

EU Sustainable Finance Disclosure Regulation and the Taxonomy Regulation

Overview

What are they?

The Sustainable Finance Disclosure Regulation¹ (SFDR) imposes sustainability-related disclosure obligations on financial services firms and financial products that have an EU-nexus.

The Taxonomy Regulation² amends SFDR and: (i) establishes a taxonomy, or glossary, for assessing whether certain economic activities are considered “*environmentally sustainable*” in accordance with one or more of six prescribed environmental objectives; and (ii) introduces additional disclosure obligations for products in scope of SFDR. In time, the intention is to extend the taxonomy beyond purely environmentally sustainable objectives to include social objectives.

Impact on the industry

SFDR requires firms to make strategic business and policy decisions regarding their approach to sustainability which must be disclosed on their websites as well as in pre-contractual and periodic disclosures for in-scope products. Although the focus of SFDR is the provision of information to investors, clients and other stakeholders, for many firms the preparation of accurate and comprehensive sustainability-related disclosures necessitates significant system and control changes, and a material allocation of resource.

The Taxonomy Regulation provides a toolkit for assessing whether investments are “*environmentally sustainable*”. Products in scope of the Taxonomy Regulation must disclose the extent to which the economic activities underlying their investments qualify as “*environmentally sustainable*”, so that investors can compare the extent to which products contribute to an environmental objective. The bar is set high so that economic activities must tick many boxes before they are considered sufficiently “green” for the investment to qualify as “*environmentally sustainable*”.

Application

Most of the SFDR obligations came into force on **10 March 2021**.

The disclosure obligations under the Taxonomy Regulation have applied, in part, from **1 January 2022** (in respect of the first two environmental objectives: climate change mitigation and climate change adaptation), with the remainder (in respect of the remaining four environmental objectives) coming into effect on **1 January 2023**.

The format and content of the disclosures required under both SFDR and the Taxonomy Regulation are subject to detailed requirements set out in Regulatory Technical Standards (RTS) which are due to take effect on **1 January 2023**.

Scope

SFDR applies at both firm and product level, and in respect of all financial products, not only those with a sustainability or ESG focus. EU firms must comply with both the firm and product-level obligations. Non-EU firms making financial products available to, or advising on financial products for, EU investors only need comply with the product-level obligations.

The majority of the obligations in the Taxonomy Regulation apply only at product level. Additional disclosure obligations apply to undertakings required to publish non-financial information pursuant to the Accounting Directive³, which are not covered in this note.

The following types of firms and products are in scope:

EU firms

“Financial market participants (FMP)”

AIFMs, UCITS management companies, MiFID investment firms, managers of qualifying VC funds or qualifying social entrepreneurship funds, pan-European personal pension product providers, manufacturers of pension products and institutions for occupational retirement provision.

“Financial advisers (FA)”

AIFMs, UCITS management companies, investment firms, insurance intermediaries relating to insurance-based investment products (IBIPs), insurance undertakings relating to insurance-based investment products (IBIPs) and credit institutions, where those firms provide investment advice.

Products established in or marketed into the EU/with an EU investor

“Financial products (FP)”

AIFs, UCITS, portfolios managed under MiFID, insurance-based investment products (IBIPs), pension products and pan-European personal pensions (PEPPs).

¹ Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector.

² Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

³ Broadly, these are large undertakings which are public-interest entities with more than 500 employees and parent undertakings of such entities.

New concepts

SFDR introduces several new concepts that firms will need to consider when disclosing their approach to sustainability.

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|---------------------------------|---|
| “Sustainable investment” | <p>An investment in an economic activity:</p> <ul style="list-style-type: none"> ▪ that contributes to an environmental or social objective, or an investment in human capital or economically or socially disadvantaged communities; ▪ that “does not significantly harm” those objectives; and ▪ where the investee company follows good governance practices. |
| “Sustainability risk” | <p>An environmental, social, or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of an investment.</p> |
| “Sustainability factors” | <p>Environmental, social and employee matters, respect for human rights, anti-corruption, and anti-bribery matters.</p> |

The Taxonomy Regulation introduces the following concept:

“Environmentally sustainable economic activities”

An economic activity qualifies as environmentally sustainable where it meets the following four conditions:

- it contributes substantially to one or more of the following environmental objectives, or directly enables other activities to make a substantial contribution to one or more of those objectives:
 - climate change mitigation (Article 10);
 - climate change adaptation (Article 11);
 - the sustainable use and protection of water and marine resources (Article 12);
 - the transition to a circular economy (Article 13);
 - pollution prevention and control (Article 14); and
 - the protection and restoration of biodiversity and ecosystems (Article 15);
- it “does not significantly harm” any of the environmental objectives;
- it is carried out in compliance with the minimum safeguards listed in Article 18 of the Taxonomy Regulation; and
- it complies with technical screening criteria established by the Commission (some of which are yet to be published).

UK application

The UK has decided not to incorporate SFDR and the Taxonomy Regulation into UK law. Instead, it will implement its own regime: the Sustainability Disclosure Requirements or “SDR”. Some of the disclosure obligations in the SDR will reflect the EU rules; for instance, the six environmental objectives in the UK Green Taxonomy are intended to be identical to the six Taxonomy Regulation objectives. However, there will be some differences. Firms that seek to market products into the EU and the UK will likely need to comply with the product-level requirements in both SFDR and SDR.

The FCA published a discussion paper for SDR and investment labels in November 2021 and the consultation paper is expected in Q3 2022 after a six-week delay. A staggered implementation of parts of the SDR is expected from 2023.

Next steps

Firms should consider the obligations required below and ensure that appropriate disclosures are made accordingly. They should also consider their internal systems and controls to ensure the disclosures can be supported in practice.

Disclosures

Firm-level disclosures applicable to in-scope FMPs and FAs

| Requirement | | Disclosure | RTS? | Deadline |
|--|---|------------|------------|---------------|
| Sustainability risk policies (SFDR Art. 3) | Publish information about the firm's policies on the integration of " <i>sustainability risks</i> " in its investment decision-making process (for FMPs) or investment/insurance advice (for FAs). | Website | No | 10 March 2021 |
| Principal adverse impacts (SFDR Art. 4) | <p>For FMPs: Publish and maintain either:</p> <ul style="list-style-type: none"> where they consider principal adverse impacts on sustainability factors (PAIs)*, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available (for FMPs) or advise on (for FAs); or where they do not consider PAIs, clear reasons for why they do not do so, including information as to whether and when they intend to consider such adverse impacts. <p>*This is mandatory for FMPs with >500 employees/parent undertakings of such.</p> <p>For FAs: Publish and maintain either:</p> <ul style="list-style-type: none"> information as to whether, taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider PAIs in their investment advice or insurance advice; or information as to why they do not consider PAIs in their investment advice or insurance advice, and, where relevant, including information as to whether and when they intend to consider such adverse impacts. | Website | Yes | 10 March 2021 |
| Remuneration policy (SFDR Art. 5) | Include in their remuneration policy information on how that policy is consistent with integration of " <i>sustainability risks</i> ", and publish that information. | Website | No | 10 March 2021 |

Product-level disclosures applicable to the in-scope products of FMPs and FAs

| Requirement | Disclosure | RTS? | Deadline |
|--|--|-----------------|--|
| All financial products | | | |
| Integration of sustainability risks (SFDR Art. 6) | Describe: <ul style="list-style-type: none"> the manner in which “<i>sustainability risks</i>” are integrated in investment decisions (for FMPs) or investment/insurance advice (for FAs); and the results of the assessment of the likely impacts of “<i>sustainability risks</i>” on the returns of the financial products they make available (for FMPs) or advise on (for FAs). If the firm deems “ <i>sustainability risks</i> ” not to be relevant, include a clear and concise explanation of the reasons. | Pre-contractual | No 10 March 2021 |
| Principal adverse impacts (SFDR Art. 7) | For each financial product where the FMP considers PAIs at the firm level, include in the SFDR Art. 6 disclosure: <ul style="list-style-type: none"> whether and how the financial product considers PAIs; and a statement that information on PAIs is available in the information to be disclosed under SFDR Art. 11. If not, a statement that the FMP does not consider principal adverse impacts and its reasons for doing so. | Pre-contractual | No 30 Dec 2022 10 March 2021 for negative statements |
| Financial products with a promoted environmental or social characteristic or sustainable investment objective | | | |
| ESG characteristic (SFDR Art. 8) | If the financial product promotes environmental or social characteristics, or a combination of such characteristics (provided the investee companies follow good governance practices), include in the SFDR Art. 6 disclosure: <ul style="list-style-type: none"> information on how those characteristics are met; and if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. | Pre-contractual | Yes 10 March 2021 |
| Sustainable investment objective (SFDR Art. 9) | If the product has “<i>sustainable investment</i>” as its objective, include in the SFDR Art. 6 disclosure: <ul style="list-style-type: none"> information on how the designated index is aligned with that objective; an explanation as to why and how the designated index aligned with that objective differs from a broad market index. If no index has been designated as a reference benchmark, include an explanation on how that objective is to be attained. <p>Where a financial product has a reduction in carbon emissions as its objective, include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.</p> | Pre-contractual | Yes 10 March 2021 |

| Requirement | Disclosure | RTS? | Deadline |
|---|---|-----------------------------|---|
| Website disclosures (SFDR Art. 10) | <p>Publish and maintain the following:</p> <ul style="list-style-type: none"> a description of the environmental or social characteristics or the sustainable investment objective; information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product; the information referred to in SFDR Arts. 8 and 9; and the information referred to in SFDR Art. 11. | Website | Yes 10 March 2021 |
| Attainment of the ESG characteristic or sustainable investment objective (SFDR. Art 11) | <p>For financial products in scope of SFDR Art. 8:</p> <p>A description of the extent to which environmental or social characteristics are met.</p> <hr/> <p>For financial products in scope of SFDR Art. 9:</p> <ul style="list-style-type: none"> a description of the overall sustainability-related impact of the financial product by means of relevant sustainability indicators; or where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators. | Periodic | Yes 1 Jan 2022 |
| Taxonomy alignment (Taxonomy Regulation Arts. 5 and 6) | <p>For financial products in scope of SFDR Art. 9 which invest in an economic activity that contributes to one of the Taxonomy Regulation environmental objectives, include in the SFDR Arts. 6 and 11 disclosures:</p> <ul style="list-style-type: none"> information on the environmental objective(s) in the Taxonomy Regulation 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 “<i>environmentally sustainable economic activities</i>”. This should specify the proportion of investments in “<i>environmentally sustainable economic</i>” activities selected for the financial product, including details on the proportions of enabling and transitional activities as a percentage of all investments selected for the financial product. <hr/> <p>For financial products in scope of SFDR Art. 8 which promote environmental characteristics that contribute to one of the Taxonomy Regulation environmental objectives, include the same disclosures as listed above accompanied by the following statement:</p> <p><i>“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.</i></p> <p><i>The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.”</i></p> | Pre-contractual Periodic | Yes 1 Jan 2022 for climate-related objectives. Otherwise, 1 Jan 2023 |

Requirement

Disclosure RTS? Deadline

Financial products that do not have an environmental or social characteristic or sustainable investment objective

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|--|--|-----------------------------|----|------------|
| Not Taxonomy eligible (Taxonomy Regulation Art. 7) | Include in the SFDR Art. 6 and 11 disclosures the following statement: <i>"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."</i> | Pre-contractual Periodic | No | 1 Jan 2022 |
|--|--|-----------------------------|----|------------|

In addition to the specific disclosures listed above, firms must also ensure that:

- their marketing communications do not contradict the information disclosed in accordance with SFDR and the Taxonomy Regulation (SFDR Art. 13); and
- any information published in accordance with SFDR Arts 3, 5 or 10 is kept up to date, providing a clear explanation on their websites where they amend that information (SFDR Art. 12).

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