

CLIENT ALERT

EU Sustainable Finance Disclosure Regulation: Key Points for Asset Managers

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Background

The European Commission first unveiled its Action Plan: Financing Sustainable Growth in 2018. The aims of that action plan are to:

- a) Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- b) Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- c) Foster transparency and long-termism in financial and economic activity.

With those aims in mind, the European Commission has launched a number of legislative initiatives relevant to financial market participants. In relation to banks, investment firms, insurers and asset managers, these include proposals to amend relevant sectoral legislation such as the UCITS Directive, AIFMD, MiFID II, Solvency II and the Insurance Distribution Directive. See our 2019 client briefing [here](#). This briefing focuses on the transparency i.e. disclosure and reporting requirements for asset managers under the Sustainable Finance Disclosure Regulation¹ (“**SFDR**” or “**Disclosure Regulation**”), as amended by the Taxonomy Regulation.²

¹ Regulation (EU) 2019/2088.

² Regulation (EU) 2020/852.

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Overview

The SFDR sets out rules on transparency (i.e. disclosure) for “**financial market participants**” and “**financial advisers**” with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability related information with respect to the firm itself and certain financial products. Financial market participants include the full range of EU regulated firms, including portfolio managers, banks that provide portfolio management, insurers, AIFMs and UCITS ManCos and financial advisers that provide investment advice or insurance advice with respect to insurance based investment products.

Financial products are also widely defined and include alternative investment funds, UCITS and individually managed accounts.

The Taxonomy Regulation also applies to financial market participants and financial advisers and, in effect, supplements the SFDR.

The requirements under the SFDR in relation to website and pre-contractual disclosures will apply in the EU from the 10 March 2021. Requirements relating to periodic reporting to investors will apply from January 2022.

Application to Non-EU Asset Managers

Although there is some lack of clarity in the SFDR, ESMA has recently asked the European Commission for urgent clarification³ on the application of the SFDR to non-EU asset managers, it is clear that the pre-contractual disclosure and periodic reporting requirements described below will apply to non-EU asset managers that market funds to investors in the EU under the national private placement regime. It is not certain that the website disclosure rules (see below) will apply to non-EU firms. In addition, we expect that non-EU asset managers that are sub-advisers/managers to EU AIFMS or UCITS Mancos will indirectly be affected by these rules through additional information requirements from EU asset managers that have been delegated to them.

The UK Government has not implemented the SFDR and will be consulting on its own ESG and climate-related disclosure regime later in 2021. It has stated that it intends to progressively roll out mandatory TCFD⁴ reporting to large companies and financial institutions by 2025. UK firms providing services to EU asset managers or selling funds in the EU may in the future have to comply with UK and EU rules which are divergent.

³ Click [here](#).

⁴ Task force on climate related financial disclosures.

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Website Disclosure Requirements

From 10 March 2021, EU financial market participants (including EU asset managers) will be required to publish on their website the following:

- Information about their policies on the integration of sustainability risks in their investment decision-making process.
- Where a firm considers principal adverse impacts of investment decisions on sustainability factors (“PAI”), a statement on due diligence policies with respect to those impacts, taking account of their size, the nature and scale of their activities and the type of fund. If a firm does not consider PAI as part of its investment decisions it must provide reasons as to why it does not (“comply or explain”).
- Information as to how their remuneration policies are consistent with the integration of sustainability risks.
- If any fund managed by an EU asset manager does promote environmental or social characteristics or has sustainable investment as its objective, information as to those characteristics or that objective, information as to the methodologies used to assess, measure and monitor such characteristics or objective, including data sources, screening criteria and sustainability indicators, as well as the information in pre-contractual disclosures and periodic reports referred to below.

Each firm must ensure that the information on its website on the above matters is kept up to date. Where changes are made, the firm must include a clear explanation of the amendments. Practically, each firm will need to ensure that its operational processes include a check to amend information on its website at the time new pre-contractual disclosures are made, and at the time of any periodic reports being made. In addition, any marketing materials should be checked to ensure they are consistent with information on the website or in any pre-contractual disclosures.

Pre-Contractual Disclosures⁵

EU AIFMs and non-EU asset managers that market a fund in the EU are required to make pre-contractual disclosures by reference to the items stated in article 23 of the AIFMD. Those disclosures are either made in the PPM or in an AIFMD supplement to the PPM. Likewise, UCITS Mancos are required to make disclosures in their prospectuses. The pre-contractual disclosures required by relevant sectoral legislation such as the AIFMD are amended by the SFDR as described below. The disclosures under the SFDR should be made in the same way as for existing AIFMD pre-contractual disclosures.

⁵ Additional requirements apply if a fund has a reduction in carbon emissions as its objective which is not covered by this briefing.

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Those disclosures will need to include descriptions relating to the firm and to the relevant fund as follows:

Transparency of the integration of sustainability risks

- a) “The manner in which sustainability risks are integrated into the firm’s 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”.⁶

Where a firm deems sustainability risks **not** to be relevant, the descriptions referred to above shall include a clear and concise explanation of the reasons why not.

Transparency of adverse sustainability impacts at financial product level⁷

In addition, by 30 December 2022, firms must provide in their pre-contractual disclosure either a clear and reasoned explanation of whether and, if so, how a fund considers principal adverse impacts on sustainability factors and a statement mentioning that information on PAI will also be available in its periodic reports; or a statement that the firm is not considering PAI, and the reasons why.

Transparency of the promotion of environmental or social characteristics (an Article 8 fund)

Where a fund promotes, among other characteristics, environmental or social characteristics, or a combination thereof, provided that the investee companies follow good governance practices, the pre-contractual disclosure shall include:

- a) information on how those characteristics are met; and
- b) if an index has been designated as a reference benchmark, information on whether and how the benchmark is consistent with those characteristics.

Transparency of sustainable investments (an Article 9 fund)

Where a fund has sustainable investment as its objective and an index has been designated as a benchmark, the pre-contractual disclosure shall contain information as to how the index is aligned with that objective and an explanation as to why and how the index differs from the broad market index. Where the fund has sustainable investment as an objective but no index has been designated, the disclosure shall contain an explanation as to how the objective is to be attained.

⁶ SFDR, Article 6.

⁷ SFDR, Article 7.

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Practical Steps for Asset Managers

A key step for firms is to identify the products falling under Articles 8 and 9 of the SFDR and apply the corresponding transparency requirements provided for in the SFDR.

Firms must determine whether any fund promotes “environmental or social characteristics or a combination of those characteristics and if so that the relevant investee companies follow good governance practices” (an “Article 8” fund). The SFDR does not include a definition of the meaning of “environmental or social characteristics”, nor is there yet any guidance on the meaning of “promotes”. Clarifications could, however, be made at a later date by the European Commission or the European supervisory authorities.

In particular: (i) does “promoting” require the ESG feature of a fund to be actively promoted in its marketing materials or is it sufficient for it to be mentioned as part of the fund’s disclosures; and (ii) does the use of a screening or exclusion strategy bring a product within the scope of Article 8?

If a fund promotes environmental or social characteristics it still must be determined if in addition it has sustainable investment as its objective. That is, a fund could fall within both Articles 8 and 9. If that is the case, such a fund would also need in due course to consider the PAI of investment decisions referred to above.

We recommend that all marketing materials (i.e teaser documents, PPMs or other offer documents, websites and pitch materials) are reviewed as part of this exercise to ensure their messaging is not inconsistent with the fund’s objectives. Clearly, if it is decided that a fund does promote environmental or social characteristics and/or has sustainability as an objective this will result in the more onerous obligations under the SFDR and the Taxonomy Regulation being applicable which may not be the desired outcome.

Local regulatory authorities are working actively with market participants, their counterparts and European institutions to facilitate the implementation of the new European framework within local law. Firms should turn to their respective regulatory authority in order to seek potential clarifications.

Technical Standards

The detail of the presentation and content of the information to be disclosed and periodic reporting is to be set out in technical standards which were due to be published in December 2020. A draft of the technical standards was published for consultation in April 2020 and following much negative comment are now expected to be published in Q1 2021. It is likely that the detailed technical standards will not apply until 1 January 2022. These will provide guidance and in some cases templates as to the content and presentation of disclosures.

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Periodic Reporting

Where the fund promotes environmental or social characteristics or has sustainable investment as its objective, the manager should include in its periodic reports (i.e. its annual report to investors) as applicable:

- (a) a description as to the extent to which the environmental or social characteristics are met; or
- (b) a description of the overall sustainability-related impact of the fund by means of relevant sustainability indicators or, where an index has been designated, a comparison between the overall sustainability-related impact of the fund with the impacts of the designated index and of the broad market index through sustainability indicators.

The periodic report requirement does not commence until 1 January 2022.

Taxonomy Regulation

This supplements and amends the SFDR and contains additional pre-contractual disclosure requirements and information to be included in periodic reports. These requirements apply from 1 January 2022 where the environmental objective relates to climate change mitigation or climate change adaptation and from 1 January 2023 in respect of the other four environmental objectives listed under environmental objectives in the Key Concepts below.

The extent of the obligations under the Taxonomy Regulation will depend upon the objective of a fund. Where a fund is neither an Article 8 fund nor an Article 9 fund, the obligation is limited to a mandatory disclosure.⁸

Obligations for funds which promote environmental characteristics

For funds which promote environmental characteristics the pre-contractual disclosure must include:

- (a) the information on the environmental objective(s) to which the underlying investment contributes; and
- (b) a description of how and to what extent the underlying investments are invested in “environmentally sustainable” economic activities. Such disclosure should specify the share of investments in environmentally sustainable economic activities, including details on the respective proportions of enabling and transition activities, as a percentage of all investments selected for the fund.

The disclosure should also be accompanied by the following disclaimer statement: “*The ‘do no significant harm’ principle is applied only for the investments underlying the product that take into account the EU criteria for environmentally*”

⁸ “*The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities*”.

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sustainable investments. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable investments”.

Obligations for funds that have a sustainable investment objective or objective to reduce carbon emissions

If a fund invests in an activity that contributes to an environmental objective, the pre-contractual disclosure must include:

- (a) information on the environmental objective(s) to which the underlying investment contributes; and
- (b) a description of how and to what extent the underlying investments are invested in “environmentally sustainable” economic activities. Such disclosure should specify the share of investments in environmentally sustainable economic activities, including details on the respective proportions of enabling and transition activities, as a percentage of all investments selected for the financial product.

Funds in scope of the Taxonomy Regulation as described above must also include specific information in their periodic reports.

Further detail is to be contained in technical standards which are yet to be finalised.

Key Definitions and Concepts

A “**sustainable investment**” means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives **and** that the investee companies follow good governance practices, in particular, with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

“**Sustainability risk**” as an [ESG] “event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment”.

“**Sustainability factors**” mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

Financial products can promote “sustainable characteristics” or a “sustainable objective”, these concepts are not defined in the SFDR.

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“Principal adverse impacts on sustainability factors” this concept is not defined but there are indicators provided in draft technical standards to the SFDR. Further draft legislation is due to be published Q1 2021.

An **“environmental objective”** is an economic activity defined in the Taxonomy Regulation that contributes to:

- (a) climate change mitigation;
- (b) climate change adaptation;
- (c) sustainable use and protection of water and marine resources;
- (d) transition to a circular economy;
- (e) pollution prevention and control; and
- (f) the protection and restoration of biodiversity and ecosystems.

An **“environmentally sustainable activity”** is an activity which: (i) contributes substantially to one of the environmental objectives; (ii) does not significantly harm any of the above objectives; and (iii) be carried out in compliance with international standards such as the Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights.

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