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EU SFDR: ESAs publish revised draft RTS on Taxonomy alignment disclosures

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On Friday 22 October 2021, the European Supervisory Authorities (ESAs) (i.e. ESMA, EBA and EIOPA) published a revised draft of the Regulatory Technical Standards (RTS) under the Sustainable Finance Disclosure Regulation (SFDR) regarding Taxonomy alignment disclosures (following on from their consultation paper in March 2021). The ESAs' final report can be accessed here and the press release here.

By way of recap, the Taxonomy alignment RTS amends the SFDR RTS by inserting Taxonomy alignment disclosures in the SFDR pre-contractual, periodic and website disclosures. The ESAs' final report also contains the latest consolidated version of the SFDR RTS (which however is still being reviewed at an EU level). Overall, the amendments are very much Taxonomy focused so that most of industry questions relating to the SFDR are still open (see here and here).

Although the draft consolidated SFDR RTS in the final report has a 1 January 2022 effective date, the **application date** of the SFDR has been **delayed to 1 July 2022** (as previously indicated by the Commission). Accordingly, firms only have to make Level 1 compliant SFDR disclosures and (starting from 1 January 2022) Level 1 compliant Taxonomy alignment disclosures until 1 July 2022 (from when the Level 2 rules will kick in).

Key changes

In terms of the key changes made to the RTS:

- **SFDR and Taxonomy sustainable investment / DNSH tests will apply cumulatively:** In a significant change from the March consultation paper, the ESAs have now decided that a Taxonomy-aligned investment will no longer automatically be an SFDR compliant "sustainable investment". That is, financial market participants (FMPs) will need to additionally apply the SFDR principal adverse indicators (PAI) based 'do no significant harm' (DNSH) test to any investments in Taxonomy-aligned economic activities, if they want to badge them as SFDR sustainable investments.

  This is a key change, as previously many FMPs were hoping to just rely on the Taxonomy alignment disclosures of investee companies to create Article 9 products/Article 8 products with sustainable investments ("**Article 8+ products**") under the SFDR. Whereas now they will have to apply an SFDR DNSH assessment framework (based on PAIs) on top and interrogate the economic activities of the investee companies as a whole to conclude that they amount to SFDR "sustainable investments".
- **Product qualification / structuring:** For both Article 9 and Article 8+ products, despite industry push back, the regulator seems to require a binding statement on asset allocation and the minimum share of sustainable investments. According to the regulator disclosing "planned" asset allocation risks resulting in greenwashing.
- **Multiple Taxonomy alignment disclosures:** FMPs with Article 9 / Article 8+ products will have to make multiple Taxonomy alignment disclosures:
  - <u>distinguishing sovereign disclosures:</u> FMPs will need to show two sets of Taxonomy alignment disclosures in all cases (see sub-bullets below) - one for all investments including sovereign debt and one for all investments excluding sovereign debt (i.e. sovereign debt is excluded from numerator and denominator). This change is to address the concern that products with high sovereign exposures could be regarded as having low Taxonomy alignment figures because of the

lack of a reliable methodology to determine Taxonomy alignment for sovereign exposures.

- pre-contractual disclosures (potentially x2 alignment disclosures because of sovereign split): FMPs must show Taxonomy alignment graphically by selecting one key performance indicator (KPI) for non-financial investee companies (with turnover being the default KPI, but FMPs can use capex or opex instead, provided they can demonstrate that capex / opex would give a more representative calculation of Taxonomy alignment) and for financial investee companies, by using the KPIs prescribed for financial institutions under Article 8 of the Taxonomy Regulation;
- periodic disclosures (potentially x6 alignment disclosures because of sovereign split): FMPs must show a graphical representation of Taxonomy alignment against all three KPIs of non-financial investee companies (i.e. turnover, capex and opex) and, for financial investee companies, by using the KPIs prescribed for financial institutions under Article 8 of the Taxonomy Regulation;
- breakdown between enabling and transitional activities: as was the case previously, firms need to supplement their Taxonomy alignment disclosures by showing a further split between enabling and transitional activities under the Taxonomy Regulation – however now these will need to be shown across the multiple disclosures noted above;
- derivatives: the ESAs have now decided that derivatives should not be included in the numerator when assessing Taxonomy alignment. This will be an unhelpful development for financial products that gain exposure to Taxonomy aligned investments through swaps, CFDs, etc;
- netting: calculations should be netted for the purposes of reporting the share of investments in taxonomy-aligned economic activities by applying the methodology used to calculate net short positions laid down in Article 3, paragraphs 4 and 5 of the SSR (i.e. Regulation (EU) No 236/2012); and
- external assurance: despite industry push back, the ESAs have not dropped the requirement for FMPs to disclose whether their Taxonomy alignment disclosures will be / have been subject to an assurance review by an auditor or other third party, and if yes, they must name the auditor / third-party. Note: there is not however a requirement for firms to have this review/assurance done – they just need to disclose where they will (for pre-contractual disclosures) / have had it done (for periodic disclosures).

› **Social:** For Article 9 and Article 8+ products that make social SFDR “sustainable investments” – they must now separately disclose the minimum share of social sustainable investments within the product.

› **Reliance on third-party data:** Recital 6 of the revised RTS indicates that FMPs should in the first instance rely on Taxonomy alignment disclosures made by financial/non-financial undertakings that are subject to Taxonomy alignment disclosures under Article 8 of the Taxonomy Regulation and the upcoming Corporate Sustainability Reporting Directive (CSRD) rules (which will not be available in the market until 2023 at the earliest). However, where these disclosures are not available, FMPs can source data directly from investee companies or from third parties “in each case provided the information is equivalent” to that required under Article 8 of the Taxonomy Regulation and the upcoming CSRD rules. Given the significant data gaps and small population of entities that will be subject to the Article 8 Taxonomy disclosure requirements, “equivalent” seems like a very high standard.

› **Templates:** New pre-contractual and periodic SFDR templates for product disclosures (including the above Taxonomy related disclosures) have been provided in the RTS. The Taxonomy portions have changed significantly (as summarised above) but there have also been changes to some of the SFDR sections (e.g. certain sections have been moved around). We would recommend that firms use these templates when thinking about their Level 2 compliant disclosures.

Next steps

The European Commission now has three months to decide whether to adopt the RTS. Following adoption by the Commission, the European Parliament and Council will have three months (which can be extended by a further three months upon their request) to scrutinise the RTs. If the Parliament and Council raise no objections, the RTS will then be published in the Official Journal of the EU.

The Commission has indicated that it aims to adopt the RTS **by the end of December 2021**.

For more information on the SFDR, Taxonomy Regulation and CSRD, see the Linklaters Sustainable Finance survival guide.

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