

# ESG – ESAs publish their Final Report with draft RTS under SFDR

On 22 October 2021, the European Supervisory Authorities (ESAs) published their **final report** on draft Regulatory Technical Standards (RTS) on the taxonomy-related disclosures for financial products subject to the disclosure requirements under Article 8 and Article 9 **Sustainable Finance Disclosure Regulation** (SFDR). This follows the ESAs’ **consultation paper** issued in March 2021.

This RTS primarily relates to the disclosures required under Articles 5 and 6 **Taxonomy Regulation** which require SFDR Article 8 and 9 financial products which make sustainable investments with an environmental objective to make certain additional disclosures, including how and to what extent the investments made by that financial product are in taxonomy-aligned economic activities.

However certain of the disclosures under this RTS will also have an impact on financial products which are not subject to Articles 5 or 6 Taxonomy Regulation and, as further described below, will have implications for the changes to the ESG related changes to the MiFID suitability assessment coming into force in August 2022 (see our **client note**).

As per the ESAs’ consultation, the structure of this RTS is as an amendment to the SFDR RTS (the **final draft** of which was published in February). The SFDR RTS contains pre-contractual and periodic disclosure templates for Article 8 and 9 financial products. The SFDR RTS has not yet been adopted by the Commission but it is expected to apply from 1 July 2022 (see our **client note**).

## What next?

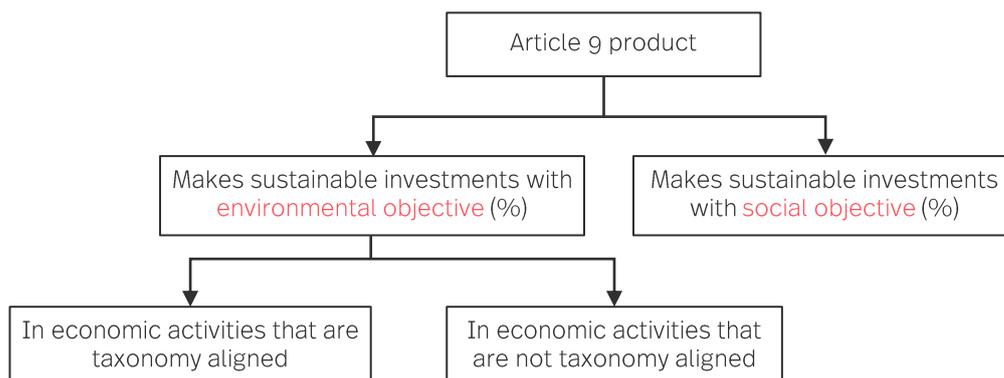
The European Commission will need to endorse the RTS and intends to combine this RTS with the SFDR RTS and publish them in a single delegated act. The delegated act will then be subject to a 3-month scrutiny period by the European Parliament and Council (which can be renewed for a further three months) before being formally adopted.

The ESAs have noted that the SFDR RTS has an expected application date of 1 July 2022 and therefore anticipate that this RTS will also apply from this date. Note that this does not impact the application of the “Level 1” disclosure requirements under Articles 5 and 6 Taxonomy Regulation, which, in respect of the “climate” environmental objectives, will apply from 1 January 2022, and the negative disclosures under Article 7 Taxonomy Regulation which also apply to Article 6 SFDR / “other” products from this date.

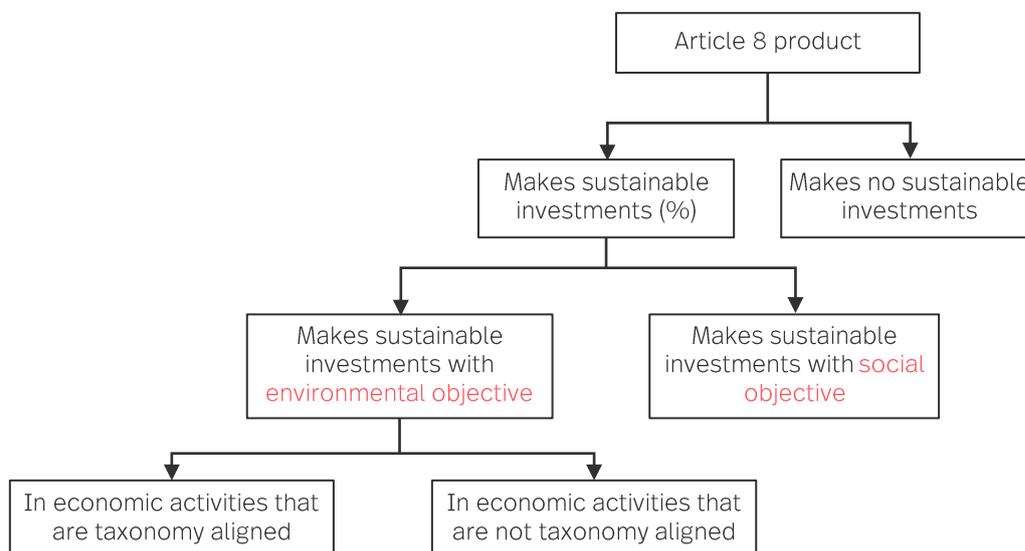
## What are the key points?

### Sub-categories of Article 8 and 9 products

The RTS clearly presents sub-categories of SFDR Article 8 and 9 financial products which will be identifiable in the opening section of the pre-contractual and periodic disclosure templates.



Article 9 products (which have sustainable investment as an objective) will be clearly categorised as financial products making sustainable investments with an environmental objective and/or sustainable investments with a social objective (in each case, identified by a percentage of such investments the product will make (for pre-contractual disclosures) or did make (for periodic disclosures)). For those financial products making sustainable investments with an environmental objective, such products will be further categorised as investing in taxonomy-aligned economic activities and/or non-taxonomy-aligned economic activities.



Article 8 products (which promote environmental and/or social characteristics but do not have sustainable investment as an objective) will be clearly categorised as those which commit to (or made) a minimum proportion of sustainable investments and those which will not (or did not) make any sustainable investments. Those Article 8 products which commit to (or made) a minimum proportion of sustainable investments will further identify whether those sustainable investments have an environmental or social objective. For those products making sustainable investments with an environmental objective, it shall further be disclosed whether such investments were taxonomy-aligned or not.

We expect that the clear creation of sub-categories within Article 8 will, in time, be followed by an increase in sophistication of investor demand: certain investors will no longer consider a financial product that is simply subject to Article 8 to be sufficient and will demand Article 8 financial products that commit a minimum percentage to sustainable investments and potentially taxonomy alignment. This also aligns with the concept of “sustainability preferences” under the changes to the MiFID suitability assessment rules (applicable from August 2022) which include, as one of the limbs of a client’s potential sustainability preferences, products which invest a minimum proportion in sustainable investments or taxonomy-aligned investments, as determined by the client. The content of these disclosures is more than simply compliance reporting and will have strategic importance to many firms.

### How to calculate taxonomy-alignment

The taxonomy-alignment of the investments in non-financial undertakings made by Article 8/9 financial products can be calculated using one of three key performance indicators (KPIs): turnover, capital expenditure (CapEx) or operating expenditure (OpEx). In the consultation paper the ESAs had suggested that, for investments in non-financial undertakings, taxonomy-alignment would need to be disclosed using one KPI for all investments, but firms could choose which KPI they would use. The final RTS has changed this:

- For pre-contractual disclosures, turnover will be the default KPI for investments in non-financial companies but financial market participants may use CapEx or OpEx where this may be more appropriate given the features of the financial product. However the same KPI must be used for all investments in the pre-contractual disclosure.
- For periodic disclosures, the extent of taxonomy-alignment shall be illustrated using each of the three KPIs, not just the KPI used in the pre-contractual disclosure.

For the pre-contractual disclosure, the extent of taxonomy alignment will still be made by way of a pie chart. However for periodic disclosures, given the three separate KPIs, the extent of taxonomy alignment will be illustrated by way of a bar chart.

For investments in financial undertakings the calculation of the extent of taxonomy-alignment shall use the KPIs referred to in the **Article 8 Taxonomy Regulation Delegated Act** - there will be different KPIs for asset managers, credit institutions, investment firms, and insurance and reinsurance undertakings. Note that, although this delegated act has been adopted by the Commission, it has yet to pass the scrutiny of the European Parliament and the Council.

The requirement for periodic reports to include three KPIs in their reporting on taxonomy-alignment will add to the data availability concerns for firms. Many firms are concerned about how they will be able to access the necessary data to make the taxonomy-alignment calculations required both under the RTS and for the Level 1 disclosure requirements from 1 January 2022. Undertakings subject to Article 8 Taxonomy Regulation disclosure requirements will not be making the necessary disclosures to allow firms to make these calculations until 1 January 2023 at the earliest (for non-financial undertakings). The ESAs did not address concerns raised during the consultation in respect of data availability. The recitals to the RTS continue to refer to third party data providers where Article 8 Taxonomy Regulation disclosures are not yet being made. In respect of investments in undertakings not subject to Article 8 Taxonomy Regulation, the recitals state that public reporting of data should be prioritised, followed by privately obtained data, either directly from the investee company or from third parties, “in each case provided the information is equivalent to the disclosures made in accordance with [Article 8 Taxonomy Regulation].”

### How to deal with sovereign issuers?

The ESAs acknowledged in the consultation paper that there was a lack of established methodologies to determine the proportion of taxonomy aligned activities funded by sovereign bonds which meant that they cannot (yet) be considered to contribute positively to taxonomy-aligned investments of Article 8 or 9 products. To deal with the impact this may have on Article 8 or 9 products which make investments in sovereign bonds and which are subject to the disclosure requirements under Articles 5 or 6 Taxonomy Regulation, the ESAs have proposed making two sets of disclosures for the extent to which a financial product’s investments are taxonomy aligned: one which includes exposure to sovereign issuers in the calculation and one which excludes such exposure. Sovereign exposure is defined as an exposure to central governments, central banks and supranational issuers.

### SFDR Do No Significant Harm

In the consultation paper, the ESAs had proposed that, although taxonomy-aligned investments qualified as “sustainable investments” under SFDR, they would not be subject to the “do not significant harm” (DNSH) requirement under Article 2a SFDR. As a reminder, the DNSH requirement for a sustainable investment under SFDR is assessed by reference to the adverse impact indicators in Annex I of the SFDR RTS. For an economic activity to be taxonomy-aligned under the Taxonomy Regulation, it is subject to a separate DNSH requirement in respect of that economic activity’s impact on the environmental objectives under Article 9 Taxonomy Regulation. This taxonomy DNSH requirement is prescribed under the Taxonomy technical screening criteria. The ESAs had proposed in the consultation paper that, because taxonomy-aligned investments would already be subject to a DNSH requirement under the Taxonomy Regulation, such investments would not need to be subject to the SFDR DNSH requirement. However, the ESAs have determined that they are not legally capable to make this derogation and therefore all sustainable investments (including taxonomy-aligned investments) will be subject to the SFDR DNSH requirement (including consideration of the adverse impact indicators in Annex I SFDR RTS).

Firms and data providers will therefore have to make adjustments to their processes for determining whether an investment is taxonomy-aligned. As the SFDR DNSH requirement is more subjective than the prescriptive measures for the Taxonomy DNSH requirements under the technical screening criteria (as under SFDR, it is up to firms to determine what would amount to “significant” harm), firms may need to add the SFDR DNSH assessment as an overlay to any taxonomy-alignment assessment that they obtain from third party data vendors.

### How to deal with short positions?

To date, SFDR disclosures have been silent on how to deal with short positions which has left many firms unsure of how to treat any short positions held in their fund when it came to disclosures relating to, for example, asset allocation. In the context of taxonomy-alignment the RTS states that the calculation of taxonomy alignment should be netted by applying the methodology used to calculate net short positions in the [EU Short Selling Regulation](#).

Although this only explicitly refers to the calculation of taxonomy alignments, firms using short positions in their products may find this useful in determining how to approach shorting techniques/strategies in the context of the SFDR disclosures more broadly

### Clarity on the SFDR Principal Adverse Impacts disclosures

Under Article 7 SFDR, certain financial products (where the financial market participant considers principal adverse impacts (PAI) of its investments decisions on sustainability factors) are required to make pre-contractual disclosures, by 30 December 2022, whether, and if so how, the financial product considers PAI and refer to a PAI statement in the periodic reports. Although the ESAs were not mandated under SFDR to address Article 7 in the SFDR RTS, the SFDR RTS had included (for pre-contractual disclosures only) a section stating whether (but not how) the financial product considers PAI. The lack of a requirement in the RTS pre-contractual template to disclose “how” the product considers PAI and an absence of any further disclosures in the periodic template relating to PAI had created some uncertainty as to what disclosures were required under Article 7 SFDR. Furthermore, the SFDR RTS had suggested that an Article 9 financial product was required to consider PAI (which was not technically correct under SFDR).

In this RTS the ESAs have amended the PAI section in the pre-contractual template to include a “clear and reasoned explanation” of how it considers PAI and where in the periodic disclosures the information on PAI is available. The periodic disclosure template will also include a section (if applicable) of how the product considered PAI. The RTS also removes the suggestion that an Article 9 product is required to consider PAI. Note that, in accordance with Article 7 SFDR, these disclosure requirements will apply from 30 December 2022.

The consideration of PAI is the third “limb” of a client’s potential “sustainability preferences” which will apply as part of the MiFID suitability assessment from August 2022. As a result, disclosures relating to consideration of PAI will increasingly have strategic importance for firms looking to position their financial products in the market.

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