



Is the ESG-carriage being pulled by two horses running at different speeds?

Merlys ESG Series
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Sustainable Finance Disclosure Regulation and the Taxonomy Regulation

Following the 10 March 2021 commencement of the SFDR disclosure obligations, this briefing note is aimed at in-scope non-EU alternative investment fund managers (AIFMs) that market alternative investment Funds (AIFs) via national private placement regimes under Article 42 of the Alternative Investment Fund Managers Directive which will include what the FCA calls “UK UCITS”.



Merlys is happy to walk clients you through the various regulations and technical standards where you require assistance in this process. We are able to assist with reviewing (or drafting) suitable disclosures and other documentation should your organisation find that they are not comfortable with their current solutions.

This briefing is not a substitute for taking appropriate bespoke advice and is an up-date to our briefing notes issued in February and March 2021.

What is SFDR?

The Sustainable Finance Disclosure Regulation (“SFDR”) are part of a package of initiatives and legislation to move Europe toward several sustainability goals (also referred to as ESG). SFDR came into effect, for EU firms, funds and mandates, on 10 March 2021.

SFDR sets out requirements in respect of sustainability related disclosures in the financial services sector. It requires financial sector firms to consider two main issues:

- disclosure of the principal adverse sustainability impacts (PASI)(doing harm); and
- quantification of the beneficial investment results.

What is TR?

The Taxonomy Regulation (“TR”) is also part of the same sustainability package and was agreed by the EU 22 June 2020 and entered into force on 12 July 2020. It establishes the framework for the EU **taxonomy** by setting out four overarching conditions that an economic activity has to meet in order to qualify as environmentally sustainable.

What has now happened?

As part of the EU’s initiatives on ESG, on 15th March 2021, the three European Supervisory Authorities (ESAs) published a Joint Consultation Paper (CP) on taxonomy-related sustainability disclosures together with draft regulatory technical standards (RTS). The CP and draft RTS **relate to the content and presentation of sustainability disclosures** pursuant to Articles 8(4), 9(6) and 11(5) of the TR.

Why is this important?

The TR empowers the ESAs to develop further RTS on “taxonomy-related product disclosures” which is much needed as the deadlines for the taxonomy-related product disclosures RTS range from 1 June 2021 to 1 June 2022.

- The RTS on pre-contractual and periodic product disclosures for environmental taxonomy products are due to be delivered to the European Commission by **1 June 2021** for “climate change mitigation” and “climate change adaptation” environmental objectives.
- The RTS for the “sustainable use and protection of water and marine resources”, “transition to a circular economy”, “pollution prevention and control” and “protection and restoration of biodiversity and ecosystems” environmental objectives are due by **1 June 2022**.

Does the TR apply to non-EU AIFMs?

Where a non-EU Alternative Investment Fund Manager (AIFM) is UK-regulated the answer is “yes”. The TR is applicable as it forms part of EU retained law post-Brexit. That means that the framework for the taxonomy, including the high-level environmental objectives, forms part of UK law.

However, the detailed rules of how firms define those high-level environmental objectives will not automatically form part of the UK law as this area is being developed by the FCA post-Brexit.

The UK government has reserved the right to come up with different technical rules for the taxonomy. So it is possible that asset managers and other financial market participants in the UK may end up having to follow one set of taxonomy rules for financial products placed on the EU market and another set of rules in the UK.

For non-UK non-EU AIFM the TR will not be applicable where it sells funds in the EU in response to reverse enquiry only.

Does the SFDR apply to non-EU AIFMs?

The simple answer is “no” SFDR does not apply to a non-EU Alternative Investment Fund Manager (AIFM) which sells funds in the EU in response to reverse enquiry only.

Who or what do TR and SFDR apply to?

SFDR does apply to (please do not take this as an exhaustive list as it is possible that there will be further guidance) to the following entities / activities:

- EU-domiciled AIFMs, MiFID investment firms and UCITS management companies providing investment management and/or investment advisory services.
- The managers of European Venture Capital Funds (EuVECAs) and European Social Enterprise Funds (EuSEFs).
- AIFs, UCITS funds, MiFID portfolio accounts, EuVECAs and EuSEFs under management by the Managers listed above.
- EU-domiciled managers managing accounts or managing a fund under delegation from an AIFM.
- Non-EU fund managers (including U.K. fund managers) where they register any of their funds for marketing under Article 42 of the AIFMD—i.e., private placement—in any EU member state. (They are also potentially in scope to the extent that they manage or advise EU-domiciled funds, even if those funds are not privately placed in the EU.)

Although SFDR has not been adopted into UK law post-Brexit, there are a number of ways in which SFDR could be relevant for UK firms, either as a mandatory requirement or on a practical level.

Below are some of the circumstances under which SFDR could become applicable to UK firms:

- A UK fund manager marketing funds into the EU under national private placement regimes (NPPRs).
- A UK AIFM is now a non-EU (or third country) AIFM and if it is registered to market into an EU Member State under NPPRs, it will be subject to the SFDR.

- A UK fund manager acting as the delegated investment manager to an EU firm which is subject to SFDR will need to comply where the EU firm imposes the obligations to comply with the SFDR on the UK firm.
- UK firms may come under client or investor pressure to comply with SFDR and therefore decide to opt in.
- A global group that has UK and EU-based entities may decide to implement SFDR as a global standard (i.e. the group may decide to impose SFDR as the highest common denominator standard.)
- A UK firm may see SFDR as a “gold standard” for ESG disclosure requirements and decide to adopt it on a voluntary basis.
- Some UK firms may adopt SFDR to gain a competitive advantage.
- A UK firm operating funds with an EU structure where it is responsible for compliance with SFDR may also adopt it for the whole.
- An EU firm that is subject to SFDR in relation to the fund, has a UK firm as the operator and so the UK firm takes the lead on SFDR implementation as an operator.

How might a UK firm assess whether SFDR applies?

- Are you are planning to market any funds into the EU after 10 March 2021 under NPPRs? If so, even though operating under the NPPRs, it will be necessary to comply with local law disclosure requirements under SFDR.
- Are you operating or sponsoring any EU fund structures? If so, by now you should have liaised with the fund Board and any third parties involved to ensure that the responsibilities for SFDR have been clearly allocated and documented..
- Are you are providing fund management or advisory services to EU clients that are financial market participants? If so, SFDR requirements will have been imposed on you and you should now be compliant, having documented any decisions and, if applicable, decided to delay until June 2021.
- Is your firm part of a group containing an EU firm? Has the group / firm reviewed group policies and decided whether to impose SFDR to the UK firm on a voluntary basis? If so, SFDR may have been internally imposed on your business and you should be following your firm’s new policies and disclosure requirements.
- Has there has been any pressure to comply with SFDR from clients or investors? If so, you will have discussed this with your investor or client’s relations teams and record the conclusion.
- Is there a commercial or competitive advantage in complying with SFDR on a voluntary basis? If you have not already carried out this analysis, it should be done as a matter of commercial priority.

What is the UK’s current approach to Sustainable Investment Regulation?

The UK has taken the view that, given the urgency of the climate threat, a voluntary approach to climate related financial disclosures is not sufficient. The UK has decided that it will, instead, be the first country in the world to make disclosures that are aligned with the Task Force on Climate related Financial Disclosures (TCFD) fully mandatory by 2025. In adopting this approach, the UK will be going beyond the “comply or explain” approach adopted under SFDR.

The FCA intends to consult on these new requirements in the first half of 2021 and aims to finalise the rules by the end of 2021. Implementation is likely to be phased, starting with the largest firms in 2022 and introducing requirements for smaller firms in 2023.

What is the SFDR timetable?

SFDR became effective on 10 March 2021. For larger managers the date is June 2021.

The reporting on specific data gathered by funds and portfolio managers becomes effective by 30 June 2021 and year end 2021.

There are also detailed requirements in the Regulatory Technical Standards (“RTS”) (see below) which, once they are approved and adopted by the European Commission, should apply from 1 January 2022. Therefore, although the RTS is informative for the purposes of complying with the 10 March deadline, the requirements of the RTS will not be binding until they are formally adopted.

Position post 10 March 2021

The SFDR requirements include certain disclosures to be made on websites and in pre-contractual documents e.g. Private Placement Memoranda.

Financial services firms, referred to in SFDR as “financial market participants”, had to make a decision to:

- either to comply with the principal adverse sustainability impacts (“PASI” or “PAS”) of the investment (see below); or
- explain why not and include that in pre-contractual disclosures.

What do the new SFDR disclosures change for firms?

The website disclosures cover policies on Remuneration, Risk Management, Portfolio Management and disclose relevant components of these. There are also impacts on a firm’s website disclosures, pre-contractual documentation, and periodic information.

The financial product decisions need to be made as to the product’s categorisation as either:

- a sustainable investment (Article 9 of SFDR);
- a partially sustainable investment (Article 8 of SFDR); or
- neither, in which case disclosure is on the sustainability risks and possible impact to financial returns.

What else has happened?

As part of the EU’s initiatives on ESG, on 15th March 2021, the three European Supervisory Authorities (ESAs) published a Joint Consultation Paper (CP) on taxonomy-related sustainability disclosures together with draft regulatory technical standards (RTS). The CP and draft RTS relate to the content and presentation of sustainability disclosures pursuant to Articles 8(4), 9(6) and 11(5) of the TR.

Why are RTS important?

The TR empowers the ESAs to develop further RTS on “taxonomy-related product disclosures” which is much needed as the deadlines for the taxonomy-related product disclosures RTS range from 1 June 2021 to 1 June 2022. The RTS are the details needed to “flesh out” the various disclosure requirements consistently across the industry.

- The RTS on pre-contractual and periodic product disclosures for environmental taxonomy products are due to be delivered to the European Commission by 1 June 2021 for “climate change mitigation” and “climate change adaptation” environmental objectives.
- The RTS for the “sustainable use and protection of water and marine resources”, “transition to a circular economy”, “pollution prevention and control” and “protection and restoration of biodiversity and ecosystems” environmental objectives are due by 1 June 2022.

What are the key points?

The ESAs issued on 25 February 2021 a Supervisory Statement (Statement) accompanying the SFDR RTS which contains a table of application dates for the various obligations in SFDR.

Article 25 of the TR amends SFDR by adding new RTS to support additional disclosure requirements for products making use of the environmental taxonomy divided into climate objectives and other environmental objects for:

- the pre-contractual information for SFDR **Article 8** products using the environmental taxonomy (so-called “light green” products – i.e. that promote environmental characteristics).
- the pre-contractual information for SFDR **Article 9** products (also known as “dark green” products making use of the environmental taxonomy – being products that invest in an “economic activity that contributes to an environmental objective”).
- the periodic information for both SFDR **Articles 8 and 9** products (see also Article 11) that make use of the environmental taxonomy.

The disclosure requirements added in **Articles 8(2a), 9(4a), and 11(1)(c)-(d)** SFDR refer to information that has to be published according to **Articles 5 and 6 TR**.

Article 5 TR sets out the additional disclosures required by Article 9 SFDR products making sustainable investments according to Article 2(17) SFDR in economic activities contributing to environmental objectives:

- Information on the environmental objective or objectives listed in Article 9 TR to which the investment underlying the financial product contributes; and
- A description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 TR.

Article 6 TR applies Article 5 TR disclosures to Article 8 SFDR products that make sustainable investments.

Article 3 TR sets out the key criteria for environmentally sustainable economic activities, where economic activities must:

- Contribute substantially to one or more environmental objectives;
- Not significantly harm any of the environmental objectives
- Comply with the minimum safeguards in **Article 18 TR**; and
- Comply with all the technical screening criteria under the following TR articles:
 - **Articles 10(3)** (substantial contribution to climate change mitigation),
 - **Article 11(3)** (substantial contribution to climate change adaptation),
 - **Article 12(2)** (substantial contribution to sustainable use of and protection of water and marine resources),
 - **Article 13(2)** (substantial contribution to the transition to a circular economy),
 - **Article 14(2)** (substantial contribution to pollution prevention and control) or
 - **Article 15(2)** (substantial contribution to the protection and restoration of biodiversity and ecosystems).

The draft screening criteria for these objectives, to be adopted in a Delegated Act by the Commission, were published by the Technical Expert Group (TEG) on sustainable finance in their final report technical annex in March 2020.

The European Commission published a draft Delegated Act for consultation on 20 November 2020, with the final text expected to be adopted later in 2021.

What do I need to do?

- **Be aware that there are different timetables for different ESG disclosure requirements depending on whether they are TR or SFDR derived.**
- For UK firms, be aware that the UK is not necessarily going to follow the EU position and to keep up-to-date on the UK government and FCA positions on ESG and disclosure requirements

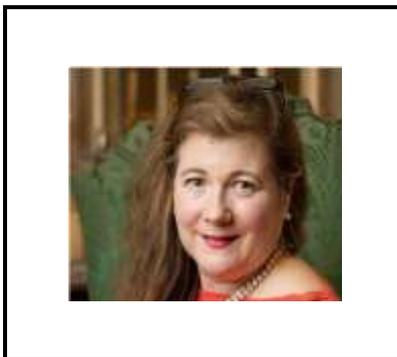
- Become familiar with the SFDR, TR and RTS – there is a lot of detail and further changes are to be made later in 2021.
- Ensure that your firm’s pre-contractual, periodic information and product documentation is up-to-date and compliant for both TR and SFDR and the RTS, as applicable.
- Check your firm’s application of the draft screening criteria, where applicable.
- Check that you know the relevant applicable deadlines for each separate set or requirements.

How can Merlys help?

- Provide advice on the application and implementation of the TR, SFDR and RTS for UK, EU and non-EU firms.
- Undertake reviews of relevant documentation to support in-house teams and prevent those teams from being diverted from important day-to-date business activities.
- Draft revised, up-to-date, documentation.
- Support product teams carrying out analytical work on classifying / identifying products where this has not yet been completed.
- Support in-house teams wanting to further enhance their understanding whether as an external technical resource and/or by providing bespoke training.

We are happy to discuss, give advice or support on any aspect arising from this article and for all things regulatory.

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This briefing note is intended to act as general guidance and is not intended to offer specific legal advice.