

The 'Sustainable Finance' Issue: planning for SFDR compliance post the initial deadline of 10 March 2021

The first compliance deadline for UCITS managers and AIFMs under the Sustainable Finance Disclosures Regulation (**SFDR**) is upon us. As funds and fund management companies (**FMCs**) finalise their compliance preparations for the initial 10 March 2021 deadline, we look ahead to the key SFDR-driven action items for 2021 and beyond.

POST-10 MARCH SFDR COMPLIANCE TIMELINE

30 June 2021 - deadline for:

- SFDR adverse impact website disclosures for large FMCs (if opted to explain non-compliance from 10 March 2021)

1 January 2022 - deadline for:

- SFDR fund annual report disclosures
- SFDR/Taxonomy prospectus disclosures for green funds
- SFDR draft Level 2 prospectus, annual report, website disclosures for green funds

30 December 2022 - deadline for:

- SFDR fund-level adverse impact prospectus disclosures

30 June 2023 - deadline for:

- SFDR draft Level 2 adverse impact website disclosures - applicable to large FMCs and small FMCs opting to comply before end-2022

SFDR (LEVEL 1) – Post-10 March 2021

Website Disclosure Requirement – effective 30 June 2021

From 10 March 2021, SFDR requires FMCs, on a comply-or-explain basis, to assess and make website disclosure of the impact of investment decisions of funds under management on environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters (sustainability factors). From 30 June 2021, large FMCs (those with more than five hundred employees) are mandated to comply i.e. the 'explain' aspect of this requirement falls away and instead large managers must comply with the assessment and disclosure obligation from this date.

Annual Report Disclosure Requirements – effective 1 January 2022

From 1 January 2022, fund annual reports published by FMCs must include sustainability-related disclosures, as set out below.

- Funds in scope of Article 8 SFDR (**Light Green Funds**) must disclose:
 - i) a description of the fund's success in implementing the sustainable elements of the investment strategy;
 - ii) if the fund's strategy targets one of the environmental objectives under the Taxonomy,
 - iii) if a Taxonomy objective forms part of the fund's strategy, a description of how and to what extent the fund's investments are aligned with the Taxonomy, including the proportion of investments in environmentally sustainable economic activities (including enabling and transition activities) per the Taxonomy as a percentage of AUM; and
 - iv) the following mandated statement: "The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities".

- Funds in scope of Article 9 SFDR (**Dark Green Funds**) must disclose:
 - i) the overall sustainability-related impact of the fund using either (a) relevant sustainability indicators or (b) where a benchmark index is used, a comparison of the impact of the fund with the impact of the benchmark index and the impact of a broad market index by reference to the sustainability indicators of the fund; and
 - ii) the Light Green Fund disclosures at (i), (ii) and (iii) above.

- Funds outside of the scope of Articles 8 and 9 SFDR i.e. all other funds, must include the following statement:
 - i) "The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities".

FMCs should note that the requirement is by reference to the publication date only. As a result, this requirement may impact the preparation of accounts in respect of 2020/2021 financial periods to the extent they are not scheduled for publication prior to the effective date of 1 January 2022.

Annual Report Disclosure Requirements – effective post-1 January 2022

SFDR technical standards were adopted by the ESAs and published on 2 February 2021 with a scheduled effective date, following adoption by the Commission, of 1 January 2022. In addition to the above SFDR Level 1 disclosures, the SFDR technical standards include mandatory annual report disclosure templates, providing for more in-depth sustainability-related disclosures in the annual reports of both Light and Dark Green Funds. The ESAs have, however, suggested that the Commission, as part of its adoption process, delay the application of the annual report disclosure templates under the technical standards such that they apply only to annual reports in respect of financial periods commencing on or after 1 January 2022. This would be a departure from the above SFDR requirement, the application of which depends on the annual report publication date, not the relevant financial period. Subject to any extension, the Commission is mandated to finalise and adopt the technical standards as a delegated regulation by 25 May 2021. At this point the market will have clarity on whether the annual report disclosures under the technical standards are required to be included in any annual reports published after 1 January 2022 or only those referencing financial periods commencing after 1 January 2022. In the meantime, FMCs should prepare for compliance with the Level 1 rules set out above.

Prospectus Disclosure Requirements – effective 1 January 2022

By 1 January 2022, Light and Dark Green Funds must disclose in the prospectus:

- i) if a Taxonomy objective forms part of the fund's strategy, a description of how and to what extent the fund's investments are aligned with the Taxonomy including the proportion of investments in environmentally sustainable economic activities (including enabling and transition activities) per the Taxonomy as a percentage of AUM; and

- ii) the following mandated statement: "The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities".

The ESAs are expected to issue a consultation paper on Level 2 technical standards for compliance with the above requirements very shortly.

Prospectus Disclosure Requirements – effective 30 December 2022

FMCs which comply with the entity-level requirement to assess and disclose the adverse sustainability impacts of investments, must, by 30 December 2022, make prospectus disclose of whether and how adverse impacts are assessed at the level of the relevant fund, together with a statement that further information may be found in the annual report of the fund.

SFDR ESA TECHNICAL STANDARDS (LEVEL 2) – effective 1 January 2022 (ESA proposed effective date)

On 25 February 2021, the ESAs published final draft technical standards or Level 2 measures for the implementation of SFDR. The ESA-adopted Level 2 measures expand on the high-level, principles-based SFDR requirements for:

- the assessment and disclosure of the impact of funds' investments on environmental and social matters; and
- prospectus, website and annual report disclosures of Light and Dark Green Funds.

As mentioned above, the Level 2 measures are (subject to any extension), scheduled to be finalised by the Commission by 25 May 2021 and as such are subject to change pending publication of their final form. However, in a recent supervisory statement, the ESAs state that the final draft Level 2 measures should be used by FMCs "as a reference for the purposes applying the [relevant] provisions of [] SFDR" in the period between 10 March 2021 and 1 January 2022.

In addition to the final draft Level 2 measures, the ESAs also published a feedback statement responding to the varied and extensive number of responses received to its consultation on the Level 2 measures.

In response to the feedback received, the ESAs made several amendments to the draft Level 2 measures issued for consultation in April 2020. Key of these amendments, as discussed below, was the reduction to the number of KPIs mandated for use in the assessment of a FMCs impact on sustainability factors.

Website Disclosure Requirements – effective 30 June 2023 (ESA proposed effective date)

From 10 March 2021, SFDR requires FMCs, on a comply-or-explain basis, to assess the impact of investment decisions of funds under management on environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters (sustainability factors). From 30 June 2021, larger FMCs are mandated to comply i.e. the 'explain' aspect of this requirement falls away.

For FMCs complying with this requirement, the ESA-adopted Level 2 measures stipulate that, from 1 January 2022, the adverse impact assessment be undertaken by reference to a minimum number of specified adverse impact KPIs. The ESA-adopted Level 2 measures mandate the use of eighteen KPIs (reduced from thirty-two KPIs in the consultation) plus 2 additional KPIs to be chosen from a list of forty-six additional KPIs. In addition to the reduction in the number of mandated KPIs, the assessment of adverse impacts on sustainability factors is to be based on the average of four assessment calculations made on 31 March, 30 June, 30 September and 31 December during the relevant reference period. This represents a significant change to the assessment proposed under the consultation which provided for a continuous assessment of impacts throughout the reference period with disclosure of an aggregated assessment at the end of the relevant reference period. Under the ESA-adopted Level 2 measures, the first reference period runs from 1 January 2022 – 31 December 2022, with publication of the outcome of the assessment of adverse impacts during the reference period due by 30 June 2023.

Furthermore, the ESAs have reduced the span of historical assessments required to be disclosed, down from 10 years to 5 years. The ESAs have also delayed, until 1 January 2023, the mandated assessment of Scope 3 GHG emissions and tailored the mandatory KPIs to investments in investee companies, sovereigns and real estate assets.

In what is likely a disappointing response to the many requests from consultation respondents to move away from aggregated, entity-level assessment and disclosure of adverse impacts, the ESAs noted in their feedback statement that it was not within their power to 'change the scope of reporting' under SFDR, the objective of which is 'achieving comprehensible, comprehensive and comparable disclosures for entities' PAI of investment decisions'.

Prospectus and Annual Report Disclosure Requirements – effective 1 January 2022

In addition to the above, the ESA-adopted Level 2 measures retain the consultation's approach of using harmonised templates for prospectus and annual report disclosures of Light and Dark Green Funds. Notably, the ESA feedback statement acknowledges the various requests from consultation respondents to amend the disclosure requirements for green funds to better take account of the differences of products in scope however; the ESAs advise that the SFDR product scope 'makes no differentiation between whether a product is "private" or "public" or whether a product is intended for a single client' and, as such, the ESAs could not seek to do so within the Level 2 measures.

TAXONOMY REGULATION – first effective 1 January 2022

As set out above, SFDR contains Taxonomy-related disclosure obligations for Light and Dark Green Funds. SFDR requires green funds to disclose the Taxonomy-alignment of their investments by disclosing the proportion of the funds' investments in environmentally sustainable activities as defined under the Taxonomy as a percentage of AUM. In addition to disclosure obligations for green funds, the Taxonomy requires disclosures from entities in scope of the Accounting Directive, as amended by the Non-Financial Reporting Directive (NFRD) i.e. listed companies with an average of five hundred employees or more. These requirements are set out under Article 8 of the Taxonomy Regulation and oblige relevant entities to disclose how and to what extent their activities are directed at funding environmentally sustainable economic activities as defined under the Taxonomy.

FMCs are unlikely to be in scope of the NFRD given the reporting thresholds and so will likely not be directly subject to Article 8 Taxonomy disclosures. However, the NFRD is currently under review and, according to ESMA, this may lead to an extension of its scope which may bring more FMCs in scope of the NFRD and consequentially, Article 8 Taxonomy disclosure requirements.

As a result, ESMA consulted on disclosure standards for FMCs under Article 8 of the Taxonomy last November and issued its Final Report, incorporating draft standards for adoption by the Commission, on 26 February 2021. As Article 8 requires disclosure on the Taxonomy-alignment of activities, ESMA interprets this requirement for FMCs as necessitating disclosure of the Taxonomy-alignment of the investments of funds under management. As set out above, FMCs of green funds are also obliged under the SFDR to disclose the Taxonomy-alignment of environmentally sustainable investments. As such, any FMC which is or, as a result of the NFRD review, becomes in scope of the NFRD will, in effect, have duplicate obligations for disclosure of the Taxonomy-alignment of their green funds' investment in environmentally sustainable investments.

NEW AIFMD & UCITS RULES – effective date unknown as not yet finalised

In support of the implementation of SFDR, it is proposed to amend the UCITS Directive and AIFMD to incorporate organisational and risk management requirements for the management of sustainability risk. It is proposed that all UCITS management companies and AIFMs will: (a) integrate sustainability risks in their internal processes, systems and controls including their initial and ongoing due diligence processes, systems and controls; (b) devote sufficient resources to the integration of sustainability risks; and (c) ensure that senior management is responsible for the integration of sustainability risks. ESMA submitted its advice to the Commission in relation to these amendments in April 2019 and the Commission published draft amending delegated regulations for consultation in June 2020. The Commission's consultation closed in July 2020 and final legislation is awaited.

NEXT STEPS

As FMCs' attention turns towards SFDR compliance post-10 March 2021, it is clear there are several significant and challenging requirements taking effect in the course of 2021 and beyond. If you have any queries on the above or more generally on SFDR and the wider EU Sustainable Finance initiative, please contact any of the William Fry Asset Management and Investment Funds team.

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