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RESPONSIBLE INVESTING

SFDR Updates and Practical Tips for Meeting Key Timing Requirements and Obligations Under Other E.U. Regimes (Part One of Two)

By Hena Lees, *Private Equity Law Report*

Maples Group (Maples) recently hosted a program to discuss updates on the E.U.'s Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation, as well as examining important changes to key E.U. legislation, including the Alternative Investment Fund Managers Directive (AIFMD), Markets in Financial Instruments Directive (MiFID II) and Undertakings for Collective Investment in Transferable Securities (UCITS).

The webinar, entitled "Navigating SFDR and the Taxonomy Regulation: Key Deadlines and Next Steps for Asset Managers," was moderated by Maples partner Peter Stapleton and featured partners Niamh O'Shea and Stephen Carty. This first article in a two-part series provides updates on timing and deliverables arising from Level 1 and Level 2 of SFDR, as well as its impact on AIFMD, MiFID II and UCITS. The second article will highlight upcoming requirements associated with the Taxonomy Regulation, as well as certain difficulties with simultaneously satisfying SFDR and MiFID II.

For additional insights from Maples attorneys, see "How PE Funds May Benefit From Anticipated Irish LP Vehicle Enhancements" (May 21, 2019); and "Tax, Legal and Operational Advantages of the Irish Collective Asset-Management Vehicle Structure for Private Funds" (Aug. 13, 2015).

SFDR Update

SFDR Level 2 Timing

SFDR Level 1 became effective on March 10, 2021, and compliance is currently required on a high-level and principle basis, O'Shea noted. The next significant SFDR milestone is expected to occur on July 1, 2022, when detailed Level 2 measures or regulatory technical standards (RTS or Level 2), which have been delayed from January 1, 2022, will apply. "In light of the RTS being deferred by six months, firms are required to continue to comply with SFDR Level 1 from a high-level and principle-based perspective and then will need to comply with the more detailed requirements once the final RTS are implemented," she said.

Deferral of Level 2 was a welcomed development because it gives asset managers more time to prepare for the Level 2 requirements, O'Shea observed. The European Supervisory Authorities (ESA) subsequently delivered the final report on the draft RTS on

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October 22, 2021. The European Commission will now scrutinize the RTS and decide whether to endorse them within three months of their publication. In publishing their report, the ESA noted that the RTS has an expected application date of July 1, 2022 and therefore anticipate the RTS will also apply from this date.

Although the application date of the RTS has been delayed, the Taxonomy Regulation remains effective from January 1, 2022, she clarified.

SFDR Level 2 Deliverables

Asset managers should consider which SFDR requirements have been delayed to July 1, 2022. The following are the main deliverables under the RTS.

See "E.U. Sustainable Finance Initiatives: Exploring the Different Application Levels of the SFDR Based on a Firm's ESG Practices (Part Two of Two)" (Nov. 3, 2020).

Mandatory Disclosure Templates

The mandatory pre-contractual disclosure templates for Article 8 and Article 9 funds (which are in the annexes to the RTS) must be populated to meet the specific content and presentation requirements under the RTS by July 1, 2022. "That is a welcome development, as those templates are very detailed and may take firms significant time to complete, particularly given the lack of environmental, social and governance (ESG) data and when firms have a number of Article 8 and Article 9 funds," she observed.

Notwithstanding the extra time that firms now have to complete the mandatory disclosure templates, Maples has suggested that firms should start considering the frameworks and data they will need to meet the disclosure requirements, O'Shea said.

As for the balance sheet periodic disclosure templates for Article 8 and Article 9 funds, the current draft of the RTS specifies that the reference period is the period covered by the annual report for the relevant entity. That means the periodic report mandatory templates will apply to annual reports beginning July 1, 2022, O'Shea explained.

Principal Adverse Sustainability Impact Statements

Firms that consider the principal adverse impacts of their investment decisions must disclose the appropriate information from the date they start considering those impacts, O'Shea said. The additional details specified by the policy statement in Annex 1 of the RTS were to be phased in from January 1, 2022, but will now be phased in from July 1, 2022, she added.

"When firms publish the policy statement for the first time, the current draft of the RTS does not require disclosure of any information for a previous reference period," O'Shea continued. As a result, the earliest that information on the indicators in the policy statement will need to be completed could be June 30, 2024, for a reference period of the calendar year 2023.

Additional SFDR Level 1 Requirements

Periodic reports for Article 8 and Article 9 funds that are produced after January 1, 2022, will need to comply with Article 11 of SFDR on a high-level and principle basis, O'Shea said.

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It will be necessary to include disclosures of the extent to which environmental or social characteristics are met for Article 8 funds, along with the overall sustainability-related impact for Article 9 funds, she explained.

In addition, by December 30, 2022, firms that are considering principal adverse impacts will need to update their pre-contractual disclosures to cover the requirements of Article 7(1) of SFDR on disclosures of principal adverse impacts at the financial product level, O'Shea noted.

European Commission Q&A

In January 2021, the European supervisory authorities sought interpretative clarity on a number of SFDR priority issues from the European Commission (EC), O'Shea said. The EC published its replies in a Q&A format on July 26, 2021. "Although certain of the explanations and clarifications are welcomed, a number of answers did not provide the clarity expected and does not clearly answer all the outstanding questions," she observed. The EC's Q&A provides color in relation to six main areas, O'Shea noted.

First, the EC confirmed that the SFDR applies to registered alternative investment fund managers (AIFMs). Second, the EC confirmed that SFDR applies to non-E.U. AIFMs that are either managing E.U. funds or marketing funds in the E.U. through a national private placement regime. As a result, those non-E.U. AIFMs must make the same product-related disclosures for funds marketed in the E.U. as E.U. AIFMs. "There is still some uncertainty on the application of the firm-level obligations to non-E.U. AIFMs, and hopefully the EC will provide some further clarity on this important point," she added.

Third, the EC confirmed that the head calculation for the 500-employee test for evaluating principal adverse impacts should take into account the number of employees at the firm – including a parent undertaking and each of its subsidiaries – regardless of whether they are in the E.U., O'Shea explained.

Fourth, the EC included a broad definition of promotion for an Article 8 categorization, O'Shea continued. As a result, the test as to whether a fund promotes environmental or social characteristics is subjective when those matters are included in the pre-contractual disclosures, rather than operating from any minimum sustainability criteria. Instead, a firm must "do more than simply integrate the consideration of sustainability risks into the decision-making process," she observed. "We feel that definition should be approached cautiously, however, as the EC recently indicated that it will consider the introduction of minimum sustainability criteria for Article 8 funds."

Fifth, the EC did not include a minimum percentage of sustainable investments required for Article 9 classification, O'Shea noted. The EC did state that an Article 9 fund should primarily consist of sustainable investments, however, which may also include investments for certain specific purposes (*e.g.*, hedging and liquidity) once they are aligned with the sustainable investment objective, she added.

Sixth, the EC took a conservative approach to its reply on applying SFDR to segregated mandates and reiterated that they are financial products for the purposes of SFDR, O'Shea said. That means firms must ensure compliance with data protection and maintain confidentiality to clients when making website disclosures, she noted.

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Key Takeaways

O'Shea summarized the key takeaways for SFDR updates as follows:

- Although completion of mandatory pre-contractual templates is now not required until July 1, 2022, firms should still be considering how they will meet the disclosure requirements.
- Firms should be aware that periodic reports for Article 8 and Article 9 funds produced after January 1, 2022, will need to comply on a high-level and principle basis under Article 11 of SFDR, irrespective of reference periods.
- Non-E.U. AIFMs that are marketing funds within the E.U. and had formed the view that SFDR did not apply to them, should now consider complying with SFDR. At a minimum, SFDR product-related disclosures will be required.
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See "How ESG Disclosure Requirements Under the E.U.'s SFDR May Impact U.S. Fund Managers" (Sep. 14, 2021).

Sustainable Finance Changes to AIFMD, UCITS and MiFID II

E.U. Financial Services Update Package

Seven new Delegated Acts came into force in August 2021, Carty said. The legislation is part of the broader E.U. sustainable finance action plan and their purpose is to integrate sustainability considerations into the regimes for UCITS, AIFMD, MiFID II and Solvency II. The Delegated Acts will each become effective on August 1, 2022, except that the changes to the MiFID II directive changes will apply from November 22, 2022, he added.

UCITS/AIFMD Changes

The sustainable finance changes relating to UCITS/AIFMD appear to align with some of the entity-level disclosure requirements under SFDR, Carty noted. "The changes require UCITS management companies and AIFMs to consider the impact of sustainability risks in the context of fund management, their conflict-of-interest procedures, their investment due diligence processes and their risk management policies."

Many of the changes already occurred due to SFDR and are confined to the consideration of sustainability risks, which are ESG events that could cause a material negative impact on the value of an investment, Carty said. When there are ESG risks of financial loss, most fund managers are probably already taking those risks into account when investing or they will not significantly impact firms, he opined.

For more on potential changes to AIFMD, see "The European Commission and ESMA Lay Groundwork for AIFMD II" (Nov. 3, 2020).

MiFID II

Suitability Assessment

"The new MiFID rules could have a more significant impact and potentially drive a huge push for ESG products from investors investing through MiFID distribution channels," Carty speculated. The changes include a regulation to integrate sustainability considerations into a firm's suitability assessment and a directive to factor sustainability into product governance obligations, which are very much connected, he added.

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Currently, when a regulated firm offers investment advice or portfolio management services to a client, the firm must first obtain information on the client's investment objectives (*i.e.*, financial objectives) and the client's risk tolerances. There are some exceptions, such as execution-only orders for non-complex products such as UCITS. In addition, the process is simplified when clients are professional investors because it is reasonable to assume those investors have a certain level of knowledge about their investments, he explained.

Under the new regulation, however, it will also be mandatory for firms to obtain information and assess investment suitability on the basis of the client's sustainability preferences, Carty said.

Sustainability Preferences Categories

The new regulation sets out three criteria that should be integral to a client's suitability preferences:

1. the level of alignment with environmentally sustainable investments under the Taxonomy Regulation;
2. products invested in sustainable investments more generally and aligned with SFDR; and
3. products that consider principal adverse impacts on sustainability factors.

At a more granular level, investors can set their minimum proportions for sustainable investments and specify elements to show they are considering principal adverse impacts, Carty explained.

Although the industry has started considering how to develop sustainability standards and translate them into understandable client preference criteria, there is not yet any clear conceptual consensus, Carty noted. "Firms subject to MiFID product manufacturer obligations need to consider the sustainability-related objectives of clients when identifying a target market. Effectively, they are coming at the same issue but from the opposite direction as the investor," he clarified.

Potential Impact

In practical terms, the new regulation means that investors going through MiFID distribution channels may be asked to make elections about ESG credentials for preferred investment options, Carty said. Proactively requiring investors to make an election about sustainability during the sales process could have a significant impact. "We think that is a bit like having to ask a customer at the entrance to a car showroom if he or she would prefer to buy an electric, petrol or diesel car," he posited. "If the customer says 'yes' to that very leading electric car preference question, then the salesman cannot recommend a petrol or diesel car. That could be a bit of a problem if the dealer still wants to sell petrol or diesel cars."

Particular sales channels may also be more or less conducive to continuing to sell non-ESG products, Carty noted. For example, it could be harder to steer a client back toward mainstream non-ESG product options using sales processes that are conducted online or through form-filling compared to face-to-face processes, he elaborated.

For more on rules affecting marketing in Europe, see "The New E.U. Cross-Border Distributions of Funds Rules" (Aug. 31, 2021).

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