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RESPONSIBLE INVESTING

Upcoming Taxonomy Regulation Compliance Deadlines and the Interplay Between SFDR and MiFID II (Part Two of Two)

By Hena Lees, *Private Equity Law Report*

The E.U. has long been at the forefront of environmental, social and governance (ESG) regulations, most notably in setting forth the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation. Implementation of those regulations has been haphazard, however, as they have both been beset with delays in various related deadlines. Further, E.U. fund managers are beginning to confront the complicated reality of attempting to simultaneously comply with those new E.U. ESG regulations on the one hand and certain existing E.U. regulations – *i.e.*, the Alternative Investment Fund Managers Directive (AIFMD), Markets in Financial Instruments Directive (MiFID II) and Undertakings for Collective Investment in Transferable Securities (UCITS) – on the other.

Those topics and more were examined in a recent Maples Group webinar, entitled "Navigating SFDR and the Taxonomy Regulation: Key Deadlines and Next Steps for Asset Managers," which was moderated by partner Peter Stapleton and featured his fellow partners Stephen Carty and Ian Conlon. This second article in a two-part series identifies upcoming requirements associated with the Taxonomy Regulation, as well as certain obstacles when attempting to simultaneously comply with SFDR and MiFID II. The first article offered updates on timing and deliverables under Level 1 and Level 2 of SFDR, as well as its impact on AIFMD, MiFID II and UCITS.

See "How ESG Disclosure Requirements Under the E.U.'s SFDR May Impact U.S. Fund Managers" (Sep. 14, 2021).

Relationship Between MiFID II and SFDR

Phase 1 SFDR Fund Categorization

According to a Morningstar report on Phase 1 of SFDR, about 18 percent of funds were categorized as Article 8, and less than 4 percent were categorized as Article 9, Carty noted. Many recent reports highlight that ESG fund sales are outstripping non-ESG fund sales, and the next question must be whether the Article 8 funds will be compatible with investor sustainability preferences under the MiFID II regime, he observed.

It is important to note, however, that the MiFID II sustainability preference categorizations do not align with SFDR Article 6, 8, and 9 categorizations, Carty said. Instead, MiFID II

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sustainability preferences drill down through the product to look at the underlying alignment with taxonomy, whether principal adverse impacts are considered and other factors. “The European Commission (EC) has explained that it wants to design preferences to steer investors away from products that lack sustainability-related materiality, and it has indicated clearly that it considers some Article 8 products to be on the wrong side of the line,” he explained

As a result, from a MiFID distribution perspective, there is a very high bar for quantitative parameters to be applied around the degree of investment in sustainable investments before a product is deemed suitable for an investor who has expressed ESG preferences, Carty explained. That is aligned with the wider debate around the level of sustainability of funds categorized as Article 8. For example, Hortense Bioy, director of sustainability research at Morningstar, has said that the “key message” for investors is that they should not “expect anything” from Article 8 products, he noted.

Phase 2 SFDR Fund Categorization

Relatively speaking, there may be more complexity when assessing the detail required in Phase 2 of SFDR, Carty opined. For example, the mandatory template for Article 8 fund prospectus disclosures asks for disclosure on the minimum level of assets allocated to taxonomy-aligned objectives. Many firms’ first response may be “not applicable,” effectively stating the fund does not maintain a minimum level of alignment with taxonomy, he noted. Although that response may not affect the relevant fund’s Article 8 categorization, it may mean the fund is insufficiently green to meet investor preferences through MiFID distribution channels, he explained.

“What could potentially emerge is a split between ‘Article 8 Lite’ and ‘Article 8+’ categories of funds, with only Article 8+ funds making quantitative commitments to invest material levels in sustainable investments,” Carty speculated. As a result, only Article 8+ funds and Article 9 funds would have the necessary level of sustainability-related materiality to be eligible to recommend to clients that have expressed sustainability preferences to their distributors or sales advisors, he said.

As signaled in a paper published in July 2021, the EC may be working on minimum sustainability criteria that could apply to Article 8 funds in the future, Carty stated. “That could potentially - although not definitively - require changes to the Level 1 text of SFDR. That effectively presents a possibility of future shifts in the categorization that adds a further degree of uncertainty to the current picture.”

Key Takeaways

“The UCITS/AIFMD changes reflect what we see as an orderly transition of sustainability considerations into the two regimes, whereas we think the MiFID changes could be significant,” Carty said. Systematically asking investors to indicate if they have a preference for ESG products at the outset of the sales process could cause a radical shift in demand for ESG products, as well as require a reset on how those ESG products are designed and packaged. “Fund managers designing those products will need to be ready and adapt to meet these investor demands if that shift occurs.”

MiFID II changes begin on August 1, 2022, only one month after Phase 2 of SFDR was due to be effective. Therefore, it is worth factoring that

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into firms' Phase 2 SFDR projects, Carty recommended.

Taxonomy Regulation Update

Overview and Key Features

The Taxonomy Regulation is also part of the E.U. sustainable action plan, which is designed to support the transition to a low carbon sustainable economy, Conlon said. The Taxonomy Regulation seeks to establish a framework to classify activities that are green or sustainable and what are deemed to be "environmentally sustainable economic activities." Having a framework of common concepts at the E.U. level is intended to create an even playing field and to avoid divergence and gold-plating by individual E.U. member states that could ultimately be harmful to consumers and investors, he explained.

"The Taxonomy Regulation differs from SFDR in that it is entirely environmentally focused," Conlon noted. The framework establishes six environmental objectives, which are as follows:

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
   pollution prevention, as well as control and
5. protection; and
6. restoration of biodiversity and ecosystems.

Only climate change mitigation and climate change adaptation apply from January 1, 2022, Conlon specified. The remaining four environmental objectives do not apply until January 1, 2023, he added.

The Taxonomy Regulation also creates a set of uniform criteria for determining how economic activities contribute to those environmental objectives, Conlon said. The Taxonomy Regulation builds on SFDR requirements for both Article 8 and Article 9 funds by imposing additional disclosure obligations on funds that invest in environmentally sustainable economic activities, he noted.

See "E.U. Sustainable Finance Initiatives: Preparing to Apply the Taxonomy Regulation and Other Proposed ESG Regulations (Part One of Two)" (Oct. 27, 2020).

Environmentally Sustainable Activities

According to Conlon, an economic activity must comply with each of four criteria to qualify as an environmentally sustainable economic activity:

1. substantially contribute to one of the six environmental objectives;
2. do no significant harm to the remaining environmental objectives;
3. comply with the minimum safeguards as set out in the Taxonomy Regulation; and
4. comply with the technical screening criteria for the environmental objectives.

"The technical screening criteria classify whether or not economic activities are environmentally sustainable or taxonomy-aligned," Conlon explained. "The minimum safeguards include adherence to international standards such as the Organisation for Economic Co-operation and Development's Guidelines on Multinational Enterprises, and the U.N.'s Guiding Principles on Business and Human rights."

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Disclosure Obligations

Disclosure obligations for fund prospectuses under the Taxonomy Regulation depend on the product's classification under SFDR, Conlon said. Prospectuses of Article 6 funds must include a prescribed disclaimer that the fund is not taxonomy-aligned. Most PE funds will include that disclaimer because the vast majority were classified as Article 6 funds under SFDR earlier in 2021, he added.

Further, the Taxonomy Regulation requires Article 8 and Article 9 funds to disclose the underlying investments' contributions to an environmental objective, Conlon noted. "The extent of taxonomy alignment or, said another way, the extent of the underlying investments which qualify as being environmentally sustainable economic activities, must be specified as a percentage of the portfolio," he explained. "Finally, Article 8 and Article 9 funds must also include prescribed disclaimers confirming that the remaining portion of the portfolio is not taxonomy aligned."

See "Key Features of CFA Institute's New ESG Disclosure Standards" (Sep. 21, 2021).

Staggered Timeline

The Taxonomy Regulation was always intended to be implemented on a staggered basis, but the timeline has been disrupted and, much like SFDR, Level 2 is deferred until July 1, 2022, Conlon said. The next three key dates for the Taxonomy Regulation include:

1. January 1, 2022, when Level 1 applies, including the first two environmental objectives;
2. July 1, 2022, when the Level 2 regulations become effective; and
3. January 1, 2023, when the remaining four environmental objectives become effective.

As the Level 2 regulations are only effective from July 2022, compliance with Level 1 from January 1, 2022, will be on a high level and principle-based perspective, similar to SFDR, Conlon added.

Impact of Delayed Regulatory Technical Standards

Disclosure Language

In practical terms, the delay of Level 2 of the Taxonomy Regulation presents challenges for fund managers that need to meet the first deadline on January 1, 2022, Conlon said. Aside from the operational issues arising from having two regulatory deadlines in rapid succession, the disclosures included in fund prospectuses to satisfy Level 1 requirements in January 2022 will be overhauled with the introduction of SFDR mandatory disclosure templates in July 2022, he noted.

In light of that, Conlon identified three options for Article 8 and Article 9 funds to comply with the January 2022 deadline:

1. insert the prescribed disclaimers for non-taxonomy alignment only;
2. take a blended approach by including the prescribed disclaimers but also stating that there may be taxonomy alignment, but the fund is not in a position to disclose that due to the delay in Level 2; or
3. attempt full disclosure on the extent of taxonomy alignment, but from a high level and principle-based perspective, he explained.

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Maples has developed language to satisfy all three options, Conlon continued. "We believe that, given these disclosures will only cover the interim period between January and July of next year, most managers will opt for option two," he opined.

Taxonomy Alignment Review and Filing

Undertaking a taxonomy alignment review may be a daunting prospect, Conlon acknowledged. The perception that European sustainability funds will have substantial taxonomy alignment is not necessarily realistic, however. For example, commentary from the Sustainable Investment Forum Europe in April 2021 stated that although retail clients probably expect a sustainable fund to have 50- to 100-percent taxonomy alignment, most UCITS funds for retail investors will be about 2 to 5 percent. That level of alignment is supported by what Maples is currently seeing in the market, he added.

Currently, the Central Bank of Ireland (Central Bank) has indicated that it may apply a fast-track filing procedure, although it has not indicated the parameters for the procedure, Conlon noted. In any event, firms with UCITS funds should start looking at the taxonomy disclosures now rather than waiting for any potential fast track procedure because a number of regulatory changes must be implemented before year end, he suggested.

In addition, it is important to remember that one of the key conditions of the fast track for SFDR from March 2021 is that only SFDR-related amendments can be made under the procedure, Conlon cautioned. "Our proposed option two disclosures have already successfully gone through the Central Bank, under the regular Central Bank prior-approval scrutiny. Therefore, we would not be daunted and would not wait until clarification of a fast track. We would encourage people to pursue their taxonomy disclosures today," he emphasized.

For more on Central Bank issues affecting fund managers, see "What Does the Central Bank of Ireland's Review of CP86 Mean for Private Fund Managers?" (Feb. 16, 2021).

Key Takeaways

Conlon summarized the following key takeaways with respect to the Taxonomy Regulation:

- Consider an approach for meeting the disclosure deadline on January 1, 2022. In particular, whether option two of the three disclosure options is a suitable interim solution before further changes are required in July 2022.
- Review portfolios for taxonomy alignment.
- Consider the data needed to determine taxonomy alignment. Specifically, undertake an analysis of the investments underlying Article 8 and Article 9 funds to determine which of those funds are involved in environmentally sustainable economic activities.

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