

SFDR – February 2021: Regulatory Technical Standards published

Top 10 things that asset managers need to know

On 4 February 2021, the European Supervisory Authorities (the ESAs) published an updated [draft version of the Regulatory Technical Standards \(the draft RTS\)](#) which will sit underneath the [Sustainable Finance Disclosure Regulation \(the SFDR\)](#). The RTS provides technical detail on how in-scope firms must comply with the headline disclosure obligations specified in SFDR.

The updated draft RTS replaces the [consultation draft](#) which was originally published in April 2020 (the April 2020 draft). The April 2020 draft was - overall - very poorly received by the asset management industry, which identified significant flaws with the proposals.

The February 2021 draft RTS has rectified some of the concerns over the April 2020 draft, particularly relating to the principal adverse impact regime. It should therefore be cautiously welcomed by firms in-scope of SFDR. Some questions remain unresolved or unaddressed, and we draw these out below.

In this client briefing note, we summarise the Top 10 things that an asset management firm needs to know about the draft RTS:

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This note is not a complete summary of the requirements of the draft RTS; rather, it is designed to highlight the key immediate talking points and key changes from the April 2020 draft.

SCOPE AND PURPOSE

1. What is the draft RTS? When does it come into force?

SFDR is an EU regulation which creates new disclosure obligations relating to environmental, social and governance (ESG) and sustainability matters, for a financial market participant (FMP) or a financial adviser, in relation to financial products. The disclosures cover:

- (a) the integration of sustainability risk into investment decision-making processes
- (b) (on a comply or explain basis) due diligence policies with respect to the consideration of principal adverse impacts (PAI) on sustainability factors
- (c) additional disclosure requirements, beyond those specified at (a) and (b), for a financial product either which promotes environmental or social characteristics (an article 8 or “light green” product) or which has sustainable investment as its objective (an article 9 or “dark green” product).

SFDR requires additional technical details on the content, methodologies and presentation of the disclosures at points (b) and (c) to be set out in the RTS, which will supplement SFDR. The February 2021 draft RTS provides a further version of the RTS, following the initial consultation draft of April 2020.

SFDR comes into force on 10 March 2021. However, the European Commission [confirmed](#) in October 2020 that the RTS would not come into force on that date. Instead, firms are expected to comply with the SFDR on a “principles-based” basis. The RTS is expected to come into force on 1 January 2022. Please see question 3 below for what the publication of the draft RTS means for principles-based compliance.

2. Who is subject to the draft RTS? Is the draft RTS relevant to UK and other non-EU firms?

The Draft RTS applies to EU FMPs which are in-scope of SFDR. In particular, the RTS directly applies to FMPs which are complying with the PAI regime, and to FMPs which manage or offer article 8 or article 9 products.

UK and other non-EU firms are generally not subject to SFDR as a regulatory matter. There are [certain situations](#) in which a non-EU firm may be indirectly caught by SFDR, including when a non-EU AIFM markets funds under AIFMD private placement rules into the EU. In those situations, the RTS may be indirectly relevant to non-EU firms, depending on the nature of the products they market into the EU.

The remainder of this note assumes that references to FMPs are to firms and products which are within scope of SFDR and the RTS.

3. How should in-scope firms approach principles-based compliance?

As noted above in question 1, FMPs must comply with the PAI regime and the article 8 / 9 regime in SFDR on a principles-based basis as from 10 March 2021. This means that firms must make subjective judgments about how to comply with the high-level requirements of SFDR.

Firms are not required to comply with the RTS until it comes into force. If the RTS comes into force on 1 January 2022 (as proposed by the ESAs), firms must adopt a principles-based compliance model from 10 March 2021 to 31 December 2021, and then comply with the RTS only as from 1 January 2022.

As at the date of this briefing note (February 2021), many FMPs are very well advanced with their principles-based plans for compliance with SFDR. Given that the draft RTS is not finalised, we at Simmons & Simmons see no need for FMPs to follow the provisions of the draft RTS in designing their principles-based compliance. We would instead recommend that in-scope firms continue to prepare for 10 March 2021 on the basis of the SFDR text, and then turn to prepare for the 1 January 2022 deadline in Q2 2021 and onwards. This may include, for some firms, a gradual realignment of indicators chosen on a principles-based basis to adhere more closely to the RTS, where this is operationally feasible.

PRINCIPAL ADVERSE IMPACTS – DISCLOSURE REGIME

The following questions relate to technical compliance with the PAI regime. This discussion applies only to FMPs which are subject to the PAI regime, on a voluntary or mandatory basis. Other firms may therefore disregard this discussion.

4. Does the draft RTS address the concerns about the PAI indicators in the April 2020 draft? Can we differentiate between different asset classes, and between long and short positions?

The February 2021 draft RTS clarifies many of the issues which were raised by the asset management industry about the April 2020 draft. We generally anticipate that these changes will be welcomed by the industry. However, some technical issues remain unhelpfully unresolved. We summarise this below.

Issue	April 2020 draft RTS	February 2021 draft RTS
PAI indicators	<ul style="list-style-type: none"> • identified a total of 50 indicators, of which 32 were mandatory and 18 were optional (although at least 2 of the optional indicators would also need to be selected) • widely criticised by the industry as being too extensive and not based on consideration of data availability 	<ul style="list-style-type: none"> • considerably revises the approach for PAI indicators • list of mandatory indicators has been reduced to 14 items for investments in companies (rather than 32), as follows • Climate and environmental indicators: <ol style="list-style-type: none"> 1. Greenhouse gas (GHG) emissions, broken down into Scope 1, Scope 2 and (from 1 Jan 2023 only) Scope 3 GHG emissions 2. Carbon footprint 3. GHG intensity of investee companies 4. Exposure to companies active in the fossil fuel sector 5. Share of non-renewable energy consumption and production 6. Energy consumption intensity per high impact climate sector 7. Activities negatively affecting biodiversity-sensitive areas 8. Emissions to water 9. Hazardous waste ratio • Social and employee matters: <ol style="list-style-type: none"> 10. Violations of UN Global Compact principles and OECD Guidelines 11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines 12. Unadjusted gender pay gap 13. Board gender diversity 14. Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons) • revised approach to adopting optional indicators <p><i>Comment: we expect that the revised list of indicators will be a significant relief to many firms</i></p>

Issue	April 2020 draft RTS	February 2021 draft RTS
Asset classes	<ul style="list-style-type: none"> did not distinguish between investments in different asset classes indicators appeared to have been drafted largely with direct investments in corporates in mind 	<ul style="list-style-type: none"> PAI indicators are sub-divided into bespoke, differentiated lists for each of investments in companies, sovereigns and supranationals, and real estate assets <p>intended to include both direct and indirect investments in such asset classes</p>
Green bonds	<i>[not specifically addressed]</i>	<ul style="list-style-type: none"> for investments in green bonds or social bonds (which exclusively finance a sustainability-focused project), the PAIs should be calculated exclusively by reference to the adverse impacts of the targeted project only
Other asset classes	<i>[not specifically addressed]</i>	<ul style="list-style-type: none"> draft RTS is silent on how FMPs should treat <i>other</i> asset classes, beyond those expressly discussed this might include, for example, investments in commodities, macro positions in currencies or interest rates, index positions, or derivatives on any such investment type <p><i>Comment: it is unclear whether positions in other asset classes would be excluded from the PAI regime, and (if so) whether such exclusion would mean that the FMP or its products are deemed to be non-compliant with the PAI regime or whether they can simply be disregarded</i></p>
Look through holding structures	<i>[not specifically addressed]</i>	<ul style="list-style-type: none"> FMPs are expected to look-through holding companies, fund vehicles, and SPVs, to ascertain the PAIs of the underlying investments more controversially, if the FMP cannot obtain the information on underlying investments, it will be deemed not to be taking into account the adverse impacts of their decisions on sustainability factors
Short positions	<i>[not specifically addressed]</i>	<ul style="list-style-type: none"> draft RTS remains silent on how to treat short positions or short exposure for the purposes of the PAI regime (while acknowledging in the summary of the feedback received to the April 2020 draft that respondents had requested clarity on how to account for exposure through short strategies). <p><i>Comment: It therefore remains unclear how FMPs should treat short exposure. It remains theoretically possible that short exposure could be treated in any of the following ways:</i></p> <ul style="list-style-type: none"> <i>disregarded altogether</i> <i>treated as a negative number and subtracted from "positive" adverse impact exposure</i>

Issue	April 2020 draft RTS	February 2021 draft RTS
		<ul style="list-style-type: none"> • <i>treated as an absolute number and added to “positive” adverse impact exposure</i> <p><i>It is hoped that regulators will offer further clarity on this, or (failing that) firms may collaborate via trade associations or industry working groups to reach an industry consensus.</i></p>

5. Does the draft RTS confirm what qualitative impact the consideration of PAI should have on a firm’s investment process?

One of the areas of debate in relation to the PAI regime has been what it means, in practice, to “consider” PAIs as part of the investment due diligence process. In other words, there has been a lack of clarity about what practical impact the identification of adverse impacts should have on a firm’s investments.

The Simmons & Simmons view has consistently been that identification of PAIs must have some practical impact on a firm’s investment process, but it is up to firms to determine what the action is. This Simmons approach is now confirmed by the Draft RTS, which specifies that relevant actions in respect to PAIs may include the following indicative actions:

- exercising voting rights as a shareholder
- sending letters to or attending meetings with the management of investee companies
- setting up documented and time-bound engagement in actions or shareholder dialogue with specific sustainability objectives
- planning escalation measures in case those objectives are not achieved
- reductions of investments
- exclusion decisions

We therefore expect that, for firms adhering to the PAI regime, their diligence policies will generally need to reflect at least some of these options as consequences of identifying PAIs for a particular proposed investment.

6. Does the draft RTS clarify the calculation mechanisms for the quantitative disclosures? Does the draft RTS clarify which products managed by a manager are in-scope?

Data availability:

The ESAs have responded to concerns on data availability by re-asserting that the obligation is a “best efforts” obligation.

The draft RTS also clarifies that data can be obtained from market research providers, internal analysts and specialists, by undertaking specifically commissioned studies, using publicly available information or shared information. The RTS also clarifies that direct engagement with issuers may be necessary in situations where there is insufficient data otherwise available.

Calculation mechanism:

A key industry concern with the April 2020 draft RTS was the apparent requirement that calculations to determine the quantitative reporting were required on a continuous basis across the entire portfolio for the entire year. Many asset managers asserted that a “snapshot in time” calculation mechanism would be preferable, whether on a one-off annual basis or averaged across different measurement points.

Helpfully, the February 2021 draft RTS has revised the approach for calculations used in quantitative reporting. It is now required to calculate the PAI metrics on four quarter-end dates, and to disclose annually. There is therefore no longer a requirement to continuously monitor the PAI data in the portfolio, for reporting purposes.

Manager-level vs product-level reporting:

Our clients in-scope of the PAI regime frequently expressed a concern that the April 2020 draft appeared to require that all products managed by the FMP would be in scope of the PAI reporting regime. This appeared to be the case, irrespective of the decision taken by the FMP to apply the PAI policy to particular products. (We note for these purposes that Article 7 of SFDR allows FMPs which are complying with the Article 4 PAI regime to determine that particular products are in-scope or out-of-scope of the FMP's PAI policy).

Unfortunately, the February 2021 draft RTS appears to continue the approach from the April 2020 draft. In other words, it appears that the draft RTS will still require that PAI reporting takes place at the level of the FMP, consolidated across all of its managed products, irrespective of whether individual products are out-of-scope.

The ESAs acknowledged this concern in the feedback statement, citing respondents' concerns that *"product-level reporting would have proven more proportionate and more meaningful, given that the approach to PAIs can widely differ from product to product and strategy to strategy, as suggested under Article 7 SFDR"*. However, the ESAs state that they were unable to address concerns such as these, due to the scope of their mandate under SFDR.

7. When is the first PAI report due?

PAI quantitative reports will be tied to a reference period, which is a calendar year. For firms which immediately comply with the PAI regime under article 4 of SFDR, the first reference period will be 1 January 2022 to 31 December 2022.

PAI reports are due by 30 June in the year following the reference period. As such, the first quantitative report will be due by 30 June 2023, in respect of calendar year 2022.

This will likely be seen as good news by the industry, as it means there is no need to be actively tracking PAI data during 2021 for reporting purposes.

ARTICLE 8 AND 9 PRODUCT DISCLOSURES

8. Does the draft RTS change the definition of article 8 or article 9 products?

The draft RTS does not formally define article 8 or article 9 products (and indeed the ESAs do not have the required legal mandate under SFDR to do so).

However, we can infer from certain of the recitals to the draft RTS what the regulators' policy intent is with respect to the definition of these products. In particular, the recitals provide a helpful guide to the intended boundary between article 8 and "other" products falling outside of the article 8 / 9 regime. The April 2020 draft established a number of useful principles on this point, and these have been largely carried forward into the February 2021 draft RTS, although with some clarifications.

Many firms in the asset management industry have in practice been basing categorisation decisions on the April 2020 draft, and will welcome that the February 2021 draft RTS continues these established principles.

We wish to highlight a couple of important points in the February 2021 draft RTS:

- **Compliance with the PAI regime:** The draft RTS newly asserts that compliance with the PAI regime is one way in which a product can be an article 8 product. In our view, it is important to emphasise that an article 8 product *need not* comply with the PAI regime (although in practice, some will). Second, we also believe that complying with the PAI regime does not in itself make a product an article 8 product (in other words, our view is that "other" products can technically comply with the PAI regime), provided that they do not expressly promote environmental or social sustainability in the way that is required of an article 8 product. If, however, this becomes the ESAs' or the Commission's view, then that would represent a change in current industry understanding.
- **Names and labels:** A new recital (22) has been added to the draft RTS, which is somewhat confusingly drafted. The new recital (22) appears to suggest that (amongst other things) where a product's name, marketing communications, or labels it adheres to, promote sustainability, then it must include article 8 disclosures. This appears to be saying that for example the name of a product (e.g. the "Sustainable Equities Fund") or adherence to e.g. a "green fund" label could be enough to push a product into article 8 territory. It appears to be a "back door" way of saying that a financial product cannot call itself sustainable (or related terms) or market itself as sustainable, unless it complies with article 8.
- **No prescribed list of investment strategies:** In a move which may be welcomed by the industry, the ESAs have *rejected* a proposal to create a defined list of strategies which can be used within an article 8 product.
- **Exclusion-based strategies remain permissible:** The ESAs have retained exclusion-based strategies as a permitted basis for an article 8 product, although reiterating the note of caution about not greenwashing exclusion-based products.
- **Good governance requirement:** The draft RTS has aligned the "good governance" requirement for both article 8 and 9 products, such that an article 8 product is required to consider the full list of governance matters which had in the April 2020 draft, appeared to be reserved to an article 9 product (namely sound management structures, employee relations, remuneration of staff, and tax compliance). The draft RTS does not provide further clarity on whether good governance requirements apply to non-corporate structures.

9. Is there a prescribed format for pre-contractual and periodic disclosures?

Yes, the draft RTS adopts the approach of requiring mandatory use of pre-contractual disclosure templates and periodic disclosure templates for an article 8 or article 9 product. The templates must be annexed to the pre-contractual disclosure document (e.g. the prospectus for a fund, or IMA for a portfolio management service) and to the periodic report.

In unusually intemperate language for an EU regulatory document, the ESAs describe the SFDR requirement to use a single mandatory template as a “*sub-optimal situation leaving the disclosures unfit for purpose*”. While many in the industry may agree with that sentiment, the ESAs (and the industry) are nevertheless going to be obliged to use the templates as from January 2022, unless the Commission objects to the Draft RTS or seeks to amend the SFDR.

We expect that many asset management firms will wish to continue to make substantive disclosures in the fund prospectus, and then use the mandatory template as additional paperwork on top of the prospectus. This approach does not appear to be prohibited by SFDR.

10. Does the draft RTS provide any further clarity on website disclosures?

An ongoing concern in the industry has been the requirement under Article 10 SFDR for detailed information about article 8 and article 9 products to be posted on the FMP’s public website. The particular concern in the asset management industry relates to:

- *in the case of portfolio management services*, confidentiality requirements for bespoke managed accounts or for “fund of one” or similar structures
- *in the case of alternative funds which cannot be publicly marketed*, whether such public website disclosures undermine the private placement of these funds.

In both cases, a commonly-proposed solution has been to suggest that such disclosures could be made on a private or password-protected website. The ESAs acknowledge this concern in their feedback, but (as with certain of the points noted above) state that they are constrained by the SFDR provisions:

“With regard to tailor-made products, the ESAs note that they cannot change the SFDR product scope which makes no differentiation between whether a product is “private” or “public” or whether a product is intended for a single client, according to the products listed in Article 2(12) SFDR. Furthermore, the public website disclosure requirement in Article 10 SFDR makes no provision for password protected disclosure, which by definition is not “public” then.”

As such, we do not believe that a gated or password-protected website would satisfy article 10 requirements, although we are aware that certain FMPs are taking the risk-sensitive view that some forms of restricted access are necessary to ensure compliance with other prevailing legal requirements.

It should be noted that the draft RTS does retain the recital which clarifies that the website disclosures should comply with national and EU law on protecting confidentiality, protecting undisclosed know-how and business information, and protecting personal data. FMPs may therefore have some room to modify the public disclosures in the pursuit of those goals (for example, by anonymising or redacting information), but would still need to ensure that baseline information is publicly disclosed.

HOW SIMMONS & SIMMONS CAN HELP

Simmons & Simmons would be pleased to assist with scoping, advising on decision-making, advising on application, project plans and drafting disclosures.

In addition, we have prepared a set of templates that clients can use as the basis for document updates.

Simmons & Simmons resources

For more information, please see our [ESG – notes for clients](#) webpage on our online [Sustainable Financing and ESG Investment](#) resource.

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