Proskauer

European ESG Disclosure Regime – What Comes Next?

April 28, 2021

On 10 March 2021, the new European regime on sustainability-related disclosures in the financial services sector (EU/2019/2088) (the "**Disclosure Regulation**", or the "**SFDR**") came into force. In this article, we look at what firms in the scope of the SFDR (e.g. EU investment firms, EU alternative investment fund managers ("**AIFMs**") and non-EU AIFMs marketing their funds in the EU) need to be thinking about with respect to the upcoming regulatory developments following implementation of the SFDR.

1. **Key date: 10 March 2021**

- As of 10 March 2021, the SFDR has applied. The SFDR introduced new transparency and disclosure requirements for "financial market participants", which as defined, includes investment firms and asset managers, including AIFMs, on how they factor sustainability into their investment decision-making processes. The SFDR is part of the wider European sustainable finance package that requires firms in scope to integrate environmental, social or governance ("**ESG**") considerations into their investment decisions and advisory processes in a consistent manner across financial sectors. Within this sustainable finance package, there are two key pieces of regulation: the regulation on the establishment of a framework to facilitate sustainable investment (EU/2020/852) ("**Taxonomy Regulation**") and the aforementioned SFDR. For further details on SFDR, please refer to our update from September 2020.

- Both the Taxonomy Regulation and the Disclosure Regulation empower the European Commission to adopt delegated and implementing acts to specify how local EU member state regulators and market participants shall comply with the obligations laid down in both regulations. Therefore, there are a number of upcoming delegated legislative acts that are in the pipeline for the year ahead.

2. **What are the next key regulatory milestones?**

- *Disclosure Regulation – Level 2 Requirements*

  The SFDR itself sets out high-level requirements (known as "**Level 1**" requirements), which will be supplemented by regulatory technical standards ("

SFDR RTS" or "**SFDR Level 2**"). The SFDR Level 2 will provide more specific requirements and guidance to comply with the disclosure requirements. The SFDR RTS are in final draft form and are expected to pass the European legislative process in summer 2021. The SFDR RTS are expected to apply from 1 January 2022.

- *Taxonomy Regulation – Level 1 Requirements*
  - The Taxonomy Regulation is the second key legislative measure that complements the SFDR. The majority of the provisions of the Taxonomy Regulation will apply from 1 January 2022. The disclosure requirements for climate mitigation and adaptation objectives begin to apply from this date, while the disclosure requirements relating to remaining environmental objectives will start to apply from 1 January 2023.
  - The European Commission is expected to publish a report by the end of 2021 concerning the provisions required for extending the scope of the Taxonomy Regulation to cover the remaining sustainability objectives, including social objectives.

- *Taxonomy Regulation – Level 2 Requirements*
  - The Taxonomy Regulation is also further specified by a suite of RTS ("**Taxonomy RTS**") and technical screening criteria ("**TSC**").
  - The publication due dates for the Taxonomy RTS range from 1 June 2021 to 1 June 2022. Articles 8, 9 and 11 of the Taxonomy RTS, which relate to pre-contractual and periodic product disclosures for environmental taxonomy products, are due to be delivered to the European Commission by 1 June 2021, where those disclosures relate to the "climate change mitigation" and "climate change adaptation" environmental objectives, and 1 June 2022 for those that relate to the "sustainable use and protection of water and marine resources", "transition to a circular economy", "pollution prevention and control" and "protection and restoration of biodiversity and ecosystems" environmental objectives.
  - A similar staggered approach is taken for the implementation of TSCs. The TSC for the "climate change mitigation" and "climate change adaption" environmental objectives (also known as "**Taxonomy Climate Delegated Act**") are expected to be adopted by the end of Q2 2021 and are expected to apply from 1 January 2022 (given that the legislative process is now delayed). TSC for the remaining environmental objectives are expected come into force on 1 January 2023.

3. **What impact do the SFDR Level 2 Requirements have?**

- The SFDR Level 2 requirements introduce more detailed, and (for those products in scope) more onerous, sustainability-related disclosures at the firm and product level. It includes disclosure templates that should be used to comply with the disclosure requirements in the SFDR. The information disclosed must follow the prescribed content, methodology and presentation set out in the SFDR RTS.
- The product-level requirements are mostly relevant for firms that have classified their product as Art. 8 funds (i.e., "light green funds", being products that promote environmental or social characteristics) or Art. 9 funds (i.e., "dark green funds", being products that have sustainable investment as their main objective, such as an impact fund relating to the prevention of climate change).
- It is proposed that SFDR RTS will be amended to align with the first set of Taxonomy RTS in an effort to align the approach of both regulations (see below "*Taxonomy Regulation – RTS for the "climate change mitigation" and "climate change adaptation" environmental objectives").*

4. **What impact will the Taxonomy Regulation have?**

- The Taxonomy Regulation introduces an EU-wide classification system (or taxonomy) for environmentally sustainable activities. The framework aims to create a common language and classification tool to assist businesses in making informed investment decisions on what can be considered environmentally sustainable economic activities. In addition to the disclosures required by the Disclosure Regulation, the Taxonomy Regulation specifies additional disclosures for economic activities to be marketed as "environmentally sustainable".
- An economic activity would qualify as such, if the activity:
    - Contributes substantially to at least one of the six environmental objectives set out in the Taxonomy Regulation (being climate change mitigation, climate change adaptation, pollution prevention & control, circular economy transition, water & marine resources and biodiversity & ecosystem protection);
    - Does no significant harm to any of the other environmental objectives;
    - Is carried out in accordance with minimum social and governance safeguards; and
    - Complies with the relevant TSCs.
- Despite the fact that the Taxonomy Regulation does not require investment in only sustainable practices, it will cause a considerable change to firms with Art. 8 and Art. 9 products. These firms will be expected to provide additional disclosures under the Regulation to investors in order to justify the classification of their product.

Firms will also have to ensure they have systems in place to be able to collect and process the relevant data relating to sustainability factors from underlying investments.

5. **Overview of Taxonomy Regulation Level 2 Requirements**

- *Taxonomy Regulation – Taxonomy Climate Delegated Act (TSC for the "climate change mitigation" and "climate change adaptation" environmental objectives)*

  The draft Taxonomy Climate Delegated Act sets out the conditions under which a wide range of economic activities would classify as significantly contributing to climate change mitigation or adaptation, as well as determining whether such economic activities do no significant harm to one or more of the Taxonomy Regulation's additional environmental objectives. The criteria are dynamic and will be subject to regular review. The Taxonomy Climate Delegated Act groups the economic activities into thirteen categories, for example: information and communication (e.g. computer programming or data centres), financial and insurance (e.g. reinsurance) or energy (e.g. solar, wind power and gas electricity generation).

- *Taxonomy Regulation – RTS for the "climate change mitigation" and "climate change adaptation" environmental objectives*
  - The draft Taxonomy RTS provide for the content and presentation of additional information to the SFDR product disclosures where the product constitutes sustainable investments contributing to environmental objectives.
  - The consultation paper which includes the first set of Taxonomy RTS includes several proposals including:
    - **Single Rulebook** - establishing a single rulebook for sustainability disclosures under the SFDR and the Taxonomy Regulation. This would be accomplished by amending the draft SFDR RTS to reduce contradictory or duplicative provisions.
    - **Pre-Contractual Disclosure Templates** - proposals to amend the templates for pre-contractual and periodic disclosures proposed in the draft SFDR RTS, by adding a new section that includes the disclosures required under the Taxonomy Regulation. This would help standardise the presentation of the relevant disclosures.

Firms in scope of the SFDR and Taxonomy Regulation will need to consider in detail how these legislative developments will impact their approach to the disclosures they are currently making under Level 1 of the SFDR and should ensure they have appropriate policies and systems in place to ensure the requisite data under the incoming regulations are included in their disclosures.

For assistance on any aspect of the sustainable financing package and the legislative developments discussed in this article, please reach out to our Regulatory team.

Related Professionals

- **John Verwey**
  Partner
- **Michael Singh**
  Associate