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Sustainable Finance Disclosure Regulation: Detailed Rules on Disclosures

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As part of the European Commission's Sustainable Finance Action Plan, the new Sustainable Finance Disclosure Regulation ("SFDR") imposes an obligation on fund managers, financial advisers and certain other regulated firms in the European Union ("EU") (and likely to non-EU fund managers who are marketing their funds in the EU) to disclose information on various environmental, social or governance ("ESG") considerations to potential investors, and on their websites. These disclosure obligations are in addition to the existing transparency obligations required under the Alternative Investment Fund Managers Directive ("AIFMD"). Although SFDR is framed as a disclosure framework, compliance with its sustainability-related disclosures is intended (and expected) to have behavioural effects on fund managers.

Certain disclosure obligations in SFDR are high level in respect of which the European Supervisory Authorities (the "ESAs") are required to publish detailed regulatory standards. Several open questions remain on the scope and application of SFDR as discussed in our previous [Alert](#).

Despite the uncertainty concerning certain aspects, managers should note that SFDR will apply from 10 March 2021. Helpfully, the ESAs have announced that they plan to issue a statement before the application date of SFDR in order to achieve an effective and consistent application of the SFDR's requirements.

Disclosure Rules Under the RTS

On 4 February 2021, the ESAs published their [final report](#) on the draft regulatory technical standards (the "RTS") on the detailed disclosure obligations under SFDR. The European Commission is expected to endorse the RTS within three months.

In response to overwhelming feedback from the industry on the [consultation paper](#) published by the ESAs in April 2020 – particularly on the challenging timelines and difficulty in data-gathering – the RTS has pared back the mandatory indicators that market participants, including fund managers, would have had to report against. Further, in recognition of the systemic changes that market participants may have to make in order to gather data from their investee companies on the mandatory indicators, the timeline for the application of the RTS has also been extended.

Timing

To provide market participants with sufficient time to gather necessary data and modify their existing processes, the ESAs have proposed that the detailed disclosure rules under the RTS (as described below) should apply from 1 January 2022.

The RTS primarily contain detailed rules on:

1. firm-level website disclosures relating to principal adverse impacts of investment decisions made by a fund manager on sustainability factors; and
2. product-level pre-contractual disclosures for those financial products that promote environmental or social characteristics (“Article 8 Funds”) or have sustainability as their investment objective (“Article 9 Funds”).

Firm-level Disclosures on Principal Adverse Sustainability Impacts

Article 4 of SFDR requires managers (on a “comply or explain” basis) to publish on their websites a statement on the due diligence policies concerning principal adverse impacts of investment decisions on sustainability factors (the “PAI Statement”), taking into account the manager’s size, nature, scale of activities and the types of financial products they make available. The “explain” option is not available from 30 June 2021 to those managers with more than 500 employees during the financial year (or managers that are the parent undertaking of a group with more than 500 employees).

Where a manager does not consider principal adverse sustainability impacts, then a statement to that effect must be made with clear reasons as to why the manager does not do so, and whether it intends to do so in the future.

The PAI Statement requires both quantitative and qualitative disclosures, and applies to in-scope managers of all types of funds.

Quantitative Disclosures

The PAI Statement must include a “description” of principal adverse sustainability impacts and any related planned or taken actions by the manager as well as other information. The various aspects of this description are more fully set out in the RTS – it requires managers to publish quantitative data on 14 key indicators (nine indicators related to the environment, while the remaining five will cover social factors) for assessing adverse sustainability impacts across a range of ESG factors, with additional indicators applicable to investments in sovereigns and supra-nationals, and investments in real estate assets. In addition to the 14 key indicators set out above, managers must report against at least one additional environmental indicator and one additional social indicator. The template for reporting against the indicators is available in the annexes to the RTS.

Qualitative Disclosures

For qualitative descriptions in the PAI Statement, the RTS requires the inclusion of:

- a summary of the PAI Statement and the relevant reference period;
- a description of policies to identify and prioritise principal adverse sustainability impacts, the date of their approval and description of the methodologies to select the indicators, and description of the data sources used;
- information on engagement policies and policies relating to reducing principal adverse impacts; and
- references to international standards, including a description of adherence to responsible business conduct codes, internationally recognised standards for due diligence and reporting, and where relevant, the degree of alignment with the objectives of the Paris Agreement.

Reference Period for Reporting

Reporting the information set out in PAI Statement is with reference to the previous calendar year. As the ESAs propose that the RTS should apply from 1 January 2022, managers must prepare to disclose information against the indicators described above from that date.

Where a manager discloses a PAI Statement for the first time, the RTS does not require the manager to make disclosures relating to a previous reference period. In practice, this means that the earliest that the information on the indicators in the PAI Statement would be disclosed in accordance with the RTS is 2023 in respect of a reference period relating to 2022.

Product-level Disclosures on ESG-Focussed Funds

SFDR requires Article 8 Funds and Article 9 Funds to make enhanced disclosures in pre-contractual documentation and on websites. The RTS specifies the details of the form and content of the information to be disclosed, including through the use of reporting templates to be attached as an annexe to the private placement memoranda or in the AIFMD-related fund disclosures.

Pre-Contractual Disclosures for Article 8 Funds

For pre-contractual disclosures relating to Article 8 Funds, the RTS requires the disclosures to address the following questions:

- what environmental or social characteristic is promoted by the fund and what are the sustainability indicators used to measure the attainment of each of the environmental or social characteristics promoted by the fund;
- what is the investment strategy used to attain the environmental or social characteristic that is being promoted by the fund;
- what is the asset allocation of the fund;
- the RTS considers additional issues with respect to asset allocation, including:
 - what is the narrative explanation of the investments of the fund;
 - where the fund intends to make one or more sustainable investments, how that investment contributes to the sustainable investment objective;
 - is there a minimum proportion of investments of the fund allocated to attain the environmental or social characteristics of the fund, and is there a minimum proportion of investments allocated to sustainable investments; and
 - where the fund intends to make one or more sustainable investments, how are the key indicators in the PAI Statement taken into account and whether the investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights;

- whether the manager takes into account principal adverse impacts on sustainability factors for the fund under Article 7 of the SFDR;
- if product-specific information is available online and, if so, where can investors access it; and
- whether a specific index has been designated as a reference benchmark and its alignment with each of the environmental or social characteristics promoted by the fund.

Pre-Contractual Disclosures for Article 9 Funds

For pre-contractual disclosures relating to Article 9 Funds, the RTS requires the disclosures to address the following questions:

- what is the sustainable investment objective of the fund and what are the sustainability indicators used to measure the attainment of the sustainable investment objective;
- what investment strategy does the fund follow to attain the sustainable investment objective and how is the strategy being implemented in the investment process on a continuous basis;
- what is the asset allocation of the fund;
- the RTS considers additional issues with asset allocation, including:
 - what is the narrative explanation of the investments of the fund;
 - is there a minimum proportion of investments of the fund allocated to attain the sustainable investment objective and for the remaining proportion of investments, a description of any minimum environmental or social safeguards; and
 - how the investments contribute to a sustainable investment objective of the fund and do not significantly harm any of the sustainable investment objectives, including how the key indicators in the PAI Statement are taken into account and whether the investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights;
- whether the manager takes into account principal adverse impacts on sustainability factors for the fund under Article 7 of the SFDR;
- if product-specific information is available online, and if so, where can investors access it;
- whether a specific index has been designated as a reference benchmark and its alignment with the sustainable investment objective of the fund; and
- where the fund has the objective of reducing carbon emissions, does the reference benchmark used by the fund qualify as an EU Climate Transition Benchmark or an EU

Paris-Aligned Benchmark, and if not, how does the fund seek to make a continued effort of attaining the objective of reducing carbon emissions.

Website Disclosures

Managers of Article 8 Funds or Article 9 Funds are also required to publish (and maintain) sustainability disclosures on their websites. The RTS provides where and how fund managers must publish the information on the website, the list of metrics to be disclosed, methodologies to measure the attainment of the environmental or social characteristics of the sustainable investment objective, data sources and how they are processed, limitations to methodologies and data, due diligence processes, engagement policies and details of the index designated as a reference benchmark. Although the requirements on website disclosures are detailed, there are no disclosure or reporting templates, allowing managers some flexibility in crafting their website disclosures.

Periodic Disclosures

SFDR requires annual disclosures with quantitative and qualitative indicators to demonstrate how the fund meets its environmental or social characteristics or sustainable investment objectives be provided to investors. The RTS provides a reporting template for Article 8 Funds and for Article 9 Funds, which need to be annexed to the fund annual reports. It includes a requirement, amongst others, to describe:

- to what extent the environmental or social characteristic promoted or sustainable investment objective has been attained during the reference period along with a historical comparison against previous reference periods;
- the proportion of sustainability-related investments held by the fund, and how the indicators in the PAI Statement have been taken into account; and
- the actions taken to attain environmental or social characteristic or sustainable investment objective.

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- Transactional
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Suggested Reading

- 12 February 2021 Speaking Engagement 2020 U.S. Sanctions Year-in-Review

- 11 February 2021 Press Release Kirkland Advises Mill Point Capital on Close of \$886 Million Fund II at Hard Cap
- 10 February 2021 Press Release Kirkland Represents Atlas Crest Investment Corp on \$3.8 Billion Merger with Archer

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