

UK and EU Sustainable Finance Regulation: Taking Stock with Change on the Horizon

September 12, 2023

Both opportunities and challenges have arisen for the asset management industry as a result of the rapid introduction of UK and EU sustainable finance regulation in recent years. The new requirements have been heightened in complexity due to the piecemeal official guidance provided, jurisdictional “gold-plating” of expectations, the start of greenwashing enforcement and litigation cases, and the sheer volume of legislation and regulation itself.

With a brief pause before further significant movement in this space is expected in Q3 and Q4 2023, Proskauer’s UK Regulatory team explores some actions and considerations for now, whilst also setting out some of the legal and regulatory changes on the horizon. Please refer to our previous horizon scanning article [here](#).

EU Sustainable Finance Disclosure Regulation (SFDR)

Current
considerations

Closed-ended funds: For closed-ended funds classified as Article 8 or 9 under SFDR, there remains an ongoing obligation to provide website and periodic reporting in compliance with the SFDR Regulatory Technical Standards (SFDR Level 2), with effect from 1 January 2023 (which we wrote about [here](#)). Where no SFDR Level 2 pre-contractual disclosure is in place, there can be additional challenges in meeting these disclosure requirements. SFDR Level 2 often drives practical actions, policies and procedures that are implemented in the investment lifecycle. With no SFDR Level 2 pre-contractual disclosure triggering certain SFDR Level 2 concepts and considerations, there can be gaps when it comes to making the SFDR Level 2 periodic reports in particular. We recommend that for any closed-ended funds in this situation, the SFDR Level 2 periodic reporting template is reviewed in good time ahead of publication.

New strategies: Guidance from the European Commission, European Securities and Markets Authority (ESMA) and local regulators, has consistently moved the needle on key areas such as good governance and principal adverse impacts. As such, there may be additional considerations for new strategies to meet the current regulatory and market expectations, in comparison to previous strategies. We recommend care is taken in any reliance on disclosures and approaches from previous funds.

Future
developments

The European Supervisory Authorities (ESAs) have consulted on significant changes to SFDR, in particular on:

1. principal adverse impacts (PAIs) with new social PAI indicators, inclusion of value chain information and derivative calculations;
2. the do no significant harm (DNSH) test for sustainable investments and whether to maintain the status quo, require further, more specific disclosures, or add in a safe harbour for certain Taxonomy-aligned investments – meaning no further DNSH SFDR disclosures are required;
3. whether further additional disclosures should be included where a strategy commits to greenhouse gas (GHG) emissions targets; and
4. updates to the template disclosures with a new “dashboard” to highlight all the critical information required in one place. The deadline for responses was 4 July 2023.

There is no set timeline committed to for this consultation, although the updated rules are currently expected to be published in Q4 2023 / Q1 2024.

A political decision has reportedly been reached to carry out a comprehensive review of SFDR. This includes consulting on the very nature of SFDR as a disclosure and transparency regime, rather than as a labelling regime (which it has de facto become). The consultation is also set to review SFDR’s interaction with other sustainable legislation and regulation. We are expecting the consultation to be launched in September 2023 and will provide an update once it is published.

Current considerations

The EU Taxonomy Regulation is complex, particularly with the technical screening criteria that must be followed for any Taxonomy-aligned investment. Many firms focused on SFDR Level 2 compliance for 1 January 2023, parking analysis of the EU Taxonomy Regulation. Now could be the time to re-explore any appetite for Taxonomy-alignment moving forward, particularly as it is expanding to cover further sectors and activities as set out below.

Future developments

The EU Taxonomy Regulation is expanding to include technical screening criteria for the remaining four environmental objectives not yet covered:

1. sustainable use and protection of water and marine resources;
2. transition to a circular economy;
3. pollution prevention; and
4. control and protection and restoration of biodiversity and ecosystems.

There are also amended / new sectors and activities for the existing “climate change mitigation” and “climate change adaptation” objectives covering, for example, aviation, construction and manufacturing.

The expansion, with effect from 1 January 2024, could present an opportunity for some to explore Taxonomy-alignment for investments based on these new activities and sectors.

Current
considerations

As discussed in our update [here](#), certain UK authorised firms are required to make TCFD reports at both entity and product level. To recap, as well as covering asset managers more typically considered under that term, such as AIFMs, the FCA's ESG Sourcebook also captures portfolio managers and firms which carry on private equity or other private market activities. The latter consists of either advising on investments on a recurring or ongoing basis, in connection with an arrangement the predominant purpose of which is investment in unlisted securities (this could include a UK authorised firm that provides investment advice to a fund manager).

We are significantly into the reporting period for the second phase of in-scope firms with assets under management greater than £5 billion, but less than £50 billion (such threshold to be reviewed after three years of disclosures). The reports for this calendar year of 2023 will need to be made by 30 June 2024. We recommend any in-scope firms that have not recently reviewed their obligations and progress towards being able to report, do so as a priority.

There is also a mechanism where in-scope firms of the ESG Sourcebook can make on-demand requests for data to support them with making their TCFD disclosures, for example, where the in-scope firm has delegated portfolio management to another UK regulated firm. In this case it could be that the UK regulated firm that has the demand placed on them is outside of the ESG Sourcebook requirements directly, but is brought within its remit via the demand, and they may not be prepared to comply with the request. Whether intending to make an "on-demand request" or potentially being the recipient of one, one avenue to achieve certainty can be to contractually agree the data to be provided, including any methodologies and timing.

In addition, an investor in an unauthorised AIF managed by a UK AIFM may also make an on-demand request.

Future
developments

The UK's Sustainability Disclosure Requirements (SDR) covering labelling, disclosure and anti-greenwashing rules for UK regulated entities and funds are delayed, with the UK Financial Conduct Authority (FCA) stating that they intend to publish them in Q4 2023.

The anti-greenwashing rule is expected to apply to all FCA-regulated firms and apply from the date of the SDR Policy Statement (with the disclosure and labelling rules expected to be phased in over time).

The new anti-greenwashing rule is to set out that sustainability-related claims should be clear, fair and not misleading and consistent with the sustainability profile of products or services provided. UK regulated firms are recommended to consider their marketing procedures and internal governance with regards to sustainability claims to help minimise the risk of greenwashing claims, particularly in the context of this new regulatory rule.

We are expecting some significant changes to the SDR consulted on in terms of disclosure requirements and labels but consider it unlikely that overseas managers and funds will be brought into scope initially. We also expect the requirements to remain lighter where there are no retail investors. Nevertheless, where there is a UK regulated entity or fund within a structure, SDR will need to be carefully reviewed once published and we will publish an update at the relevant time.

On 1 September 2023, the Green Technical Advisory Group (GTAG) published its latest papers on the development of a UK Taxonomy. GTAG is advising the UK government on options for the UK Taxonomy and making recommendations for the shape it should take. Some of the headlines from GTAG's recent papers include:

1. a need to implement a UK Taxonomy of some form on "green" economic activities as soon as possible as the timetable is already significantly delayed - with the UK Taxonomy covering transition and harmful activities at a later stage;
2. setting out that the EU Taxonomy is generally a "good fit" for the UK and that there would be limited benefit from significant divergence which, if followed through, will support

EU AIFMD/EU MiFID

Current consideration

Sustainability-related updates to EU AIFMD and EU MiFID (but not UK AIFMD or UK MiFID) took effect from 1 August 2022 last year. Where there is an EU AIFM or entity captured by EU MiFID in a structure, there could be additional sustainability-related considerations. For example, EU AIFMs are required under the updated legislation to consider sustainability risks in the selection and ongoing monitoring of investments, as well as in risk management processes, and will need to document this. There may be analysis needed within delegation models where some parties are, and others are not, within scope of EU AIFMD or EU MiFID to ensure all parties agree the expected approaches to sustainability factors and/or risks.

Litigation and regulatory enforcement risk

Current
consideration

A common theme of most regulatory enforcement cases has been that there is a disjunct between marketing materials and underlying fund documentation, in terms of sustainability claims and commitments. With the imminent introduction of the FCA's anti-greenwashing rule in the UK, that in its draft form is focused on consistency in claims and the sustainability profile of financial products, and ESMA having consulted on sustainable/ESG-related fund names and requirements, a review of marketing procedures to ensure alignment with fund documentation and to help mitigate greenwashing enforcement is strongly recommended.

The disclosures triggered by the myriad of EU and UK regulations, which are continuously evolving, form a source of material that can be used in litigation claims against asset managers. In the UK this may include misrepresentation or mis-selling claims, as examples. Firms should consider analysing their risk of potential greenwashing-related claims and any subsequent mitigating actions that can be taken. The majority of the mitigating actions are rooted in the applicability and implementation of the regulatory requirements in organisations and at fund level.

Please note that we have not covered sustainability corporate reporting developments as set out in the EU's Corporate Sustainability Reporting Directive and Corporate Sustainability Due Diligence Directive, or in the ISSB's proposed standards (which the UK is likely to adopt). However, these developments may also be relevant.

Overall, asset managers and advisers may wish to refresh on the areas above to ensure they are aware of the current status, applicability and approach for existing regulatory sustainable finance requirements, as well as support readiness for the regulatory developments in the pipeline.

For further information, please reach out to UKRegulatory@proskauer.com

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