

Sustainable Finance Update – Recent Investment Funds Related Developments

June 2020

Despite disruption to work programmes wrought by the COVID-19 pandemic, the EU institutions are pressing ahead with sustainable finance initiatives as a priority and there has been a number of significant developments in the past quarter. These include the adoption by the Council of the EU (“**Council**”) and the European Parliament of the Taxonomy Regulation, the European Supervisory Authorities’ (“**ESAs**”) consultation on regulatory technical standards (“**RTS**”) under the Sustainable Finance Disclosures Regulation (“**SFDR**”) and the publication by the European Commission (“**Commission**”) of Level 2 measures under the UCITS Directive and the AIFMD addressing the integration of sustainability factors.

Adoption of the Taxonomy Regulation

In late 2019, following lengthy debate, the EU institutions agreed on a proposal to create a taxonomy or classification system to provide market clarity on what economic activities should be considered “sustainable” and to prevent “greenwashing” – the **Taxonomy Regulation**. One of the contentious issues in the negotiations related to the classification of gas and nuclear investments. In the final text, these investments may be classified as “transition” or “enabling activities” that assist in moving towards a greener economy. The Council and the European Parliament have now both voted to formally adopt the Taxonomy Regulation, paving the way for its publication in the Official Journal of the EU on 22 June 2020. The Taxonomy Regulation will apply, with respect to activities that substantially contribute to climate change mitigation and adaptation, from **1 January 2022**. The regulation will apply with respect to activities that substantially contribute to the four other environmental objectives set out in the legislation from **1 January 2023**.

ESAs Consultation on RTS under the SFDR

On 23 April 2020, the ESAs published a **consultation** setting out draft regulatory technical standards (“**RTS**”) with regard to the content, methodologies and presentation of sustainability-related disclosures under the SFDR.

The SFDR came into force at the end of December 2019 and will apply from March 2021. It seeks to harmonise the ESG disclosure requirements for financial market participants, including UCITS management companies and AIFMs. The SFDR requires the integration of ESG risks by all financial products within its scope and also contains additional requirements for two types of financial product: (1) products promoting environmental or social characteristics or a combination of these characteristics; and (2) products which have sustainable investment as their objective.

Challenges posed by Inconsistencies between SFDR and Taxonomy Regulation

The SFDR is closely linked with the Taxonomy Regulation discussed above, which, in addition to setting out an EU classification system for sustainable activities, also prescribes disclosures to be made by financial market participants. However, the SFDR and Taxonomy Regulation were not agreed and adopted at the same time, with the adoption of the Taxonomy Regulation being delayed due to political debate as to what should be categorised as sustainable activities, as noted above.

In its consultation paper, the ESAs identify the challenge arising from the fact that the negotiations on the draft Taxonomy Regulation were ongoing when the SFDR entered into force. The finalised SFDR defined “sustainable investments” without reference to the Taxonomy Regulation. The ESAs discussed whether the environmentally sustainable products under article 9 of the SFDR are limited to those investing in activities contributing to the environmental objectives according to the proposed Taxonomy Regulation. While such an approach would be favourable in terms of comparability of sustainable investments and combatting “greenwashing”, the SFDR does not link environmentally sustainable investments to the draft Taxonomy Regulation. The ESAs hope to iron out any inconsistencies between the two regulations when they are preparing RTS under the Taxonomy Regulation. The ESAs also highlight the relationship between the concept of “principal adverse impact” in the SFDR and the concept of “no significant harm” in the Taxonomy Regulation and invite the Commission to consider the feasibility of clarifying the relationship between the two concepts in the future.

Principal Adverse Impact Disclosure

The SFDR introduces the idea of “principal adverse impact of investment decisions on sustainability factors” and requires disclosure on a firm’s website where a firm has decided to take adverse impacts into account. Principal adverse impacts are described in the recitals to the SFDR as impacts of investment decisions and advice that result in negative effects on sustainability factors (ie, environmental, social and employee matters, respect for human rights, anti corruption and anti bribery matters). The RTS elaborate on the content and presentation of information required in relation to the principal adverse impact disclosure, including the use of a mandatory reporting template.

Pre-contractual, Periodic and Website Disclosures

The RTS set out details on the content and presentation of information to be disclosed in the pre-contractual, website and periodic report disclosures required under the SFDR.

The ESAs propose that mandatory disclosure templates for pre-contractual and periodic product disclosure should be developed to harmonise how the information is provided. The drafting of these templates has been delayed pending greater certainty regarding what should be disclosed. The ESAs envisage launching a separate process to develop these templates after the consultation paper has been published.

Next Steps

The closing date for comments on the draft RTS is **1 September 2020**. Following the close of the consultation, the draft RTS will be finalised and submitted to the Commission. The RTS will generally apply from **10 March 2021**, although certain provisions relating to those products with an ESG focus or objective will apply from **1 January 2022**.

Integration of Sustainability Factors in the UCITS Directive and the AIFMD

In addition to the Taxonomy Regulation and the SFDR, a further element of the Commission’s Action Plan on Sustainable Growth published in 2018 was the amendment of the level 2 measures under various pieces of legislation forming the EU financial services regulatory framework, including amendments to both the UCITS Directive and the AIFMD to explicitly require management companies to integrate sustainability risks in the investment decision-making process. Referring to the fact that the existing legislative frameworks do not explicitly mention sustainability risks, the Commission notes, “it is necessary to clarify that processes, systems and internal controls of management companies reflect sustainability risks, and that technical capacity and knowledge is necessary to analyse those risks.”

The draft delegated acts were published on 8 June 2020 and the Commission has requested feedback by **6 July 2020**. The obligations would apply 12 months after the date on which the legislation is published in the Official Journal of the EU.

The key elements of the proposed amendments are set out below.

- Definitions of “sustainability preferences”, “sustainability risks” and “sustainability factors” are introduced into the level 2 measures, as well as the concept of “material adverse impact” on the value of investments.
- Management companies must assess all relevant sustainability risks when conducting due diligence on investments.
- Management companies must identify conflicts of interest which arise as a result of the integration of sustainability risks in processes, systems and controls.
- Assessment and management of exposure to sustainability risk must be incorporated into the risk management policy and procedures of the management company.
- Sustainability risks must be taken into account in the organisational structure of the management company.
- Management companies must retain the necessary resources and expertise required for the integration of sustainability risks.
- Larger management companies, (ie, those with an average of more than 500 employees) and those who choose voluntarily to comply with the principal adverse impact reporting obligation under the SFDR, must take into account principal adverse impact of investments on sustainability factors.

Alongside the proposed amendments to the level 2 measures under the UCITS Directive and the AIFMD, the Commission also published proposals integrating sustainability factors relating to MiFID II, the Solvency II Directive and the Insurance Distribution Directive.

Further Developments

Further evidence that the Commission is determinedly pushing ahead with its sustainable finance initiatives is the publication of its **consultation** on its Renewed Sustainable Finance Strategy, which is open for feedback until **16 July 2020**.

On 9 June 2020, a **joint letter** was published by European Fund and Asset Management Association (“**EFAMA**”) in relation to the establishment of a centralised register for ESG data. The letter emphasises that the recent regulatory developments in the context of the EU sustainable finance agenda create an urgent need for publicly available ESG data as well as a need to identify how to enhance their sourcing.














For an overview of the SFDR, Taxonomy Regulation and the Low Carbon Benchmarks Regulation, please see our **Sustainable Finance and Investment Funds** briefing note.

Response to Consultations

Tara Doyle, in her capacity as Chair of the Irish Funds ESG Sustainability Working Group, is very closely involved with the co-ordination of the Irish industry’s response to the various consultations which are currently in train. If you would like to input to any of these consultations, please do not hesitate to contact **Tara**.

Full details of the **Asset Management and Investment Funds Group**, together with further updates, articles and briefing notes written by members of the **Asset Management and Investment Funds team** can be accessed at **www.matheson.com**.

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