



The implementation of sustainable finance disclosure regulation (SFDR) level 2: key takeaways from EU regulator guidance

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Background

It has been confirmed that SFDR level 1 (Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosure in the financial services sector) was just the tip of the iceberg. Additional complexities have come with the entry into force of the SFDR RTS (Commission Delegated Regulation (EU) of 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector) in January 2023.

This article does not aim to be exhaustive, but rather to pick and choose a few questions that we are frequently discussing with clients. Our views are based on guidelines and releases issued by regulators in the last months, including but not limited to the FAQ on the Sustainable Finance Disclosure Regulation dated 2 December 2022 of the Luxembourg Commission de Surveillance du Secteur Financier (**CSSF**) and the European Securities and Markets Authority (**ESMA**) Consultation Paper on Guidelines on funds' names using ESG or sustainability-related terms, of 18 November 2022).

Use of exclusion strategies: where do we stand?

A question that clients frequently have in practice is whether an exclusion strategy alone is sufficient to meet the environmental or social characteristics of an Article 8 product (Article 8 and Article 9 products are funds that comply with Article 8 or Article 9 of the SFDR, respectively). This has recently been

clarified in the CSSF FAQ, which clearly distinguish Article 8 (so-called light green) and Article 9 (so-called dark green) products in the following respect.

- Article 8 products need to provide a description of how their investment strategy allows them to meet the environmental and/or social characteristics. If an exclusion mechanism alone is to be applied as a key element of the ESG strategy, this should be sufficiently elaborated to allow investors to understand how the product's environmental and/or social characteristics are met
- For Article 9 products, an exclusion strategy alone is not sufficient because the underlying assets must qualify as “sustainable investments” as defined by Article 2(17) of the SFDR. The CSSF clarifies that an inclusion strategy setting out the positive investment selection process is mandatory for Article 9 products in their pre-contractual information. This does not prevent an exclusion strategy being used in line with and on top of a positive investment selection process. In other words, simply considering ESG criteria in an investment selection process is not sufficient for Article 9 products: having a positive investment selection process is mandatory

The distinction made by the regulator between Article 8 and Article 9 products in this respect is welcome. For Article 8 products having an exclusion strategy only, a question remains regarding the granularity required for such a strategy.

Periodic disclosure requirements: are you ready?

While the majority of fund sponsors and managers have focused on complying with precontractual and website disclosure requirements, periodic reports seem to be less on their radar. As of 1 January 2023, Article 8 and Article 9 products have to provide periodic disclosures in accordance with Article 11 of the SFDR and Articles 5 and 6 of the Taxonomy Regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 201/2088).

The periodic disclosure requirements referred to in the SFDR and the Taxonomy Regulation have been further completed by the SFDR RTS, which provides mandatory Templates to be used in the annual reports.

These requirements have been further clarified by the three European Supervisory Authorities (EBA, EIOPA and ESMA) in their last Q&A on the SFDR RTS, published on 17 November 2022. The ESAs highlighted that some sections of the Templates can be removed if they are deemed to be not relevant in the periodic disclosures, if accompanied by a red text instruction limiting the scope of their application. This guideline also applies to templates for pre-contractual disclosures.

In practice, the financial year for the majority of products ends on 31 December. Taking into account reporting deadlines, periodic reports for 2022 will be those issued between April and June 2023, depending on the type of product. It is time for sponsors and managers to review their annual reports

to be issued in 2023.

Fund names using ESG or sustainability-related terms: are we moving towards an additional classification rule?

In November 2022, ESMA launched a Consultation Paper on guidelines on fund names using ESG or sustainability-related terms. After the response deadline on 20 February 2023, ESMA will finalise the guidance. Its application is expected three months after the publication of translations on the ESMA website, and there will be a transitional period of six months for funds launched prior to the application date.

The Consultation Paper aims to protect investors against greenwashing risks by ensuring that funds' names are not misleading. Names including terms such as "sustainability", "ESG" or impact-related words should also reflect the actual investment policies and objectives of the funds.

The main elements of the Consultation Paper are:

- for the use of ESG- and impact-related words – a quantitative threshold of 80% of the fund's investments would have to be used to meet the environmental or social characteristics or sustainable investment objectives within the binding investment strategy disclosed under the SFDR RTS
- for the use of “sustainable” or any derived term, an additional threshold of 50% within the above 80%, must be allocated to sustainable investments under the SFDR
- minimum safeguards must be applied to all investments for funds using such terms (exclusion criteria); and
- additional considerations for specific types of funds (index and impact funds)

The main objective of this Consultation Paper has been well received by market players. However, questions still arise around the mechanisms to be put in place to make sure funds' names are not misleading – especially as definitions of numerous terms still need to be clarified, harmonised between various regulations and implemented adequately. In addition, the complexity of the proposed criteria seems to slip into an additional layer of regulation for these funds.

Conclusion

Throughout 2022, regulators were very active and a slowdown is not in sight, given the amount of work that remains to be done until the full implementation of the SFDR and the Taxonomy Regulation. Keeping up to speed on new publications remains crucial for fund sponsors and managers in order to assess potential impacts on their funds' strategies and current documentation.

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