



Matheson



SFDR / Taxonomy
Implementation – Further
Regulatory Guidance

On 25 May 2022, the European Supervisory Authorities ("**ESAs**") **published** the European Commission's ("**Commission**") responses to their **questions** related to the implementation of the Sustainable Finance Disclosure Regulation ("**SFDR**") and Taxonomy Regulation¹. The Commission's statements in relation to: the consideration of principal adverse impacts at product level; what brings Article 8 SFDR funds within scope of the Taxonomy Regulation disclosure requirements and the nature of those disclosures; and good governance practices of investee companies, will be of particular interest to fund management companies.

This was followed by further guidance from the European Securities and Markets Authority ("**ESMA**") on 31 May 2022, in the form of a **supervisory briefing** on sustainability risks and disclosures in the area of investment management (the "**Supervisory Briefing**"). The Supervisory Briefing is directed at national competent authorities ("**NCA**s"), but will be informative for fund managers as regards the supervisory expectations in relation to the implementation of the SFDR and Taxonomy Regulation requirements.

¹ The ESAs' published questions are dated 13 May 2022, but they were sent to the Commission in late 2021.

Commission Q&A

Principal Adverse Impact Disclosures at Entity / Product Level

The ESAs asked the Commission whether financial market participants ("**FMPs**") that do not consider principal adverse impacts ("**PAI**") under Article 4 SFDR may indicate that they do consider PAI at product level only for a certain subset of financial products. The ESAs queried whether an FMP may not consider PAI at entity level but still consider PAI under Article 7 SFDR for some of the products it manages, and if so, can they disclose this under Article 4 SFDR.

The Commission has stated that, where an FMP does not consider PAI under Article 4 SFDR, it may still provide a product that *"pursues a reduction of negative externalities caused by the investments underlying that product"*.

In the context of funds that "opt-out" of Article 4 SFDR and choose to provide clear reasons why they do not consider PAI, the Commission states, *"A financial product pursuing a reduction of negative externalities caused by investments underlying the product must not be part of such entity level information"*.

This would appear to confirm that a fund may consider PAI where there is no corresponding positive entity level disclosure under Article 4 SFDR. Due to the language chosen by the Commission – ie, the reference to *"products pursuing the reduction of negative externalities caused by the investments underlying that product"* as opposed to *"products which consider PAI"* – the Commission appears to be attempting to facilitate product level disclosure, notwithstanding that the potential interaction of Articles 4 and 7 SFDR might have precluded such an approach. So, while an FMP may not be able to make an Article 7 disclosure in relation to a fund when it has not made an entity level disclosure under Article 4(1)(a), the Commission has indicated that the more general product level disclosures under Articles 6(1) and (3) can include information on how it considers or has considered the PAI on sustainability factors of a fund that pursues a reduction of negative externalities caused by the investment underlying the product.

While the introduction of a new concept of a *"financial product that pursues a reduction of negative externalities caused by the investments underlying that product"* potentially adds to the complexity of an already challenging body of regulation, the potential for FMPs to be permitted to make product level disclosures, where there is no corresponding entity level disclosure under Article 4, is to be welcomed. This is particularly the case as it may facilitate such a fund coming within the criteria for financial products meeting clients' sustainability preferences under the revised suitability rules under MiFID II, which will apply from 2 August 2022.²

² Commission Delegated Regulation (EU) 2021/1253 (available [here](#)).

Taxonomy Disclosures

Significant Change for Article 8 Funds

The ESAs asked the Commission whether an Article 8 product that does not commit to making sustainable investments with an environmental objective is obliged to make disclosures under Article 6 Taxonomy Regulation.

The Commission states that "*to trigger the application of Article 6 of [the Taxonomy Regulation], it is irrelevant if a financial product commits to invest in economic activities that contribute to an environmental objective within the meaning of [Article 2(17) SFDR]*". The disclosure requirements set out in Article 6 Taxonomy Regulation (relating to which of the environmental objectives set out in the Taxonomy Regulation the investment contributes to and the extent of Taxonomy-alignment) applies to Article 8 funds that promote environmental characteristics, where it has been assessed based on reliable data that investments will be in economic activities that contribute to an environmental objective.

Previous statements made by the ESAs,³ and the final form of the SFDR **regulatory technical standards ("RTS")** and **mandatory disclosure templates** adopted by the Commission on 6 April 2022, had suggested that an Article 8 fund would only be required to make Taxonomy disclosures if it committed to making sustainable investments with an environmental objective. The Commission's view as expressed in the Q&A therefore represents a significant change and may require fund management companies to reconsider their approach to implementation. We would hope that regulators would recognise that existing disclosures were prepared based on the view previously expressed by the ESAs and implicitly endorsed by the Commission and would facilitate an orderly updating of disclosures at the next reasonable opportunity.

The Commission has also clarified that periodic disclosures must include the Article 6 Taxonomy Regulation disclosures if the investments made during the reference period were in economic activities contributing to an environmental objective, irrespective of commitments in the pre-contractual disclosures. Pre-contractual disclosures should be updated where a fund's investments change over the life of the fund to include Taxonomy-aligned investments.

Data Challenges

Although the ESAs had not raised a specific question in relation to the availability of data, the Commission addresses data use in its Q&A. The Commission states that, where an FMP fails to collect data on the environmental objective(s) and on how and on the extent of Taxonomy-alignment, the pre-contractual and periodic disclosures must "indicate zero". The Commission argues that the use of narrative explanations on the lack of reliable data risks contradicting the purpose of Articles 5 and 6 Taxonomy Regulation. Clarifications must not be ambiguous as to the extent of Taxonomy-alignment and should not include negative justifications, such as explaining a lack of alignment by a lack of data. It is disappointing that the Commission characterises the inability of FMPs to collect data in circumstances where there is

³ See ESAs' Joint Consultation on Taxonomy-Related Sustainability Disclosures March 2021 (available [here](#)); ESAs' Open Hearing April 2021 (available [here](#)) and ESAs' Final Report on draft Regulatory Technical Standards under the SFDR (available [here](#)).

currently no legislative obligation on investee undertakings to provide such data as a "failure" on the part of the FMP and that a disclosures regime would seek to prevent an FMP from disclosing to investors the extent of the data challenges which prevail.

The Commission reaffirms the position already stated in Recital 21 to the Taxonomy Regulation that, in exceptional cases where FMPs cannot obtain information on Taxonomy-alignment in relation to undertakings not required to disclose under the Taxonomy Regulation, FMPs may make complementary assessments and estimates based on information from other sources.

Good Governance Practices

Article 8 funds may only invest in companies that follow good governance practices, or they will be "*in breach of Article 8*". Investee companies of Article 9 products (which have the objective of making "sustainable investments") must also follow good governance practices, as required by the definition of "sustainable investment" in Article 2(17). The use of the term "breach" introduces additional questions around the consequences of such a breach, given that SFDR is a disclosures regime.

The good governance requirement only applies to investments in companies, so it will not apply to securities issued by other issuers eg, government bonds.

Application to Funds Existing at 10 March 2021

The ESAs asked whether products in existence as at 10 March 2021 but no longer made available to new investors have to update and deliver to existing investors pre-contractual disclosures under Articles 6 and 7 SFDR and provide website and periodic disclosures under Articles 7, 10 and 11 SFDR to existing investors.

The Commission states that, as no specific transitional regime is set out in the SFDR, the requirements apply to products made available to end investors before 10 March 2021 that continue to be made available to end investors after that date.

Where a product is no longer made available to end investors as from 10 March 2021, the SFDR periodic report and website disclosures must be complied with. While not explicitly confirmed, this would appear to imply that at least the requirements in relation to pre-contractual disclosures do not apply to such funds.

ESMA Supervisory Briefing

As mentioned above, the Supervisory Briefing is directed at NCAs and aims to promote supervisory convergence on the supervision of sustainability-related disclosures and the integration of sustainability risks by fund managers. It is not subject to a "comply or explain" mechanism for NCAs and is non-binding. There is scope, therefore, for NCAs to adopt a different or modified approach to that set out in the Supervisory Briefing, but it can be expected that NCAs, including the Central Bank of Ireland ("**Central Bank**") will follow ESMA's recommendations.

We have highlighted below a number of notable statements from the Supervisory Briefing.

<p>Consideration of PAI by Article 9 Funds</p>	<p>While acknowledging that it is not mandatory for Article 9 funds to consider PAI, ESMA states that NCAs could reasonably expect that Article 9 funds would disclose PAI as referred to in Article 7 SFDR. This is based on the fact that Article 9 funds should only make sustainable investments – which are subject to the do no significant harm (“DNSH”) principle – and the SFDR regulatory technical standards (“RTS”) require funds applying the DNSH test to disclose how the indicators for adverse impacts in Annex I to the RTS have been taken into account.</p>
<p>Presentation of Disclosures</p>	<ul style="list-style-type: none"> ■ Disclosures should not include boilerplate language with complex legal disclaimers. ESMA states that “a warning sign for supervisors should be the repeated use of the same or similar standard text across different funds”. ■ Use of cross-references and hyperlinks should be limited to those required by the section “Where can the methodology used for the calculation of the designated index be found?” and “Where can I find more product specific information online?” in Annexes II and III of the SFDR RTS. ■ Investors should not be required to search for required information. Any link to other information should be to the exact place where the relevant information can be found.
<p>Fund Names</p>	<ul style="list-style-type: none"> ■ Funds’ names should not be misleading. The use of terms such as “ESG”, “green”, “sustainable”, “social”, “ethical”, “impact” or any other ESG-related terms should be used only when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the fund’s investment objectives and policy and its strategy as described in the relevant fund documentation. ■ It is advisable that the terms “sustainable” or “sustainability” should be used only by: <ul style="list-style-type: none"> - Article 9 funds; - Article 8 funds which in part invest in economic activities that contribute to environmental or social objectives; and - Taxonomy-aligned funds.
<p>Investment Strategy</p>	<p>For an investment strategy to be clearly defined, at least some of the following non-exhaustive key elements should be disclosed:</p> <ul style="list-style-type: none"> ■ investment universe (including limits and thresholds) ■ screening criteria applied; ■ specific ESG characteristics / themes or non-financial impacts pursued; ■ use of benchmarks / indices and relative expected tracking error (if applicable); or ■ stewardship approach.
<p>Portfolio Analysis</p>	<p>NCAs should envisage different types of supervisory actions to ensure that portfolio holdings reflect the name, the investment objective, the strategy and the characteristic displayed in the documentation to investors. ESMA states that, where specific risks are identified, or if the fund claims to invest in sustainable investments, NCAs may directly perform an analysis of the compliance with the requirements for sustainable investments of the portfolio itself and may engage with fund managers by requiring explanations and / or documentation to validate the composition of their portfolio.</p> <p>NCAs may further complement the portfolio analysis by involving the funds’ depositaries in the context of their controls on investments restrictions, as well as assessing the reporting from management companies, AIFMs, external auditors and internal control functions.</p>

The Supervisory Briefing also addresses convergent supervisory scrutiny of the effective implementation of sustainability risks by fund managers as required by amendments to the level 2 measures under the UCITS Directive and the Alternative Investment Fund Managers Directive ("**AIFMD**"), which are due to apply from 1 August 2022.⁴

Next Steps

The Central Bank had recently, on 10 May 2022, communicated its expectations relating to Taxonomy disclosures to industry, which are now likely to be reviewed in light of the Commission Q&A and the ESMA Supervisory Briefing. Representatives from Irish Funds, including Matheson Chair and Head of our Asset Management and Investment Funds Department, Tara Doyle, met with the Central Bank on 31 May 2022 to discuss implementation of the SFDR and the Taxonomy Regulation generally. The Commission Q&A and the Supervisory Briefing were only briefly referred to at that meeting, which focused primarily on the challenges industry is facing implementing the existing requirements, and there is likely to be further engagement following on from the publication of the Commission's and ESMA's guidance.

The Central Bank confirmed at that meeting that the guidance it intends to publish following the spot checks carried out on the Taxonomy-related filings made in late 2021 will now also take into account the Commission's Q&A and the Supervisory Briefing. It also confirmed that there is likely to be a streamlined approval process with quality controls in respect of the filings to be made to meet the SFDR RTS requirements, applicable from 1 January 2023. We will continue to keep you informed of further updates arising from the engagement with the Central Bank.

⁴ Commission Delegated Regulation (EU) 2021/1255 and Delegated Directive (EU) 2021/1270.



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