

# EU Sustainable Finance Framework Takes Shape for Private Fund Managers

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*"As our planet increasingly faces the unpredictable consequences of climate change and resource depletion, urgent action is needed to adapt to a more sustainable model... To achieve more sustainable growth, everyone in society must play a role. The financial system is no exception. Re-orienting private capital to more sustainable investments requires a comprehensive rethinking of how our financial system works. This is necessary if the EU is to develop more sustainable economic growth, ensure the stability of the financial system, and foster more transparency and long-termism in the economy."* (Press release, European Commission: Sustainable Finance: Commission's Action Plan for a greener and cleaner economy (8 March 2018)).

The European Commission's Sustainable Finance Action Plan<sup>[1]</sup> (the "**Action Plan**") proposed a package of measures including, amongst other initiatives, a regulation imposing sustainability-related disclosures on financial market participants ("**SFDR**"<sup>[2]</sup>) and a regulation to establish an EU-wide common language (or taxonomy) to identify the extent to which economic activities can be considered sustainable (the "**Taxonomy Regulation**"<sup>[3]</sup>). This briefing note provides an overview of the Taxonomy Regulation and the SFDR and discusses their impact on private fund managers, including non-EU managers who market their funds into the EU and/or the United Kingdom under the applicable national private placement regimes.

Each of the Taxonomy Regulation and the SFDR apply to "financial market participants", a term which is broadly defined and includes (amongst others): (i) alternative investment fund managers ("**AIFMs**"); and (ii) MiFID<sup>[4]</sup> investment firms that provide portfolio management services, and to "financial products" made available by them. "Financial products" include (amongst other things) alternative investment funds ("**AIFs**") managed by AIFMs and portfolios managed by MiFID firms.

The term "financial market participant" clearly includes AIFMs which are authorised under the AIFMD<sup>[5]</sup>. There is a lack of clarity for non-EU AIFMs in the text of both pieces of legislation. However, according to guidance on the Taxonomy Regulation, the disclosure requirements on financial market participants, which build on the obligations in the SFDR should "apply to anyone offering financial products in the European Union, regardless of where the manufacturer of such products is based". Consequently, it is clear that the disclosure obligations will apply to non-EU AIFMs that market their AIFs into the EEA (and the UK) pursuant to the national private placement regimes under Article 42 of the AIFMD.

## SUSTAINABLE FINANCE DISCLOSURE REGULATION

The aim of the SFDR is to introduce harmonised requirements in relation to the disclosures to end investors on the integration of sustainability risks, on the consideration of adverse sustainability impacts, on sustainable investment objectives or on the promotion of environmental and/or social characteristics, in investment decision-making.

Many of the framework requirements under the SFDR will apply from 10 March 2021, although some of the requirements for funds with sustainable investment as an objective or which promote environmental and/or social characteristics will come into force on 1 January 2022 and 1 January 2023. In addition to the framework requirements, the SFDR is to be supplemented by more detailed requirements set out in the regulatory technical standards (“RTS”) which are yet to be finalised. The RTS should have applied from 10 March 2021. However, the European Commission has recently, in a letter addressed to certain trade associations, confirmed that there will be a delay in the application of the RTS requirements, although no date has yet been announced for their future application (there is some expectation that the application date will be closer to 1 January 2022).

The European Commission has, however, made clear that all of the requirements and general principles contained in the SFDR itself will remain applicable to firms from 10 March 2021. Fund managers are, therefore, expected to take a principles-based approach to compliance with the SFDR and evidence this on a best efforts basis. It is considered by the European Commission that firms are already likely complying with certain product-level disclosure requirements as a result of existing sectoral legislation. This seems, however, to be an overly optimistic view, as (for example) much of the sectoral legislation does not go into the level of prescription set out in the SFDR.

The disclosures required by the SFDR include both manager-level disclosures (i.e. at the level of the AIFM or MiFID investment firm) and also product-level disclosures (i.e. at the level of the AIF or portfolio). The disclosures must be made in pre-contractual information to investors, in periodic investor reporting and publicly on the manager’s website. Importantly, the SFDR does not apply only to managers of AIFs or portfolios with a sustainable investment objective or promoting environmental and/or social characteristics. While there are enhanced disclosures for such AIFs/portfolios, the SFDR requires disclosures to be made by all in-scope “financial market participants”.

## ***Manager-level disclosures***

At the level of the manager, a financial market participant must disclose the following:

- *Information on its website about its policies on the integration of sustainability risks into its investment decision-making processes* - in order to comply, managers will need to ensure that they integrate an assessment of not only all relevant financial risks, but also all relevant sustainability risks that may have a material negative impact on the financial return of investments made, into their due diligence processes<sup>[6]</sup>. This will require firms to review all relevant investment decision-making processes and policies in order to understand how sustainability risks are currently integrated (if at all).
- *Information on its website regarding its consideration (or not) of principal adverse impacts of investment decisions on sustainability factors* - firms will need to make a commercial decision on whether or not they will consider the principal adverse impacts of investment decisions on sustainability factors. To the extent that a firm decides to consider such impacts, it will be required to publish a statement on its website on its due diligence policies with respect to those impacts. Those firms who choose not to consider adverse impacts of investment decisions on sustainability factors will be required to publish and maintain on their websites clear reasons for why they do not do so, including (where relevant) information as to whether and when they intend to consider such adverse impacts.<sup>[7]</sup>
- *Information in remuneration policy and on its website as to how its remuneration policy is consistent with the integration of sustainability risks* – firms will be required to revisit their existing remuneration policies and include in those policies and on their websites information on how the remuneration policies promote sound and effective risk management with respect to sustainability risks and how the structure of remuneration does not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance.

## ***Product-level disclosures***

At the level of each AIF/portfolio (regardless of whether the AIF/portfolio has a sustainable investment objective or promotes environmental and/or social characteristics), the following must be disclosed:

- *Information in pre-contractual disclosures to investors about the manner in which sustainability risks are integrated into investment decision-making and the likely impacts of sustainability risks on the returns of the AIF/portfolio* – a financial market participant may decide at product-level that sustainability risks are not relevant to the particular AIF/portfolio. In such case, clear reasons must be given as to why they are not relevant.
- *Information in pre-contractual disclosures to investors as to whether and how the particular AIF/portfolio considers principal adverse impacts on sustainability factors* (by 30 December 2022) – a financial market participant may decide not to consider principal adverse impacts of their investment decisions on sustainability factors at the level of the AIF/portfolio. In which case, clear reasons must be provided as to why they are not taken into account.
- *Information in periodic reports on principal adverse impacts on sustainability factors* (from 1 January 2022).

For an AIFM, the pre-contractual disclosures mean the disclosures which an AIFM is required to make to investors before they invest in an AIF pursuant to Article 23 of the AIFMD and the periodic reports mean the annual report which is required to be produced pursuant to Article 22 of the AIFMD. In the context of a MiFID investment firm, the pre-contractual disclosures mean the information that is required to be provided to a client before providing services pursuant to Article 24(4) of MiFID. The periodic reports for MiFID firms refer to the reports required to be provided to clients pursuant to Article 25(6) of MiFID.

## ***Disclosures for sustainable products***

The SFDR identifies that products with “various degrees of ambition” have been developed to date. Therefore, the SFDR draws a distinction between financial products which have a sustainable investment objective and those which promote environmental and/or social characteristics. Different disclosure requirements apply to each.

### ***Products promoting environmental and/or social characteristics***

In relation to financial products promoting environmental and/or social characteristics (provided that the investee companies in which investments are to be made follow good governance practices<sup>[8]</sup>) (“**Article 8 AIFs/portfolios**”), the following must be disclosed at product level in the investor pre-contractual disclosures:

- information on how those characteristics are met;
- where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics; and
- information as to where the index can be found.

Information is also required in the periodic reports for the AIF/portfolio on the extent to which the environmental or social characteristics are met. As this information relates to complete financial years, this requirement will apply from 1 January 2022.

In addition, this information must be published and maintained on the manager's website together with information on the methodologies used to assess, measure and monitor the environmental and/or social characteristics, including data sources, screening criteria for the underlying assets and the relevant sustainability factors used to measure the

environmental or social characteristics.

## *Products with a sustainable investment objective*

In the case of an AIF/portfolio with a sustainable investment objective (“**Article 9 AIFs/portfolios**”) where an index has been designated as a reference benchmark, product-level pre-contractual disclosures must include:

- information on how the designated index is aligned with the investment objective; and
- an explanation as to why and how the designated index aligned with the objective differs from a broad market index.

Where no index has been designated, pre-contractual disclosures will include an explanation of how the sustainable investment objective is to be attained. Where the AIF/portfolio has a reduction in carbon emissions as its objective, the information to be disclosed must include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

Information is also required to be disclosed in the periodic reports for the AIF/portfolio on: (i) the overall sustainability-related impact of the AIF/portfolio by means of relevant sustainability indicators; and (ii) where an index is designated as a reference benchmark, a comparison between the overall sustainability-related impact with the impacts of the designated index and of a broad market index through sustainability indicators.

In addition, this information must be published and maintained on the manager’s website together with information on the methodologies used to assess, measure and monitor the impact of the sustainable investments selected for the AIF/portfolio, including data sources, screening criteria for the underlying assets and the relevant sustainability factors used to measure the environmental or social characteristics.

## **TAXONOMY REGULATION**

The Taxonomy Regulation establishes an EU-wide classification system to provide a common language (i.e. taxonomy) to define environmentally sustainable economic activities. It also sets out six environmental objectives, including climate change mitigation, climate change adaption and transition to a circular economy and provides that for an economic activity to be environmentally sustainable it must make a “substantial contribution” to at least one of the environmental objectives and not cause any significant harm to any of the others.

The Taxonomy Regulation also amends the SFDR in certain respects as regards disclosures required for financial products that have a sustainable investment objective or promote environmental characteristics and requires negative disclosure for those AIFs/portfolios which do not have such objectives/characteristics.

An economic activity is considered to be environmentally sustainable for the purposes of the Taxonomy Regulation if:

- 1) it makes a “substantial contribution” to one or more of the six environmental objectives;
- 2) it does “no significant harm” to any of the six environmental objectives;
- 3) it is carried out in accordance with certain minimum safeguards<sup>[9]</sup>; and
- 4) it complies with technical screening criteria<sup>[10]</sup>.

The six environmental objectives are:

- climate change mitigation;
- climate change adaptation;
- 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.

The Annex to this alert provides an overview of what “substantial contribution” and “significant harm” means for each of the six environmental objectives.

## ***Amendments to the SFDR***

The Taxonomy Regulation makes certain amendments to the SFDR in relation to the pre-contractual and periodic reporting requirements for Article 8 AIFs/portfolios and Article 9 AIFs/portfolios where they invest in an economic activity that contributes to one or more of the environmental objectives set out in the Taxonomy Regulation. Additional pre-contractual and periodic disclosures are required for such products, including: information on the environmental objective(s) which is contributed to and a description of how and to what extent the investments are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

The Taxonomy Regulation also makes changes for other financial products too which are neither an Article 8 AIF/portfolio or Article 9 AIF/portfolio by requiring a negative disclosure using the following words: “The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.”

The amendments made to the SFDR by the Taxonomy Regulation will apply from 1 January 2022 in some cases and 1 January 2023 in others, depending on which environmental objective is contributed to by the AIF/portfolio.

## **BREXIT: IMPACT IN THE UK**

The UK left the EU in January 2020 and the agreed transition period will expire on 31 December 2020. As the disclosure obligations under the SFDR and the Taxonomy Regulation will not apply until after the end of the transition period, they do not form part of the so-called “retained EU law” in the UK from 1 January 2021. In relation to the Taxonomy Regulation, for example, the UK government has stated that it will retain the taxonomy framework, including the high level environmental objectives, however the Regulation’s disclosure requirements will not form part of this (given that they are set to apply as from a date post-transition period). As the delegated legislation containing the technical standards has not, so far, been published by the European Commission, the government has not yet been in a position to comment as to the extent of the UK’s alignment with the EU on this after the transition period<sup>[11]</sup>.

Also, with regard to the SFDR, the Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020 provide that the SFDR will continue to apply in part in the UK when the Brexit transition period ends, with key omissions relating, for example, to the upcoming technical standards and financial product-specific disclosure requirements.

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## **ANNEX**

Climate change mitigation	The process of holding the	Significant greenhouse gas
	increase in the global average	emissions.

<sup>[12]</sup>

	<p>temperature to below 2°C and pursuing efforts to limit it to 1.5°C above pre-industrial levels, as set out in the Paris Agreement. The economic activity will substantially contribute to the stabilisation of greenhouse gas concentrations in the atmosphere, including through process or product innovation by, for example:</p> <ul style="list-style-type: none"><li>• improving energy efficiency;</li><li>• increasing clean or climate neutral mobility; or</li><li>• establishing energy infrastructure that enables the decarbonisation of energy systems.</li></ul>	
Climate change adaptation	<p>The process of adjustment to actual and expected climate change and its impacts. Broadly, this includes substantially reducing the risk of the adverse impact, or substantially reducing the adverse impact, of the current and expected future climate on (i) other people, nature or assets; or (ii) the economic activity itself, in each case without increasing the risk of an adverse impact on other people, nature and assets.</p>	<p>An increased adverse impact of the current and expected climate on people, nature and assets.</p>
Sustainable use and protection of water and marine resources	<p>The activity substantially contributes to achieving the good status of water bodies or marine resources, or to preventing their deterioration, through certain means, including, for example, through improving water management and efficiency.</p>	<p>Detriment to the good status, or where relevant the good ecological potential, of water bodies, including surface waters and groundwaters, or to the good environmental status of marine waters.</p>
Transition to a circular economy	<p>Maintaining the value of products, materials and other resources in the economy for as long as possible, enhancing their efficient use in production and consumption. The activity substantially contributes to the circular economy by (among other things):</p>	<ul style="list-style-type: none"><li>• Significant inefficiencies in the use of materials and the direct or indirect use of natural resources such as non-renewable energy sources, raw materials, water and land in one or more stages of the life-cycle</li></ul>

	<ul style="list-style-type: none"><li>• improving the efficiency in the use of natural resources;</li><li>• increasing the recyclability of products; and</li><li>• preventing or reducing waste generation.</li></ul>	<ul style="list-style-type: none"><li>of products, including in terms of durability, reparability, upgradability, reusability or recyclability of products.</li><li>• Significant increase in the generation, incineration or disposal of waste, with the exception of incineration of non-recyclable hazardous waste.</li><li>• Where long term disposal of waste may cause significant and long-term harm to the environment.</li></ul>
Pollution prevention and control	The economic activity will substantially contribute to the protection and restoration of biodiversity and ecosystems by, for example, sustainable agricultural practices, sustainable forest management and nature and biodiversity conservation.	Detriment to a significant extent to the good condition and resilience of ecosystems or where that activity is detrimental to the conservation status of habitats and species, including those of community interest.
Protection and restoration of biodiversity and ecosystems	The economic activity will substantially contribute to the protection and restoration of biodiversity and ecosystems by, for example, sustainable agricultural practices, sustainable forest management and nature and biodiversity conservation.	Detriment to a significant extent to the good condition and resilience of ecosystems or where that activity is detrimental to the conservation status of habitats and species, including those of community interest.

[1] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions - Action Plan: Financing Sustainable Growth, 8 March 2018

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

[3] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[4] Markets in Financial Instruments Directive (Directive 2014/65/EU)

[5] Alternative Investment Fund Managers Directive (Directive 2011/61/EU)

[6] Recital 12 SFDR.



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[7] Note that large financial market participants (broadly, those with an average number of 500 employees during the financial year) will not have the option. From 30 June 2021 they must consider adverse impacts of their investment decisions on sustainability factors.

[8] “Good governance practices” is not defined in the SFDR. It is clear from the text that the European legislators intended it to be interpreted widely. Examples of good governance practices include: sound management structures, employee relations, remuneration of staff and tax compliance.

[9] OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

[10] These technical screening criteria will be established by the European Commission in accordance with the provisions of the Taxonomy Regulation.

[11] Letter from John Glen, Economic Secretary to the Treasury, to Sir William Cash, Chair of the European Scrutiny Committee: 9355/18: Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (28 May 2020)

[12] Further details regarding “no significant harm” to be set out in the technical screening criteria.

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Gibson Dunn’s lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm’s Financial Institutions practice group, or the following authors in London:

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