relevant to the wider category of Article 8 and 9 funds.

MiFID sustainability preferences and the impact on Article 8 & 9 funds

In what is likely an effort to better facilitate compliance with MiFID sustainability preference rules, the mandatory prospectus and financial report disclosure templates for both Article 8 and 9 funds have been amended to require up-front disclosure of:

1. the target (prospectus template) or actual (financial report template) level of Sustainable Investments in the portfolio as a percentage of AUM;
2. for environmentally Sustainable Investments, whether or not these are Taxonomy-aligned investments; and

October RTS Article 9 prospectus disclosure template

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3. whether the financial product considers principal adverse impacts (**PAIs**) of investments on sustainability factors.

As previously reported (here), the MiFID sustainability preference rules are effective from 2 August 2022 and require MiFID firms to recommend products with (i) Taxonomy-aligned investments, (ii) Sustainable Investments or (iii) products that consider PAIs, to clients which indicate a sustainability preference as part of the MiFID suitability assessment. The requirement to clearly identify the level of Sustainable Investments and the portion of which qualify as Taxonomy-aligned investments at the beginning of the mandatory templates for Article 8 & 9 funds' prospectus and financial report disclosures is therefore likely designed to facilitate easy identification of products eligible for recommendation by MiFID firms to clients with sustainability preferences. Article 8 & 9 funds which do not disclose Sustainable Investment targets or holdings or take account of PAIs in their investment strategy are not eligible for recommendation to clients with sustainability preferences and MiFID firms are required to explain this distinction to clients as part of the suitability assessment process.

Other amendments to the February RTS include:

- the extension of disclosures on the consideration of PAIs at product-level to include an explanation of how PAIs are considered; and
- re-ordering of sections and inclusion of additional explanatory texts in both the prospectus and financial report disclosure templates.

FAQ 5: HOW DO THE OCTOBER RTS DIFFER FROM THE CONSULTATION VERSION?

The finalised version of the October RTS incorporates several key amendments to the version published by the ESA for consultation last March:

SFDR DNSH compliance for all Sustainable Investments including sub-set of Taxomony-aligned investments

Sustainable Investments under SFDR are those which contribute to an environmental or social objective and simultaneously do not significantly harm any other environmental or social objective. To determine compliance with the do no significant harm (**DNSH**) limb of the SFDR sustainable investment definition, the February RTS require FMCs to take account of the PAI indicators appended to the RTS as well as show whether the investments are aligned with international standards (OECD ME Guidelines and UN Guiding Principles).

While the consultation version exempted Taxonomy-aligned investments (being a sub-set of Sustainable Investments) from compliance with the DNSH rules under SFDR (given they are subject to the separate Taxonomy DNSH test based on the Taxonomy's technical screening criteria) this concession has been withdrawn in the finalised October RTS "*as a result of a legal analysis".* Therefore, all Sustainable Investments including the sub-set of Taxonomy-aligned investments, must now be assessed for DNSH compliance using the PAIs and the international standards. To the regret of the ESA, this effectively means that Taxonomy-aligned investments will be subject to a dual DNSH compliance test under both the SFDR and the Taxonomy. The ESA specifically call out the "*significant increase of the requirements on investments in Taxonomy-aligned economic activities compared to other sustainable investments*" in correspondence to the Commission enclosing the October RTS.

Wider category of eligible investments for Taxonomy-alignment assessment

The category of investments eligible for Taxonomy-alignment assessment has been extended beyond debt and equity securities, real estate and EU GBS bonds to also include infrastructure, securitisation investments and investments in other Article 8 & 9 funds with Taxonomy-aligned investments.

Turnover as default KPI

As set out above, the Taxonomy requires both financial and non-financial companies to disclose the Taxonomy-aligned share of activities undertaken or funded in the case of financial companies. When disclosing the Taxonomy-aligned share of activities, non-financial companies must use key performance indicators (**KPI**) of turnover, capital expenditure (capex) and operating expenditure (opex) referrable to Taxonomy-aligned activities. The consultation version of the RTS allowed FMCs, when calculating the Taxonomy-alignment of investments in non-financial companies, to select one of three KPIs of turnover, capex or opex disclosed by underlying companies, however the finalised October RTS require default use of the turnover KPI in the prospectus disclosure of Taxonomy-alignment, with capex or opex to be used only where justified by the particular features of a fund. The Taxonomy-alignment of non-financial company investments

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as disclosed in funds' financial reports, however, should be disclosed using all three KPIs and presented as a bar chart instead of a pie chart.

Taxonomy-alignment disclosure including and excluding sovereign exposures

As noted above, the exclusion of sovereign exposures (being exposures to central governments, central banks and supranational issuers) as eligible for Taxonomy-alignment assessment raised several issues during the ESA preparation of the October RTS, principally as a result of the lack of an appropriate methodology to assess the Taxonomy-alignment of sovereign bonds. However, to avoid funds with high sovereign exposures having to disclose low levels of Taxonomy-alignment, the October RTS allow two calculations and graphical representations of the Taxonomy-alignment of a fund portfolio, one which includes sovereign exposures and one excluding these exposures from both the numerator (Taxonomy-aligned investments) and denominator (AUM). The potential for investors to find two Taxonomy-alignment representations overly complex has been highlighted by the ESA to the Commission in their letter enclosing the October RTS.

No derivatives but netting required

Under the October RTS, derivatives are excluded from the investments eligible for Taxonomy-alignment assessment but must be included in the overall AUM figure. However, Taxonomy-aligned investments should be reported on a net basis using the netting methodology set down in the EU Short Selling Regulation.

Taxonomy-related disclaimers for Article 8 funds

According to the October RTS, only Article 8 funds in scope of the SFDR Taxonomy-related rules i.e., Article 8 funds with an environmental strategy that hold Sustainable Investments with environmental objectives, are required to include the prescribed Taxonomy disclaimer as to the application of the Taxonomy DNSH test to Taxonomy-aligned investments only. As a result, and in a change from the consultation version, Article 8 funds with environmental strategies but no Sustainable Investment holding and those with only social objectives, are not required to include the Taxonomy-related DNSH disclaimer in the fund prospectus and financial report.

CONTACT US

If you have any queries on the issues raised in this briefing or more generally on the Sustainable Finance regime, please contact Lorena Dunne, Nessa Joyce or your usual William Fry contact.

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