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The EU Sustainability-Related Disclosures Regulation (SFDR): *What's relevant for UCITS managers and AIFMs?*

One aim of the EU Action Plan on Sustainable Finance is to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth in line with UN sustainable development goals.

Under the action plan, several measures are being introduced to encourage financial market participants to mainstream sustainability into risk management and take into account environmental, social and governance (ESG) factors.

The SFDR is just one of those measures. It impacts the investment funds, insurance and pensions sectors; this briefing considers its applicability to the investment funds sector in particular.

Who is in scope?

Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) applies to, and imposes different disclosure obligations, on:

1. **Financial market participants** including AIFMs, UCITS managers and investment firms providing portfolio management as defined in MiFID II. UCITS managers includes self-managed UCITS.
2. **Financial advisers** including AIFMs and UCITS managers providing individual portfolio management services in accordance with the AIFM Directive and UCITS Directive respectively and investment firms providing investment advice.
3. **Financial products** including UCITS and AIFs.

The SFDR can also apply to non-EU asset managers. For example, the manager of a non-EU AIF marketed in the EU on a private placement basis under the National Private Placement Regime will be in scope for certain aspects of the SFDR. If you are a non-EU asset manager with European-marketed funds or clients, you should seek advice on the specific requirements of the SFDR that might apply to you and your funds.

Timing

Level 1 SFDR applies from	Published in the Official Journal	Entry into force	Consultation Paper issued by ESAs	Consultation Period ended	Deadline for RTS
10 March 2021 except the transparency requirements for annual reports which apply from 1 January 2022	9 December 2019	29 December 2019	23 April 2020	1 September 2020	Six of the seven RTS to be delivered by 30 December 2020. This deadline has been delayed until a not-yet specified date. However, it will still be necessary for fund managers to comply with the Level 1 SFDR in full, as from the original compliance date of 10 March 2021. The remaining one is to be delivered by 30 December 2021

Background

The purpose of the SFDR is to provide harmonised rules on transparency with regard to the integration of 'sustainability risks' and the consideration of adverse sustainability impacts and the provision of sustainability-related information with respect to financial products.

All UCITS managers and AIFMs are impacted by disclosure obligations under the SFDR requirements in relation to sustainability risks. There will be additional disclosure obligations on those managing funds with sustainable ESG objectives or an ESG focus. These are outlined below.

We have inluded some key definitions at the end of this briefing.

ESG-focused Funds

In addition to the 'sustainability risks' requirements that apply to all fund managers, the SFDR sets out requirements that apply to certain types of funds with an ESG focus, including:

1. **ESG Labelled Funds:** Investment funds that promote environmental or social characteristics. Also called light green funds.
2. **Sustainable Funds:** Investment funds with sustainable investment as its objective, which may or may not have a reference benchmark index. Also called dark green funds.
3. **Carbon Reduction Funds:** Investment funds with reduction in carbon emissions as its objective.

The Disclosures

There are three key elements of the SFDR that fund managers will need to consider:

1. Website disclosures
2. Offering documentation disclosures
3. Annual report disclosures

Website disclosures

Financial market participants, such as AIFMs and UCITS managers must publish on their websites:

- information about their policies on the integration of sustainability risks in its investment decisions
- information about the fund manager's due diligence policies with respect to the adverse impacts of investment decisions on 'sustainability factors', or where they do not consider such impacts, clear reasons why. Financial market participants with more than 500 employees have more inflexible obligations in this context.
- information about how the fund manager's remuneration policies are consistent with the integration of sustainability risks. This information must also be included in the policies themselves.

In addition to the above, for each ESG-focused fund managed, fund managers must publish and maintain on their website a description of that fund's environmental or social characteristics, or the sustainable investment objective and how this is measured, as well as the information required in relevant offering documentation and in the annual reports.

Offering documentation disclosures

Fund managers must include in a prospectus, a description of how the fund manager integrates sustainability risks in its investment decisions, and the likely impacts of sustainability risks on funds they manage. Where sustainability risks are not considered relevant, a clear and concise explanation why must be included.

A fund manager must also include certain additional information where it manages ESG-focused funds:

- ESG Labelled Funds: fund managers must include information on how its ESG characteristics are met, and, where an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics
- Sustainable Funds: fund managers must include information on how the designated index is aligned with the sustainable investment objective and an explanation as to why and how the index differs from a broad market index. Where no index has been designated, the fund manager must include an explanation on how the sustainable investment objective is to be obtained
- Carbon Reduction Funds: fund managers must include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement

Annual report disclosures

Where a fund manager manages any ESG-focused funds, it must also provide detail in its annual report of how the relevant ESG objectives of those funds are being met.

Regulatory Technical Standards

The three European Supervisory Authorities (which are ESMA, the EBA and EIOPA, collectively the ESAs) were tasked with drafting implementing regulatory technical standards (**RTS**) prior to the date on which the obligations under the SFDR take effect. The RTS will provide for the implementation of the SFDR Level 2 measures.

The ESAs consultation on the draft RTS (discussed in detail here) closed on 1 September 2020.

The ESAs also issued mock-up prospectus and financial statement disclosure templates on 21 September 2020 asking for feedback in the form of a survey. These templates were helpful in focussing people's minds on fund classification and what is required to update a prospectus.

In October 2020, the European Commission announced that the RTS would be delayed to 'a later stage'. Nevertheless, the SFDR will apply from 10 March 2021 without the benefit of the RTS.

The Broader EU ESG Package

The SFDR forms part of a broader package of legislation being introduced by the European Commission as part of its Action Plan on Sustainable Finance released on 7 March 2018. This package also includes:

1. Regulation (EU) 2019/2089 amending the 2011 Benchmarks Regulation as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (**Benchmarks Regulation**)
2. Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment (**Taxonomy Regulation**)
3. Proposal for a Delegated Regulation amending MIFID II (Delegated Regulation (EU) 2017/565) to integrate ESG considerations and preferences into investment advice and portfolio management (**MiFID ESG Regulation**)

The SFDR is also supplemented by delegated acts, or Level 2 provisions, amending the UCITS Directive AIFMD regarding the sustainability risks and sustainability factors to be taken into account for UCITS and AIFMs. These were published on 8 June 2020 for consultation until 6 July 2020.

The proposed amendments under the delegated directive for UCITS and the delegated regulation for AIFMs set out definitions of sustainability risks and sustainability factors by reference to those definitions in the SFDR. You can read our publication on this here.

For an overview of ESG-related policy, regulatory and legislative developments at EU level and their relevance for the asset management and investment funds sector, see our June 2020 publication here.

Next steps

UCITS managers and AIFMs should become familiar with the requirements of the SFDR to understand how it might affect website, pre-contractual and ongoing disclosures made or required to be made in relation to UCITS and AIFs it manages. This applies even to those who are NOT managing financial products with sustainable or ESG objectives, policies or strategies.

The SFDR applies from 10 March 2021.

UCITS managers and AIFMs should also take account of the ESA consultation and continue to stay tuned to ESG-related industry work. It will be particularly important to understand the implications of implementing the SFDR requirements without the additional detail of the delayed RTS.

For more information

For more information in relation to this topic please contact your usual contact on the A&L Goodbody Asset Management & Investment Funds team.

Key Definitions

- **Financial market participants**: means insurance undertakings providing Insurance Based Investment Products (IBIPs); investment firms providing portfolio management (as defined in MiFID II); institutions for occupational retirement provision (IORP); manufacturers of pension products; AIFMs; PEPP providers; managers of qualifying venture capital funds; managers of qualifying social entrepreneurship funds, UCITS managers; and credit institutions which provide portfolio management.
- **Financial advisers**: means insurance intermediaries or insurance undertakings providing insurance advice in relation to IBIPs; credit institutions providing investment advice; investment firms providing investment advice; AIFMs authorised to provide individual portfolio management (**IPM**) services that also provide investment advice in accordance with AIFMD; UCITS managers authorised to provide IPM services that also provide investment advice in accordance with the UCITS Directive.
- **Financial product**: means:
  - a portfolio managed in accordance with MiFID II
  - an alternative investment fund (AIF)
  - an IBIP
  - a pension product
  - a pension scheme
  - a UCITS
  - a PEPP
- **Sustainability risk**: means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.
- **Sustainability factors**: means environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
- **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
  - 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.

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