



# The SFDR Jigsaw

Putting the pieces together

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# The SFDR Jigsaw – putting the pieces together

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## Introduction

On 10 March 2021 the main operative provisions of the Sustainable Finance Disclosure Regulation (2019/2088) (**SFDR**)<sup>1</sup> began to apply. However, rather than marking the end of the ESG journey, it is just the beginning.

In [PART ONE](#) of this article, we will discuss the EU sustainable finance framework as it relates to the SFDR, the implementation of the SFDR and the challenges firms faced across Europe and the US with compliance for the 10 March deadline (**Phase 1**). In [PART TWO](#) we will look at what remains to be done following the publication of two drafts of the regulatory technical standards in February and March 2021, ahead of their expected effective date of 1 January 2022 (**Phase 2**).

## PART ONE

### Background to the SFDR and the lead up to the 10 March 2021 ‘go live’ Date

Following the adoption of the 2015 Paris Agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the European Commission expressed, in its Action Plan on “Financing Sustainable Growth”, its intention to clarify fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities with the aim to:

- reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- assess and manage relevant financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity.

Since the publication of the Action Plan, Environment, Social and Governance (**ESG**) matters have remained front and centre of the regulatory agenda. To achieve the aims of the Action Plan the EU Commission determined that financial market participants and financial advisers should be required to disclose specific information on their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts in their investment decision making. The EU Commission also called for the establishment of an EU classification system for sustainable activities, i.e. an EU Taxonomy.

The SFDR and the Taxonomy Regulation<sup>2</sup> were the legislative solutions.

The [SFDR](#) sets out sustainability disclosure requirements for a broad range of financial market participants, financial advisers and financial products. It was enacted to address the twin objectives of increasing transparency of sustainability-related disclosures and harmonising disclosures for the benefit of end investors.

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<sup>1</sup> Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR), as amended by Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation).

<sup>2</sup> Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment.

The [Taxonomy Regulation](#) can best be understood as a classification system for environmentally sustainable economic activities that aims to help investors as well as companies and issuers assist in making the EU climate neutral by 2050. It applies to financial market participants who offer financial products, financial and non-financial undertakings within the scope of the Non-Financial Reporting Directive (Directive 2014/95/EU)<sup>3</sup> and the EU and individual Member States in relation to new eco-labelling or other related legislative measures. The Taxonomy Regulation also made amendments to the original version of the SFDR. The Taxonomy Regulation empowers the European Supervisory Authorities (the European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority - the **ESAs**), by amending the SFDR, to develop further regulatory technical standards on “taxonomy-related product disclosures”.

The SFDR was published in the Official Journal of the European Union (**OJ**) on 9 December 2019, with the main operative provisions applying from 10 March 2021. The Taxonomy Regulation was published in the OJ on 22 June 2020 and entered into force on 12 July 2020, with the main operative provisions applying from 1 January 2022 and 1 January 2023.

## The SFDR Explained

The Final Rule imposes a variety of new disclosure obligations on funds. The table below provides an overview of these new obligations and identifies some of the important aspects of the new disclosure requirements.

The SFDR impacts alternative investment fund managers (**AIFMs**), UCITS management companies (**UCITS ManCos**), MiFID investment managers/advisers and other in scope financial institutions (referred to as Financial Market Participants - **FMPs**) in relation to **Financial Products** (including alternative investment funds (**AIFs**), undertakings for the collective investment in transferable securities (**UCITS**) and segregated investment management mandates) and non-discretionary investment advisers in connection with their advisory mandates.

The SFDR imposes disclosure obligations at the level of the in scope FMP and also at the level of the in scope Financial Product.<sup>4</sup> These disclosures take the form of pre-contractual disclosures, website disclosures and disclosures in periodic reports, all of which necessitate additional information to be included in pre-contractual documentation and annual reports and significant changes to existing investment processes. Some of the obligations under the SFDR apply irrespective of whether the FMP or Financial Product operates an ESG investment strategy. The more onerous obligations apply where a Financial Product (i) promotes, among other characteristics, environmental or social characteristics (referred to as **Article 8 Products** or **Light Green Products**) or (ii) has sustainable investment as its objective (referred to as **Article 9 Products** or **Dark Green Products**).

From 10 March 2021, in scope investment managers, advisers and other FMPs need to have taken a number of actions, including:

- determining which of the SFDR obligations apply to their Financial Products and updating the disclosure in their pre-contractual and marketing documentation accordingly;
- updating their internal policies and procedures; and

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<sup>3</sup> On 21 April 2021, the EU Commissions published a proposal for a “Corporate Sustainability Reporting Directive” (CSRD), which will revise and extend rules introduced by the Non-Financial Reporting Directive.

<sup>4</sup> The question of which FMPs are in scope and what Financial Products are in scope is not clearly answered by the SFDR. The industry has, generally speaking, taken the approach that FMPs with a physical presence in the EU and Financial Products established in or marketed into the EU are, respectively, in scope (see further below).

- ensuring that certain content is published and maintained on their firm website.

The additional website disclosures that all in scope FMPs were required to provide from 10 March 2021 relate to:

- policies on integration of sustainability risks (article 3, SFDR);
- consideration of principal adverse impacts (article 4, SFDR);
- remuneration policies (article 5, SFDR); and
- in respect of Article 8 and Article 9 Products only, a description of the environmental or social characteristics promoted, or the sustainable investment objective pursued, and information on the methodologies used to assess, measure and monitor those environmental or social characteristics or the impact of the sustainable investments selected for the Financial Product, including data sources, screening criteria for the underlying assets and the relevant sustainability indicators used (article 10, SFDR).

The additional pre-contractual disclosures that all in scope FMPs need to include in their offering document (or wrapper) or other pre-contractual documentation for each of their Financial Products from 10 March 2021 include information in relation to sustainability risks (article 6, SFDR); and, where relevant, a statement on consideration of the principal adverse impacts of investment decisions on sustainability factors (article 7, SFDR).

The obligation to provide certain ESG-related information to be disclosed in periodic reports applies where FMPs make available an Article 8 or Article 9 Product (article 11, SFDR). For AIFMs and UCITS ManCos this would be in the annual report, for MiFID firms that provide portfolio management, this would be the periodic report and will apply to reports prepared in 2022 for the 2021 financial year.

## **The Devil is in the (lack of) detail – the RTS delay**

These Level 1 obligations imposed by the SFDR are ambitious and require significant investment in terms of updates to policies, procedures and disclosure documentation. Compliance with these new obligations has been challenging and has been compounded by the lack of Level 2 regulation in the form of regulatory technical standards (**RTS**) which would provide much needed details relating to the content, methodology and presentation of the information to be disclosed under the SFDR.

### ***Regulatory Technical Standards***

The SFDR required the three ESAs to prepare RTS. The ESAs' mandate focuses on disclosure obligations with respect to Article 8 and Article 9 Products, as well as relating to the considerations and disclosure of the principal sustainable adverse impacts of investments in underlying companies (which obligation is mandatory for FMPs with more than 500 employees and on a comply or explain basis for others). The SFDR does not provide for the development of RTS in relation to every article, so no Level 2 guidance will be provided in relation to the obligation on any FMP or financial adviser to disclose its policies on how it integrates sustainability risks in its investment decision-making process (article 3, SFDR) and its remuneration policies (article 5, SFDR) and publication of such information on its website and in pre-contractual disclosures (article 6, SFDR).

The intention was that the RTS would apply from 10 March 2021.

In April 2020, the ESAs published draft RTS (the **April 2020 RTS**) and launched a consultation on their content. The consultation contained 27 questions on which the ESAs were seeking feedback and responses were sought by 1 September 2020.

In a letter from the EU Commission to the ESAs, published on 30 October 2020<sup>5</sup> it was announced that the RTS would no longer apply from 10 March 2021 and, instead, would become applicable “*at a later stage*.” This delay was welcomed by FMPs, who were concerned as to how they could implement the detailed requirements of the RTS in the short period before 10 March 2021. However, FMPs now had to implement the SFDR without the Level 2 guidance and with the knowledge that implementation would likely need to be revisited once the final RTS was published in order to ensure compliance with the Level 2 requirements.

### **ESA’s questions to the EU Commission**

On 7 January 2021 – less than eight weeks before the SFDR “go live” date – the Chair of the Joint Committee of the ESAs wrote to the EU Commission highlighting that the ESAs had encountered several important areas of uncertainty in the interpretation of the SFDR and that there are “*certain priority questions pertaining to the SFDR that would benefit from a more urgent clarification to facilitate an orderly application of [the] SFDR from 10 March 2021.*”<sup>6</sup>

The questions raised by the ESAs encompass many of the questions that FMPs were grappling with as they tried to prepare for 10 March 2021. The questions sought clarification on some of the fundamental principles of the SFDR such as:

1. What is the meaning of “promotion” in the context of products “promoting” environmental or social characteristics?
2. Does the SFDR apply to non-EU AIFMs, for example when they market a sustainable EU AIF under a National Private Placement Regime?

At the time of writing the questions remain unanswered, although it is hoped that the EU Commission will respond (possibly by way of a Q&A document along the lines of that published for the AIFMD<sup>7</sup>) and provide FMPs with much-needed guidance.

On 4 February 2021 (with a date of 2 February), less than six weeks before the 10 March 2021 go-live, the ESAs published their final report on the draft April 2020 RTS for the SFDR (the **Revised RTS**). To the relief of the market, the ESAs recommended that the final Revised RTS take effect on 1 January 2022, and consequently there was no need for FMPs to comply with the detailed provisions of the Revised RTS from 10 March 2021.

It was against this backdrop that FMPs had to prepare for the 10 March 2021 implementation deadline.

### **How did FMPs prepare for 10 March 2021?**

FMPs took various approaches in preparing for the 10 March 2021 deadline – some took a light touch, “best efforts” approach in complying only with the SFDR requirements while others looked to the draft RTS for

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<sup>5</sup> To view the letter from the EU Commission, please click [here](#).

<sup>6</sup> To access the letter from the ESAs, please click [here](#).

<sup>7</sup> Alternative Investment Fund Managers Directive (Directive 2011/61/EU)

inspiration. In this section we consider certain of the challenges facing FMPs in implementing Phase 1 of the SFDR.

### ***Addressing the Obligations relating to Transparency of Sustainability Risks***

All in scope FMPs, regardless of whether or not they have Light Green or Dark Green Products were required to:

- (i) publish on their websites information about their firm level policies on the integration of sustainability risks in their investment decision-making process (this of course meant that policies and procedures had to reflect this) (article 3, SFDR) including how their remuneration policies were consistent with these sustainability risk management policies (article 5, SFDR); and
- (ii) describe in their pre-contractual Financial Product disclosures:
  - a. the manner in which sustainability risks are integrated into their investment decisions; and
  - b. the results of the assessment of the likely impacts of sustainability risks on the returns of the Financial Products they make available (article 6, SFDR).

While all FMPs had to meet these disclosure requirements, it did not mean that “one-size fits all” and in order to comply effectively, FMPs had to investigate their investment decision-making process and potentially develop a new risk analysis procedure to address the consideration of “sustainability risk”. FMPs also had to consider and articulate how sustainability risks, as distinct from other types of risks, impacted their Financial Products. In addition, FMPs had to consider how best to link their remuneration policies to their sustainability risk policies.

### ***Preparation of Principal Adverse Impact Statements***

Article 4 of the SFDR requires FMPs who consider the principal adverse impacts of investment decisions on sustainability factors<sup>8</sup> to include a statement (**PAI Statement**) on their 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.

FMPs who do not consider adverse impacts of investment decisions on sustainability factors are required to publish and maintain on their websites clear reasons why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts. It is important to note that the option not to consider adverse impacts of investment decisions was not available from 30 June 2021 to FMPs (or an FMP that is a parent of a group) with 500 or more employees<sup>9</sup>.

FMPs were faced with a dilemma – a desire to demonstrate their commitment to ESG in the face of increasing investor focus in the area, the proposed onerous obligations of compliance set out in the still-to-be-finalised RTS and the fact that because the RTS was still in draft, there was no clarity on the final requirements.

The April 2020 RTS included a mandatory reporting template in Annex I to use for the statement on the consideration of such adverse impacts. Mandatory reporting items include summary, scope, the principal adverse impacts (with a list of 32 mandatory indicators such as carbon footprint, solid fossil fuel exposure, water emissions, gender pay gap and child labour), policies on the identification of and actions taken in relation to principal adverse impacts, notably relating to due diligence processes and engagement policies, as well as

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<sup>8</sup> Article 2(24) of the SFDR defines “sustainability factors” as “*environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters*”.

<sup>9</sup> Article 4(3), SFDR.

historical comparisons. The Revised RTS reduced the number of general mandatory indicators to 14 – with the addition of mandatory indicators for specific asset classes (real estate and sovereigns) –with a requirement to include at least one additional indicator related to principal adverse impacts on a climate or other environment-related sustainability factor and at least one additional indicator related to principal adverse impacts on a social, employee, human rights, anti-corruption or anti-bribery sustainability factors.

If FMPs decided to voluntarily comply with the requirement to provide a PAI Statement from 10 March 2021, the content of the Revised RTS provides an indication as to what the FMPs are committing to on an on-going basis.

Many firms, particularly those FMPs falling below the 500-employee threshold, decided not to provide a PAI Statement, or rather published an explanation of what they did do in terms of due diligence and engagement, but stated that they would not be publishing a statement as to the adverse impact of their investment activities on sustainability indicators given the uncertainty around the content of such a statement. Others looked to the draft April 2020 RTS for guidance – drawing on those provisions it was expected would not change and selecting certain adverse impact indicators which could be relatively easily tracked and started building out systems to take into account those indicators on an on-going basis in the future, and in some cases scrambling to adjust to the extent possible when the Revised RTS were published.

For FMPs with multiple portfolio management teams and strategies, the publication of a PAI Statement raised unique challenges – tracking and reporting on adverse impact indicators is more obvious for certain strategies than others and certain teams may be more prepared in terms of responsible investing than other teams. What do you do if certain parts of the business are ready to publish a PAI and others are not or cannot? How do you approach a PAI Statement if you are a global team and your portfolio management teams sit in different locations and provide portfolio management services to Financial Products and clients in multiple jurisdictions, with different approaches to ESG? Even if there is consensus as to approach to providing a PAI Statement, how do you describe the firm's due diligence processes and engagements policies across teams and strategies? Some FMPs looked for consistency of approach across teams and strategies and disclosed at that level; others provided disclosures on a per team or strategy basis. Some decided not to provide a PAI Statement because not all teams were ready to commit to the data collection and reporting processes, while others determined that they would comply in part in respect of those teams that could fulfill the requirements and explain for the remainder of the business.

### ***Categorising Article 8 or Article 9 Products***

As the ESAs highlighted in their letter to the EU Commission, the SFDR is not clear on what is meant by “promotion” in the context of Financial Products promoting environmental or social characteristics – a fundamental concept for Article 8 Products, yet one that is not at all clearly explained. For example:

- Can simply including words like “sustainable,” “sustainability,” or “ESG” result in a Financial Product promoting an environmental or social characteristic or having sustainable investment as its objective?
- In the absence of active advertising of an environmental or social characteristic of the product, would an intrinsic characteristic of the product, such as a sectoral exclusion (e.g., tobacco) which is not advertised, qualify as “promotion”?
- Or is a more active component to the strategy required, for example selecting investments on the basis of their environmental or social characteristics?

While the struggle with categorization of “green” products has mostly been in the realm of Article 8 products, there is also a lack of clarity, again highlighted by the ESAs, as to how to comply with Article 9. For example, is



there a minimum share of sustainable investments that an Article 9 Product must invest in? Is there a maximum limit to the share of “other” investments?

The EU Commission has been clear that it will not tolerate “green washing”<sup>10</sup>, and aside from the risk of regulatory action, there is the risk of private action by investors claiming that a Financial Product’s disclosure was misleading and the potential for reputational risk, so how a product is categorised is of key importance. Faced with increasing investor demand for products that “promote” ESG characteristics or that have sustainable investment as their objective, FMPs need to examine their Financial Products to ensure that they are in practice Light Green or Dark Green Products. If they are, then further obligations attach to the Financial Products and, as evidenced by the content of the RTS, the depth and breadth of these obligations is far reaching.

The lack of clarity as to how to accurately categorise Financial Products has resulted in discussions between product teams, who are keen to see Financial Products described as Light Green or Dark Green given increased investor demand for these types of products, and legal and compliance teams, who are concerned about accurate disclosures and also the fact that, in the absence of the final RTS, FMPs were having to commit to a particular set of requirements without knowing what they were. As a result, the spectrum of approaches taken for the 10 March 2021 implementation was broad, with Financial Products which reference in general terms ESG integration (without identifying any specific environmental or social characteristics as being targeted) or referring to generic ESG exclusionary overlays or lists to those which undertake to invest a set percentage in investee companies pursuing environmental or social objectives all identifying as Article 8 Products.

## Our Observations across Europe

### Germany

German asset managers started early to prepare for the implementation of the SFDR. The importance of ESG in general and the expectations of the German financial regulatory authority, the Bundesanstalt für Finanzdienstleistungsaufsicht (**BaFin**) were emphasized in a detailed guidance note published by BaFin in December 2019 and in various subsequent publications. Although these were not always specifically addressed to the SFDR implementation, they clearly stated the regulator’s expectations. The December 2019 guidance note was meant to provide supervised entities with directions and included numerous examples. Some of the guidance was used by the industry to draft disclosure language for SFDR purposes. In February 2021, and with a view to the 10 March deadline, BaFin published further guidance and a table which showed the different application dates of the various provisions of the SFDR to further assist the industry with the implementation.

### Luxembourg

On 6 November 2020, the Luxembourg financial services regulator, the Commission de Surveillance du Secteur Financier (the **CSSF**) issued a communication reminding FMPs of the upcoming requirements of the SFDR. On 16 December 2020, the CSSF implemented a “fast-track procedure” which allowed any regulated financial product in scope of its supervision to update its offering documentation or prospectuses to meet the requirements of the SFDR by sending the amended documents to the CSSF before 28 February 2021, together with a letter signed by an authorised signatory confirming the amended documentation complied with the relevant provisions of the SFDR.

In its review of the documents submitted under the fast-track procedure, the CSSF focused on ensuring that amended documents comprehensively and adequately described the manner of integration of sustainability risks

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<sup>10</sup> The Taxonomy Regulation ((EU) 2020/852) states at recital 11 that “*greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met*”.

in the relevant investment-decision making process for the given financial product in accordance with article 6 of the SFDR. In contrast, the CSSF's approach to disclosures for Article 8 and Article 9 Products was less prescriptive, reflecting the limited guidance and lack of RTS before 10 March 2021, permitting FMPs to provide a large variety of investment policies for those Article 8 and Article 9 Products.

## ***Ireland***

On 4 November 2020, the Irish financial services regulatory authority, the Central Bank of Ireland, announced that it would introduce a "fast track" filing regime for pre-contractual document updates based on the SFDR Level 1 text, under which both UCITS ManCos and AIFMs would be able to certify their compliance with the SFDR. The announcement was very much welcomed by industry – particularly in the context of UCITS products. The fast-track procedure allowed FMPs to take full advantage of the lead in time to the 10 March 2021 deadline to consider the broader implications of SFDR on their business.

In line with the general experience across Europe, the focus of FMPs with Financial Products in Ireland was primarily on the classification of their Financial Products under the relevant articles of the SFDR (e.g. articles 6, 8 or 9). The Central Bank of Ireland took the view that asset managers should be in a position to classify their Financial Products without significant additional guidance from regulatory authorities. This resulted in the majority of FMPs classifying their Financial Products under article 6 of the SFDR and not as Article 8 or Article 9 Products. These classifications may now be revisited as further guidance and market practice develops with the introduction of Level 2 requirements under the RTS.

## ***France***

In March 2020, the French financial services regulator, the Autorité des Marchés Financiers (the **AMF**) published a doctrine requiring minimum investment standards in relation to ESG for collective investment vehicles marketed to non-professional investors that communicate information on non-financial characteristics, such as ESG characteristics (AMF Position-Recommendation 2020-03 (the **AMF Doctrine**))<sup>11</sup>. Although the SFDR and the AMF's Doctrine aimed to achieve similar objectives, the AMF was required to update its policy in January 2021 to clarify how the AMF Doctrine was to co-exist with the obligations of the SFDR. Some questions remain and the AMF is expected to amend its doctrine soon<sup>12</sup>.

Some French FMPs were able to easily integrate the concepts introduced by the SFDR in their approach or had already included these concepts in their policy before the 10 March 2021 in light of the AMF Doctrine. For others, complying with the obligations of the SFDR has proved more challenging, principally due to the detailed obligations and the need to dedicate significant resources to ensure compliance.

## **Other SFDR and Taxonomy Regulation related developments**

Pursuant to the Taxonomy Regulation, the EU Commission is to adopt delegated acts that provide a set of technical criteria for defining activities that contribute substantially to the six environmental objectives set out in the Taxonomy Regulation. These delegated acts build on the recommendations of the Technical Expert Group on Sustainable Finance (**TEG**), an EU Commission expert group set up in 2018.

On 21 April 2021, the EU Commission announced that it had agreed on the text of the delegated act for the first two objectives, climate change mitigation and adaptation (to be referred to as the **EU Taxonomy Climate**

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<sup>11</sup> For more information on the AMF Doctrine, please see our OnPoint, available [here](#).

<sup>12</sup> For more information on the January 2021 update to the AMF Doctrine, please see our OnPoint, available [here](#).

**Delegated Act**<sup>13</sup>). On 4 June the EU Taxonomy Climate Delegated Act was formally adopted when all the language versions were made available. It will enter into force when it is published in the OJ and it will apply from 1 January 2022. Further delegated acts are expected over the course of 2021 and 2022.

Under article 8 of the Taxonomy Regulation certain large undertakings that are required to publish non-financial information pursuant to the Non-Financial Reporting Directive (“**relevant undertaking**”) are required to disclose information to the public on how and to what extent their activities are associated with environmentally sustainable economic activities. Article 8 of the Taxonomy Regulation will rely on the EU Taxonomy Climate Delegated Act and other climate and environmental delegated acts to mandate companies to assess and report the alignment of their financial and non-financial activities with the Taxonomy Regulation.

On 7 May 2021, the EU Commission published a draft of the **EU Taxonomy Article 8 Delegated Act**<sup>14</sup> setting out the methodologies and indicators to help relevant undertakings determine the extent to which their economic activities can be considered environmentally sustainable according to the Taxonomy Regulation. They launched a request for feedback on their proposals at the same time, with responses requested by 2 June 2021. Given the time needed to appropriately implement the EU Taxonomy Article 8 Delegated Act and the planned entry into force of the EU Taxonomy Climate Delegated Act by the end of 2021, there will be a phased entry into force of the EU Taxonomy Article 8 Delegated Act, with the first disclosures commencing on 1 January 2022 for the reporting period 2021. The intention is that as of 1 January 2025 for the 2024 reporting period, the EU Taxonomy Article 8 Delegated Act will apply in full.

## PART TWO

Having completed implementation on 10 March 2021, there was no time to recover before more changes came in to play.

While FMPs may have faced challenges in complying with the Level 1 text of the SFDR, the obligations in the Level 2 text with which they will need to comply are even more challenging. Having delayed publication of the Revised RTS until 4 February, on 15 March 2021 – just five days after the SFDR go- live date – the ESAs published a further revised version of the draft RTS which now included the disclosures that the ESA were mandated to draft pursuant to the provisions of the Taxonomy Regulation (the **Taxonomy RTS**). The final version of the Taxonomy RTS is expected to be published in early July 2021, ahead of an expected 1 January 2022 effective date.

In the second part of this article, we look at the detail of the draft Revised RTS as amended by the Taxonomy RTS, what this means for in scope FMPs and what they need to be doing to ensure that they are in compliance with those obligations from 1 January 2022.

### The RTS – and further revisions

As mentioned in Part 1, the Revised RTS were published on 4 February 2021, making substantial changes to the April 2020 RTS. The Revised RTS provide more granular requirements in connection with the disclosure obligations arising under the SFDR relating to:

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<sup>13</sup> To access the EU Taxonomy Climate Delegated Act, please click [here](#).

<sup>14</sup> To access draft text of the EU Taxonomy Article 8 Delegated Act, please click [here](#) and to access an FAQ relating to the same, please click [here](#).

- The principle of “do not significantly harm” as set out in article 2(17) of the SFDR (article 2a, SFDR) which provides the definition of sustainable investment.
- A PAI Statement in relation to environmental impacts (article 4(6), SFDR) and social matters (article 4(7), SFDR) characteristics.
- Pre-contractual information for Article 8 Products (article 8, SFDR).
- Pre-contractual information for Article 9 Products (article 9, SFDR).
- Website disclosure for Article 8 and 9 Products (article 10, SFDR).
- Periodic reporting for Article 8 and 9 Products (article 11, SFDR).

On 15 March 2021, the ESAs issued a press release confirming that they had agreed to amend the soon-to-be-finalised Revised RTS, to include the Taxonomy RTS. The rationale for amending the Revised RTS instead of creating a new ruleset, was to minimise duplication and complexity in this area. The ESAs’ stated aim is to have the RTS on disclosure rules function as a “single rulebook” for sustainability disclosures at Level 2 for both the original powers in the SFDR and the additional ones introduced by the Taxonomy Regulation. The ESAs anticipate that they will issue a final report with final draft RTS by early July 2021. Whether this timeline is adhered to is an open question, given the delays to date. Even if published in July 2021 they still will not be “official” – they need to complete the EU’s legislative process.

From a practical perspective, the proposed publication date of the final RTS is a real concern for FMPs. The Revised RTS and Taxonomy RTS are very detailed and will require FMPs to make significant changes to systems and processes, as well as Financial Product pre-contractual disclosures – all of which will take time to implement. FMPs will need to have the finalized RTS before being able to start preparing to fully comply with their obligations. FMPs need to focus on coming into compliance with more detailed RTS and face a very short timetable in which to do so.

The Taxonomy RTS, which amend the proposals set out in the Revised RTS deal with:

- Additional pre-contractual disclosure and periodic reporting for Financial Products making Taxonomy-aligned investments.
- Additional disclosures required for Article 8 and Article 9 Products making environmentally sustainable investments in accordance with article 2(17) of the SFDR under articles 5 and 6 of the Taxonomy Regulation.

In this Part 2 references to RTS are to the draft Revised RTS as amended by the Taxonomy RTS.

## **The challenges that remain – complying with the RTS**

### ***Article 4 – PAI Statements***

As mentioned above, article 4 of the SFDR requires FMPs who consider the principal adverse impacts of investment decisions on sustainability factors to include a PAI Statement on their due diligence policies with respect to those impacts. FMPs who do not consider adverse impacts of investment decisions on sustainability factors are required to publish and maintain on their websites clear reasons why they do not do so.

The RTS are very detailed and prescriptive as to what they expect to see included in the PAI Statement and there is a template (Annex I of the RTS) that specifies the order and format of the PAI Statement. FMPs who are

required to, or who choose to, prepare a PAI Statement need to ensure that they provide information on all 14 of the mandatory indicators and at least one additional indicator related to principal adverse impacts on a climate or other environment related sustainability factor and at least one additional indicator related to principal adverse impacts on a social, employee, human rights, anti-corruption or anti-bribery sustainability factor. Other information that FMPs need to provide includes, amongst other things: descriptions of the actions taken during the reference period and actions planned or targets set by the FMP for the next reference period to avoid or reduce the principal adverse impacts identified; summaries of engagement policies with investee firms; and descriptions of how the FMP adheres to international standards.

The PAI Statement also needs to include a 'Summary' section and that must be provided in (i) the official language of the home Member State of the FMP and (ii) if the Financial Product is marketed in a host Member State, one of the official languages of that host Member State – meaning essentially that there is a translation requirement.

The PAI Statement needs to be published as part of the FMP's website sustainability-related product disclosures and updated by 30 June each year. Following publication of the first PAI Statement, FMPs also need to include a description of the actions taken during the reference period and actions planned or targets set by the FMP for the next reference period to avoid or reduce the principal adverse impacts identified.

The volume of information that FMPs need to obtain and then analyse to complete the PAI Statement may cause those FMPs who can choose whether to prepare the PAI Statement or not to consider carefully whether they want to provide such a statement.

Even for those FMPs who are not required to produce a PAI Statement and elect not to do so, the RTS specifies that they must include a statement on their websites in a separate section titled, "No consideration of sustainability adverse impacts". In addition to including this statement, the FMP must provide reasons why it does not do so with, where relevant, information on whether and, if so, when it intends to consider those adverse impacts by reference to at least the indicators in Annex I of the RTS.

### ***Article 8 and Article 9 Products – Regulatory Technical Standards***

Article 8 and Article 9 of the SFDR provide general rules on what must be disclosed and what information must be provided in relation to an Article 8 or Article 9 Products e.g. a fund. As discussed above Articles 8(3), 9(5), 10(2) and 11(4) of the SFDR empower the ESAs to deliver, through the Joint Committee, draft RTS regarding the content, methodologies, and presentation of sustainability-related disclosures.

One of the key objectives of the RTS is to ensure harmonization and comparability of the various sustainability-related disclosures. Therefore, the ESAs saw merit in providing mandatory disclosure templates for pre-contractual disclosures and reporting for Article 8 and Article 9 Products.

There are four mandatory disclosure templates that will be annexed to the final RTS, two for Article 8 Products and two for Article 9 Products. The text of the RTS provide further details to assist with completion of the information required in the templates.

The templates cannot be amended and their content is predefined. There is however some flexibility regarding the font size and the colours that are permitted to be adapted to match, for example, the FMP's corporate identity. The templates are structured in a "question-and-answer" format because the ESAs believe that this is the best way, particularly for retail investors, to be able to understand the content and the information disclosed about Article 8 and Article 9 Products.

The templates are not standalone documents, which means that (i) the pre-contractual templates must be attached to the sales document, e.g. for a UCITS to the prospectus and they must be an integral part of the sales documents, and (ii) the periodic reporting templates must be attached to the financial report.

The pre-contractual and the periodic reporting templates are connected to each other in that the information that must be disclosed in both templates is materially the same. The key difference is that the statements made in the pre-contractual disclosure templates relate to the future and contain predictions or intentions while in the periodic reporting template, the statements relate to the past and explain how the Financial Product performed compared to what was predicted or intended.

### ***Article 8 Products and the RTS***

In terms of Article 8 Products, the draft RTS address in more detail several disclosure obligations under the SFDR, including:

- pre-contractual information describing how a product with environmental or social characteristics meets those characteristics and, if an index has been designated as a reference benchmark, whether and how that index is consistent with those characteristics (article 8, SFDR and articles 13 to 19 of the RTS);
- information on an entity's website to describe the environmental or social characteristics or the sustainable investment objective of a Financial Product; the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments; the pre-contractual information referred to in article 8; and the periodic reports referred to in article 11 of the SFDR (article 10, SFDR and articles 32 to 44 of the RTS); and
- information in periodic reports made according to sectoral legislation specifying (a) the extent to which Financial Products with environmental and/or social characteristics meet those characteristics, and (b) for Financial Products that promote environmental characteristics and invests in an economic activity that contributes to an environmental objective, to which environmental objective set out in the Taxonomy Regulation it contributes and the extent to which underlying investments are in investments that qualify as environmentally sustainable under the Taxonomy Regulation (article 11, SFDR and articles 58 to 63 of the RTS).

### ***The pre-contractual disclosures for Article 8 Products***

The Article 8 Product pre-contractual disclosure requirements are covered in articles 13 to 19 of the RTS. These include:

- a requirement to use a mandatory template for the presentation of pre-contractual disclosure (this can be found in Annex II of the RTS);
- a list of items to be covered in the template, such as the type of Financial Product, an explanation of what the environmental or social characteristic are, and how they are achieved;
- additional items of disclosure where the product designates an index as a reference benchmark, including an explanation of how it differs from a relevant broad market index; and
- asset allocation for the Financial Product, including whether the product is making sustainable investments, and if so, a requirement to disclose how the product complies with the “do not significantly harm” principle.

### ***The pre-contractual disclosure template for Article 8 Products***

- The pre-contractual disclosure template starts with the statement that the Financial Product promotes environmental or social characteristics but does not have as its objective sustainable investment and it furthermore requires the FMP to confirm whether the Financial Product intends to make any sustainable investments, and whether these will include Taxonomy-aligned investments.
- In the section “What environmental and/or social characteristics are promoted by this financial product?” the FMP is required to describe the environmental or social characteristics that the Financial Product promotes and a list of the sustainability indicators that are used to measure the attainment of each characteristic.
- The FMP must furthermore explain what investment strategy the Financial Product follows, which requires a description of the type of investment strategy used to attain the environmental or social characteristics promoted by the Financial Product, and also the binding elements of that strategy to select the investments to attain each of those characteristics. It must furthermore be discussed how the strategy is implemented in the investment process on a continuous basis together with a short description of the policy to assess good governance practices of the investee companies.
- The FMP must confirm what asset allocation is planned for the Financial Product, i.e. the minimum proportion of the investments used to attain the environmental or social characteristics and what “other” investments are planned and what their purpose is.
- If the Financial Product invests in sustainable investments that are not “Taxonomy aligned”, the FMP must provide a description of how the sustainable investments contribute to a sustainable investment objective and do not significantly harm any of the sustainable investment objectives. In this regard, the FMP must explain how the indicators for adverse impacts on sustainability factors are taken into account, which refers to table 1 of Annex I and any relevant indicators in Tables 2 and 3 of Annex I of the RTS and whether sustainable investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.
- If the Financial Product invests in sustainable investments that are “Taxonomy aligned”, the FMP must provide a pie chart of the minimum Taxonomy alignment of investments and disclose what methodology is used for the calculation of Taxonomy alignment, what the minimum share of sustainable investments that are not “Taxonomy aligned” is and why the Financial Product invests in economic activities that are not environmentally sustainable.
- The FMP must furthermore state whether the Financial Product takes into account principal adverse impacts on sustainability factors.
- Where an index is designated as a reference benchmark for the purpose of attaining the environmental or social characteristics promoted by the Financial Product, the FMP must disclose if a specific index is designated as a reference benchmark to determine whether the Financial Product is aligned with the environmental and/or social characteristics that it promotes.
- Finally, the template must contain a reference to where more product-specific information can be found online.

## ***Periodic disclosure for Article 8 Products***

The draft RTS for periodic product disclosure set out the details of the content and presentation of information to be disclosed for Article 8 and 9 Products in the sectoral documentation prescribed in article 11(2) of the SFDR (e.g., annual financial statements).

The draft RTS include:

- a requirement to use a mandatory reporting template for the presentation of the periodic disclosure (this can be found in Annex IV of the RTS);
- a granular list of items to be included in the reporting, focusing on the success of the Financial Product in attaining its environmental or social characteristic (or combination thereof) or sustainable investment objective; and
- requirements for Financial Products making sustainable investments to disclose how it has successfully complied with the “do not significantly harm” principle from article 2(17) of the SFDR.

As discussed above, the periodic reporting disclosure mirrors the pre-contractual disclosures because the periodic reporting requires the FMP to look back and to discuss what happened since it disclosed its intentions to the perspective investors and how the Financial Product performed in the meantime. The FMP is required to look back and explain, among other things: to what extent the environmental or social characteristics that were promoted were met; how the sustainability indicators performed; what the top investments were; and what the proportion of sustainability-related investments and the share of ‘Taxonomy aligned’ investments were.

The requirement to periodically report starts as of 1 January 2022.

## ***Website disclosure for Article 8 Products***

In addition to the pre-contractual and the periodic reporting, the website disclosure is a further component of the SFDR’s disclosure requirements. The draft RTS set out the details of the content and presentation of information to be publicly disclosed on the website by the FMP for Article 8 and Article 9 Products.

The draft RTS:

- sets out where and how the FMP must publish the information on the website, including the need to publish a two-page maximum summary (this must be in at least one official language of the home Member State, if marketed elsewhere and if different, it must be translated into a language customary in the sphere of international finance and the official language of any Member State in which the Financial Product is marketed);
- provides a list of items, including required headings, to be set out in the disclosure, focusing on the following, in addition to pre-contractual disclosure items: how the sustainability indicators are monitored through the lifecycle of the Financial Product; a description of the environmental or social characteristics; the methodologies employed to measure the attainment of the social or environmental characteristics; the data sources used and how it is processed; due diligence processes; and any engagement policies;
- where a benchmark is used, requires a description of how it is aligned with the environmental or social characteristics, including data inputs and how the index is calculated; and
- includes requirements for Financial Products making sustainable investments regarding how it complies with the “do not significantly harm” principle from article 2(17) of the SFDR.



Helpfully, the order of the website disclosure items reflects the order of disclosure in the pre-contractual section of the RTS.

During the consultation on the RTS, industry respondents noted that some Financial Products are tailor-made private funds and portfolios managed on a discretionary basis set up under bilateral agreements protected by confidentiality and that public website disclosures of Financial Products for institutional investors that are not publicly marketed should not be included in the website disclosures or should be made in a password-protected area of the website, otherwise it would be problematic in view of the general confidentiality of contractual agreements with institutional investors, applicable to both tailored funds and individual mandates, to disclose the relevant details in the public domain of the website.

The ESAs note that they cannot change the SFDR product scope which makes no differentiation between whether a Financial Product is “private” or “public” or whether a Financial Product is intended for a single client, according to the Financial Products listed in article 2(12) of the SFDR. Furthermore, the public website disclosure requirement in article 10 of the SFDR makes no provision for password-protected disclosure, which by definition is not then “public”. The ESAs have, however, provided a reminder in recital 36 to the RTS that website disclosures should respect EU and national rules on confidentiality of information.

The ESAs addressed these confidentiality issues in the letter to the EU Commission dated 7 January 2021<sup>15</sup>.

### ***Article 9 Products and the RTS***

In general, the requirements applicable to Article 9 Products are substantially similar to those for Article 8 Products described above, with key variations due to certain fundamental differences between Article 8 and Article 9 Products.

- Rather than focusing on the environmental or social characteristics, the disclosure turns around the sustainable investment objective of the Financial Product: what it is, how it is attained and how such attainment is measured.
- Unlike Article 8 Products, Article 9 Products are expected to invest primarily in sustainable investments, therefore there is a requirement to disclose what the “other” investments are, their purpose and whether there are any environmental or social safeguards and how the proportion of the “other” investments and their use do not affect the delivery of the sustainable investment objective.
- While Article 8 Products need to describe whether and how adverse impact indicators are considered, Article 9 Products must describe that they do consider the adverse impact indicators i.e., a PAI statement must be provided for the Financial Product.
- Where a benchmark is used to measure whether the Financial Product meets its sustainable investment objective, there needs to be an explanation provided as to how the investment strategy is aligned with the methodology of the index on a continuous basis and why and how the index differs from a relevant broad market index.
- There are special requirements for Financial Products that have reduction in carbon emissions as their objective, which includes requiring a reference to an EU Climate Transition Benchmark or EU Paris-aligned Benchmark or, if such a benchmark is not available, an explanation of how the objective of

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<sup>15</sup> See footnote 6.

reduction in carbon emissions and its attainment is aligned with the Paris Agreement and how it is aligned with the methodologies underlying the Benchmark Regulation.

### ***Integration of the Taxonomy Regulation into the SFDR Framework***

As described above, the Taxonomy Regulation amended the SFDR and the most recent version of the draft RTS was amended to include the Taxonomy RTS so that all requirements are included in the same place in order to avoid duplication and confusion.

The Taxonomy Regulation interacts with, and imposes obligations on, FMPs and their Financial Product related disclosures in a number of ways and we consider a few key points below.

Article 8 Products which make environmentally sustainable investments are required to disclose in accordance with article 6 of the Taxonomy Regulation and Article 9 Products are required to disclose in accordance with article 5 of the Taxonomy Regulation whether and to what extent the environmental objectives of the products align with the six environmental objectives set out in Article 9 of the Taxonomy Regulation and to what extent the investments made are in economic activities that qualify as environmentally sustainable under article 3 of the Taxonomy Regulation. For Article 8 Products this includes a requirement to add a statement, the exact language of which is mandated, that the “do no significant harm” principle applies only to those investments made by the Financial Product which are aligned with article 3 of the Taxonomy Regulation.

To meet the requirement of article 3 of the Taxonomy Regulation, an investment must substantially contribute to one of the environmental objectives specified in Article 9 of the Taxonomy Regulation (e.g., climate change mitigation, climate change adaptation, etc.), must not significantly harm (note this is a different standard than that under the RTS) those objectives, and must comply with minimum safeguards and also with technical screening criteria. The technical screening criteria are so far only available for the first two environmental objectives set out in Article 9 of the Taxonomy Regulation – climate change mitigation and climate change adaptation – as set out in the EU Taxonomy Climate Delegated Act. The technical screening criteria for each objective are granular in their application and are, accordingly quite long, running to approximately 200-300 pages in length.

The RTS include a requirement that Article 8 and Article 9 Products disclose (on a pre-contractual and periodic reporting basis) the extent to which investments are in “Taxonomy aligned” investments, including the extent to which these are in enabling or transitional activities per article 10 of the Taxonomy Regulation. An underlying investment may only be partially “Taxonomy aligned” depending on the investee company’s activities. A detailed methodology for evaluating and calculating such alignment is set out in article 16(b) of the RTS which, for investments in non-financial undertakings, is to be based on such entities’ turnover, capital expenditure or operating expenditure (the basis of calculation must be used across all investments – one cannot pick and choose between the three methodologies).

The RTS provide for reduced disclosure obligations where an investment is “Taxonomy aligned”, rather than providing an analysis against the adverse impact indicators in Annex I of the RTS and alignment with the OECD Guidelines or UN Guiding Principles and other international standards, the disclosure need only state that the investment was in environmentally sustainable economic activities and whether the statement has been subject to assurance by an auditor or other third party.

The expectation is that relatively few investments will be “Taxonomy aligned”, at least in the early years, as such determination depends on the disclosure of data by the underlying investee companies in accordance with Article 8 of the Taxonomy Regulation and the EU Taxonomy Article 8 Delegated Act thereunder, and an update to the

Non-Financial Reporting Directive (to become the Corporate Sustainability Reporting Directive<sup>16</sup>) which, if adopted in its current form, will come into effect on a phased basis from 2023-2026 for a selection of large, small and medium EU listed companies and large EU established companies.

## Conclusion

The SFDR and the Taxonomy Regulation, as expanded on by the RTS, are mammoth projects that come with challenges, not only for the industry but also for regulators and lawmakers. They impose far-reaching obligations on FMPs and require not only significant procedural and operational changes and adaptation at the level of the FMPs and their Financial Products but also collecting and reporting of data at the level of investee companies.

The ever-increasing volume of ESG-related legislation requires more than just amendments to documentation and implementation of new processes. At a more fundamental level these legislative developments are looking to effect a change of mindset to encourage the industry to change the way in which it allocates resources in order to finance the future.

Whilst extensive efforts have already been made to comply, a considerable amount of work remains to be done before the RTS comes into effect on 1 January 2022.

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<sup>16</sup> The current proposal for the Corporate Sustainability Reporting Directive is available [here](#).