

# Challenges for asset managers complying with SFDR and EU Taxonomy Regulations

Ian Conlon and Niamh O'Shea of the Maples Group discuss the delay to implement the Sustainable Finance Disclosure Regulation and the Taxonomy Regulations and the impact this has had on asset managers

The EU has taken decisive action to support the transition to a low-carbon, more resource-efficient and sustainable economy. It aims to build a financial system that supports sustainable growth.

In order to incentivise and compel the asset management industry to focus private capital on sustainability, the EU adopted a Sustainable Action Plan consisting of a series of legislative measures on sustainable finance to be introduced this decade.

This commenced with the EU Sustainable Finance Disclosure Regulation (SFDR), as at March 10 2021 and will be swiftly followed by the Taxonomy Regulations (Taxonomy Regulations) as at January 1 2022.

The SFDR provides for a harmonised approach in respect of sustainability-related disclosures to investors within the EU's financial services sector. It seeks to achieve more transparency regarding how asset managers integrate sustainability risks into their investment decisions and consideration of adverse sustainability impacts in the investment process. Its objectives are to:

- Strengthen protection for investors of financial products;
- Improve the disclosures made available to investors from financial market participants; and
- Improve the disclosures made available to investors regarding the financial products, to, among other things, enable investors to make informed investment decisions.

The Taxonomy Regulations intend to establish a framework to classify environmentally sustainable economic activities. It provides criteria and factors to be considered for a product or activity to be deemed environmentally sustainable. It seeks to increase transparency and establish clarity on what activities are deemed green or sustainable.

The legislative implementation process for both the SFDR and the Taxonomy Regulations has been significantly disrupted due to the Covid-19 pandemic. The publication of



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the accompanying regulatory technical standards (RTS) for both the SFDR and the Taxonomy Regulations have been delayed. At the time of writing, both remain in draft form.

In this article, we will focus on the upcoming Taxonomy Regulations and also look at the challenges facing assets managers seeking to comply with both the SFDR and the Taxonomy Regulations, in light of, inter alia, the delay in the publication of the accompanying RTS.

### Challenges for asset managers

As the world grappled with the impact of Covid-19 during 2020, it became clear that

the European Commission had missed implementation milestones in respect of SFDR and the Taxonomy Regulations. This led industry bodies and stakeholders to call upon the European Commission to delay the implementation date of the SFDR (or certainly to consider a deferred implementation).

Notwithstanding the global crisis unfolding, the European Commission reaffirmed its position that the SFDR should be implemented as at March 10 2021, citing the central importance of sustainable finance to the European economy.

The European Commission recognised the delay but nonetheless advocated for

compliance by asset managers with SFDR (Level 1) from a 'high level/principles based' perspective. With the recommended application of the SFDR RTS deferred until January 1 2022. At the time of writing (six months from the purported effective date), those SFDR RTS remain to be finalised.

These series of delays have caused incredible regulatory uncertainty and created significant implementation challenges for asset managers (in scope of the SFDR), principally as the SFDR RTS set out the granular specifications for the content, methodology and presentation of disclosures required by Level 1 SFDR requirements.

Compounding this is the fact that certain disclosure obligations under the SFDR RTS, will be updated by the Taxonomy Regulations RTS, which again remain to be finalised (with the public consultation process of those RTS having only concluded in May 2021).

Unless the effective date of January 1 2022 for the SFDR RTS is extended, it is quite likely that asset managers will only have a matter of weeks to prepare and finalise all pre-contractual disclosures, i.e. updates to fund prospectus, etc. and the accompanying website disclosures prior to implementation date.

This will be further complicated if national competent authorities require prior approval of any changes to be made to fund prospectus in advance of such changes being formally adopted (e.g. undertakings for collective investment in transferable securities (UCITS) or retail funds). This clearly represents an insufficient lead in time for asset managers to effectively implement the SFDR RTS, which may lead to a divergence in the quality of sustainability-related disclosures, which is contrary to the principal objectives of the SFDR, i.e. harmonisation, the promotion of a level playing field and the protection of EU investors.

The implications of the delayed adoption of the SFDR RTS are already evident, particularly when considering product categorisation under the SFDR and the adoption of the principal adverse sustainability impact (PASI) statement.

The SFDR established two types of sustainability focused financial products: (i) one that promotes environmental or social characteristics (an Article 8 fund); or (ii) one that has a sustainable investment objective (an Article 9 fund).

## *"Asset managers may only have a matter of weeks to prepare and finalise all pre-contractual disclosures"*

The European Commission has not published any accompanying guidance on how to determine between an Article 8 fund and Article 9 fund categorisation, leaving asset managers to make such determination based solely on their own interpretation of the product characteristics set out in the SFDR. This has led to diverging industry views as to how to classify funds as either Article 8 or Article 9, which understandably has resulted in varying SFDR product categorisations.

The Maples Group recently undertook an analysis of the top 50 asset managers operating in Ireland and found that approximately 78% of such managers integrate the consideration of sustainability risks and ESG factors into the investment decision making process, however only 36% of those asset managers were offering funds with a sustainability focus, i.e. funds that are either categorised as an Article 8 or Article 9 fund for the purposes of SFDR.

The rationale for this considerable drop is evident from an analysis of the SFDR-compliant website disclosures of those asset managers, whereby it was clear that some are still considering their options with respect to SFDR product categorisation, with a number indicating that they will likely designate their funds as either Article 8 or Article 9 in due course (presumably following the finalisation and implementation of the SFDR RTS).

The overall position in Europe seems comparable to Ireland, Morningstar found in its survey on SFDR compliance, that 21% of Luxembourg domiciled funds were

characterised as either Article 8 or Article 9, with a similar expectation that these numbers will increase before the effective date of the SFDR RTS.

This 'wait and see' approach is also evident when analysing PASI compliance. The SFDR afforded asset managers the option to elect to either comply with the PASI obligations or elect to explain non-compliance.

The Maples Group research found that only 36% of the top 50 asset managers operating in Ireland elected to comply with the PASI on day one and 26% of those top 50 asset managers opted against complying with the PASI. These results are understandable given that the PASI mandatory indicators (which a manager must report against) are set out in the SFDR RTS, remain subject to change.

Furthermore, the SFDR RTS require that the principal adverse impact datasets must be sourced at the investee company level and therein lies the next challenge for asset managers. Most companies are not prepared for this and will not be in a position to provide asset managers with the data needed to report against the 18 indicators. Compounding this is also a lack of comparable, reliable and publicly available data.

This data gap will likely exist until 2024 when the Corporate Sustainability Reporting Directive (which will amend the Non-Financial Reporting Directive) is implemented. Options in the meantime are for asset managers to use either best efforts basis or to source the data from third-party

data providers. That will unfortunately create a dependency on third-party data providers who may also suffer from this data gap. This lack of available and comparable data is leading some asset managers to elect to opt against complying with the PASI.

What is cause for encouragement is that a majority of those asset managers opting not to comply with the PASI, explained their rationale for non-compliance as the delay in the publication of the finalised SFDR RTS and accompanying guidance (on completing the PASI) from the European Commission. This demonstrates a positive intention to comply with the PASI in due course.

### **EU Taxonomy Regulations**

As noted above, the Taxonomy Regulations provide for a framework to classify environmentally sustainable economic activities. It requires asset managers (of financial products with sustainable characteristics or objectives) to disclose:

- How and to what extent they have used the taxonomy in determining the sustainability of the underlying investments; and
- To what environmental objective(s) the investments contribute.

The Taxonomy Regulations also set out a list of economic activities with performance criteria for their contribution to six environmental objectives, namely:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;

## "Only 36% of the top 50 asset managers operating in Ireland elected to comply with the PASI on day one"

Pollution prevention and control and protection; and

Restoration of biodiversity and ecosystems (the 'environmental objectives').

In order for an economic activity to qualify as being environmentally sustainable, it must substantially contribute to one of the environmental objectives, while also complying with each of the following three criteria:

- The activity does not significantly harm any of the environmental objectives;
- The activity must comply with the technical screening criteria (TSC) in respect of each of the environmental objectives; and
- The activity must comply with minimum social and governance safeguards in the Taxonomy Regulations.

The TSC will assist in classifying whether or not economic activities are environmentally sustainable or taxonomy-aligned, principally by providing granular detail on what it means for an activity to contribute to an environmental objective.

The Taxonomy Regulations build on the SFDR requirements for both Article 8 and Article 9 funds by placing additional disclosure obligations on those funds that invest in economic activities that contribute to one of the six environmental objectives (in-scope funds).

Where a financial product is not classified as Article 8 or Article 9 under the SFDR, the Taxonomy Regulations require the insertion of a disclaimer (into the fund's prospectus and periodic report) to warn investors that the financial product does not

take the criteria for environmentally sustainable economic activities into account.

The Taxonomy Regulations empowered the European Supervisory Authorities (ESAs) to accompany RTS, which among other things amend the SFDR. The draft Taxonomy Regulations RTS introduce new requirements for the SFDR mandatory disclosure templates for In-scope Funds, whereby each will be required to:

- Provide information on the environmental objective(s) to which the In-scope funds contribute; and
- Apply the Taxonomy Regulation's criteria to determine how and to what extent the investments underlying the in-scope funds qualify as environmentally sustainable.

The objective is to create a single rulebook which will allow Article 8 and Article 9 funds to comply with both the SFDR RTS and the Taxonomy Regulations RTS obligations thereby minimising overlapping or duplicative requirements between these two regulations.

At the time of writing, the new obligations introduced by the draft Taxonomy Regulations RTS include:

- A requirement to provide information on the objectives to which the sustainable investments contribute and how they do not cause significant harm;
- A description on the minimum taxonomy alignment of investments;
- Where the In-scope Fund invests in non-environmentally sustainable economic activities, an explanation why;

A description of the in-scope fund's underlying investments in environmentally sustainable economic activities and a proportional breakdown;

- A breakdown of the proportion of investments in transitional and enabling activities; and
- A derogation from the requirement to apply the does no significant harm test where a sustainable investment has already provide a statement that the relevant economic activities are environmentally sustainable.

The public consultation on the Taxonomy Regulations RTS concluded in May 2021, with a final report to be published by the ESAs for submission to the European Commission by July. Given the delays with the publication of the final report on the SFDR, it is quite likely this deadline will be missed.

The Taxonomy Regulations will be effective from January 1 2022. However, certain requirements will apply on a staggered basis – from either January 1 2022 or January 1 2023 depending on the environmental objective of the relevant financial product. The requirements in relation to climate change mitigation and climate change adaptation will apply from January 1 2022, while the requirements for the other four environmental objectives will apply from January 1 2023.

*\*As of July 8 2021, the European Commission announced that the SFDR RTS Level 2 would be delayed until July 1 2022.*