

EU Sustainable Finance Legislative Impact on Private Funds

Overview Guide

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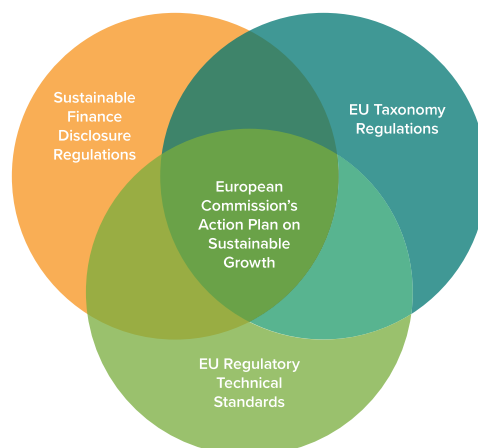
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Introduction

The Sustainable Finance Disclosure Regulation (**SFDR**) is a European regulation that has applied directly in the EU (and EEA countries) since March 2021. The aim of the SFDR is to provide harmonised disclosure requirements, qualitative and quantitative, with regard to the: (i) integration of sustainability risks in investment decision-making and asset management; (ii) consideration and assessment of Principal Adverse Impacts (**PAI**) of investment decisions on sustainability factors; and (iii) provision of sustainability-related information on financial products. The overriding intention is to redirect capital towards more sustainable investment and to assist investor decision-making through improving transparency and introducing common standards.

SFDR applies to 'financial market participants' (**FMPs**) and 'financial advisors' whose businesses are in Europe or who are marketing to investors based in Europe. FMPs include AIFMs, UCITS ManCos and MiFID investment firms providing portfolio management advice. For firms that are not 'large' (i.e., where they fall below the 500 employee threshold) this involves 'comply or explain' decisions in relation to publishing and maintaining sustainability factors/risks for due diligence policies and products they make available. Disclosures have to be made at entity level (covering sustainability practices and information that the firm has adopted for its business as a whole) and at product level (for specific funds to ensure that investors receive consistent fund-related sustainability information). Entity level disclosures are to be published on a firm's website and the product (i.e., fund-level disclosures) apply to pre-contractual, website and annual reporting.

The Taxonomy Regulation (**TR**) establishes an EU-wide classification system or taxonomy of environmentally sustainable activities. From January 2022 elements of the TR have been integrated into the SFDR disclosure obligations. In addition, the SFDR legislative package includes both regulatory technical standards (**RTS**) and guidance and supplemental delegated acts that integrate sustainability requirements into other directives (namely AIFMD and MiFID II, alongside similar measures in respect of the UCITS Directive, the Insurance Distribution Directive and Solvency II). These provisions will affect firms' general governance of and risk management in their businesses and ongoing management of funds and/or segregated mandates. They will not be limited to the distribution and marketing processes.



We would note the following three points.

- In its 13 June 2023 EU [Sustainable Finance Package](#) the European Commission (**Commission**) indicates that a consultation on assessing SFDR (which in due course may lead to SFDR II) will be

launched in autumn 2023. This is in recognition of various shortcomings of the current regulatory framework, including the fact that SFDR has been mistakenly applied as a labelling (instead of disclosure) regime and there are inconsistent market interpretations. The review will focus on how to improve SFDR's legal certainty and enhance its usability and role in mitigating greenwashing. As a consequence, minimum standards/legislative amendments for the financial products in scope may well be produced in due course.

- This potential overhaul is also likely to affect other related sustainable finance legislation, such as the TR, Benchmark Regulation, MiFID and AIFMD supplemental legislation and the Corporate Sustainability Reporting Directive (**CSRD**).
- In the meantime, further outputs are still expected from the European legislators, for instance: (i) amendments to the SFDR RTS amendments following the April 2023 consultation; (ii) from the ESA call for evidence on greenwashing; and (iii) from the ESMA consultation on guidelines on fund names using ESG or sustainability-related terms. The development of a taxonomy for social investments is also expected.

What must firms disclose: an overview

A firm will have to make specific disclosures under SFDR based on the categorisation of its financial products. The table below sets out a summary of the disclosure requirements.

Entity-related disclosures			
Entity-level disclosure	Obligation	Where	Comments
Sustainability risk policies Mandatory Article 3 SFDR	Provide information about their policies on the integration of sustainability risks in their investment decision-making process	Website	In addition, from 1 August 2022, EU AIFMs have to integrate sustainability risks into their portfolio and risk management functions
Remuneration policies Mandatory Article 5 SFDR	Include information in remuneration policies on how those policies are consistent with the integration of sustainability risks	Website	These requirements are intended to sit alongside the provisions in AIFMD and other EU legislation concerning remuneration (and the proportionality principle applies).

<p>Principal adverse impact (PAI)¹ factors</p> <p>‘Comply or explain’ for firms that are not ‘large’²</p> <p>Article 4 SFDR</p>	<p>Where a firm considers PAI of investment decisions on sustainability factors, it must publish and maintain a statement on how its due diligence policies incorporate these factors, taking into account the firm’s size, nature and scale of its activities and the type of financial product it makes available</p> <p>OR</p> <p>Explain the reasons why they do not consider the adverse impact of their investment decisions on sustainability factors and the reasons why (including whether and when they intend to comply)</p>	<p>Website</p>	<p>First statements (covering the period 1 Jan-31 Dec 2022) were to be published by 30 June 2023 and updated by 30 June each year with a reference period of the previous calendar year</p> <p>From 1 January 2023 this information must be provided in the form of the template PAI statement (Annex I to the SFDR Level 2 RTS) which sets out mandatory and additional indicators a firm must report/select and report against</p>
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Product level disclosures			
Product level disclosure	Obligation	Where	Comments
<p>Sustainability risk policies</p> <p>Comply or explain (firms that are not ‘large’ can opt out)</p> <p>Article 6 SFDR</p>	<p>Describe manner in which sustainability risks are integrated into investment decisions and likely impact on product returns</p> <p>OR</p> <p>Explain why sustainability risks not relevant/integrated</p>	<p>Pre-contractual (i.e., appended to Article 23 AIFMD investor disclosures)</p>	<p>Applied from 10 March 2021 (mandatory for ‘large’ firms from 30 June 2021)</p>

¹ PAI are the impacts of investment decisions and advice that result in negative effects on sustainability factors.

² Broadly, for SFDR purposes, this means where the firm is below the threshold of an average of 500 employees during its financial year, including a firm that is a parent undertaking of a ‘large group’ which exceeds an average of 500 employees during its financial year

<p>Principal adverse impacts (PAI) statement</p> <p>Comply or explain (firms that are not 'large' can opt out)</p> <p>Article 7 SFDR</p>	<p>Where a firm considers PAI on sustainability factors for a particular fund or mandate, a description and explanatory statement of how this is done</p> <p>OR</p> <p>A statement that the firm does not consider the PAI of investment decisions on sustainability factors and why</p>	<p>Pre-contractual</p> <p>Periodic reports (i.e., any PAI made available in annual reports)</p>	<p>Applied from 10 March 2021 (mandatory for 'large' firms from 30 June 2021)</p> <p>First product statements to be published by 30 December 2022</p>
<p>Article 6 products</p> <p>Mandatory negative disclosure for out-of-scope products Taxonomy Regulation (Article 7)</p>	<p>A negative disclosure to confirm that all out-of-scope financial products are out of scope, as follows: "The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable activities. The investments underlying the remaining proportion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities."</p>	<p>Pre-contractual</p>	<p>From 1 January 2022 (and where the fund is still open for subscription)</p>
<p>Article 8 products</p> <p>Mandatory</p> <p>Articles 8, 10 and 11 SFDR</p>	<p>Various prescribed information on how the environmental (E) and/or social (S) characteristics are met and if an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics as well as an indication of where the methodology used for the calculation of index</p>	<p>Pre-contractual</p> <p>Website</p> <p>Annual reports (from 1 January 2022, i.e., appended to Article 22 annual reports)</p>	<p>From 1 January 2023 mandatory template to apply (Annex II and IV to the Level 2 RTS) for pre-contractual and annual reporting disclosures. The Level 2 RTS also set out the detail of the website disclosures.</p>
<p>Article 9 products</p> <p>Mandatory</p> <p>Articles 9, 10 and 11 SFDR</p>	<p>Various prescribed information on a product's sustainable investment objective</p>	<p>Pre-contractual</p> <p>Website</p>	<p>From 1 January 2023 mandatory template to apply (Annex III and V to the Level 2 RTS) for pre-contractual and annual reporting disclosures. The Level 2 RTS</p>

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	‘Do no significant harm’ (DNSH) and PAI disclosures	Annual reports (from 1 January 2022)	also set out the detail of the website disclosures.
<p>Article 8 and 9 products supplemental disclosure obligations</p> <p>Mandatory (if product in scope)</p> <p>Taxonomy Regulation (Articles 5 and 6)</p>	<p>Supplemental disclosures including:</p> <ul style="list-style-type: none"> for Article 8 or 9 SFDR products: (i) information on the ‘Environmental Objective(s)’ (as per the six set out in Article 9 TR) to which the underlying investment contributes; and (ii) a description of how and to what extent the underlying investments are in economic activities that qualify as environmentally sustainable (under Article 3 TR); and for Article 8 SFDR products, an additional disclaimer. 	<p>Pre-contractual Website</p> <p>Annual reports (from 1 January 2022)</p>	<p>From 1 January 2022 for the first 2 environmental objectives under the TR (climate change mitigation or adaptation) and from 1 January 2023 for the remaining 4 (sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems).</p>

The table below highlights some of the topics to be disclosed for both Article 8 and 9 product disclosures.

Topic	Financial product disclosure
Binding elements of investment strategy	The binding elements of the investment strategy used to select the investments to attain each of the E or S characteristics promoted/ the sustainable investment objective
Strategy implementation	The investment strategy that guides investment decisions based on factors such as investment objectives and risk tolerance.
Sustainable investments	How sustainable investments DNSH to any E or S sustainable investment objective and how they are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights

Sustainability indicators	The sustainability indicators used to measure the E or S characteristics they promote/sustainable investment objectives
Asset allocation	The planned share of investments in specific assets including: the minimum proportion use to meet the E or S characteristics promoted by the financial product in accordance with the binding elements of the investment strategy; the minimum proportion of sustainable investments the financial product commits to make (if it does); and the purpose of the remaining proportion of the investments
Derivatives	Any use of derivatives to attain the E or S characteristics they promote and how the use of derivatives meets those characteristics. A financial product with a sustainable objective must disclose how the use of derivatives attains the sustainable investment objective
Other investments	Any investments that are not sustainable or do not have E and/or S characteristics, their purpose and a description of any minimum E or S safeguards. Funds with a sustainable objective must disclose how the proportion and use of these investments does not affect the delivery of the sustainable investment objective on a continuous basis and whether they are used for hedging or relate to cash held for liquidity
PAI	Whether they consider PAI on sustainability factors, including in the determination of significant harm in relation to sustainable investments
Benchmarks	When there is an objective of a reduction of carbon emissions and explain how the reference benchmark qualifies as an EU Climate Transition Benchmark or an EU Paris-aligned Benchmark and indicate where the methodology used for the calculation of that benchmark can be found
EU Taxonomy	The minimum extent that sustainable investments with an E objective are aligned with the EU Taxonomy. Various disclosures around this, including the division between E and S objectives; EU Taxonomy-aligned activities expressed as a share of turnover, capital expenditure and operational expenditure; the minimum share of investments in transitional and enabling activities; and the minimum share of sustainable investments with an E objective that are not aligned with the EU Taxonomy. In addition, the figures for Taxonomy aligned fossil gas and/or nuclear energy

SFDR scope of application

The table below covers some specific examples of SFDR’s scope of application.

Small/sub-threshold AIFMs and EuVECA managers	Non-EU AIFMs	Legacy funds (i.e., that had their final close before 10 March 2021)
<p>The Commission confirmed in its July 2021 guidance, given in response to ESA’s letter on SFDR priority areas, that SFDR (both entity and product obligations) does apply to small/sub-threshold AIFMs. Under the NPPR, country-by-country rules will need to be checked in addition.</p> <p>Also that managers of EU qualifying venture capital funds and qualifying social entrepreneurship funds (types of small AIFMs) must include the SFDR pre-contractual and periodic reporting disclosures in their materials.</p>	<p>The Commission’s view (as set out in its July 2021 guidance) is that SFDR applies to third country firms marketing under Article 42 NPPR and “... that AIFM must ensure compliance with the [SFDR], including the financial product related provisions.” This reference is being interpreted as meaning that the product disclosures apply to non-EU AIFMs <i>in addition</i> to the entity-level disclosures. However, there is no express provision in SFDR (or indeed the guidance) that imposes entity-level disclosure obligations on non-EU AIFMs (individual member states can also choose to apply the entity level requirements to non-EU AIFMs in their discretion).</p> <p>A prudent approach (in particular when marketing products that are categorised as being Article 8 or 9 SFDR products) is that a non-EU AIFM must comply with the entity SFDR disclosures in addition to the product ones. However, unless and until there is explicit guidance to the contrary, there is scope to argue otherwise (and that it is only the product disclosures and reporting obligations that apply to non-EU AIFMs marketing in the EU).</p> <p>Outside the SFDR framework, a non-EU firm may also be subject to SFDR on a contractual basis where it is acting as a delegate to an EU FMP. Or on a voluntary basis, in response to investor expectation or to align practices cross-group.</p>	<p>For products that are no longer available to investors post March 2021 the May 2022 Commission Q&A states that SFDR annual reporting and product website disclosures will apply, but not the pre-contractual disclosures.</p> <p>This seems to necessitate a retrospective assessment of whether or not a product falls within the scope of Article 8 or 9 (and therefore has to comply with any corresponding periodic and website disclosure obligations).</p> <p>If an FMP decides that a fund that closed before 10 March 2021 is an Article 6 fund, then there are no further requirements as Article 6 funds have no product level reporting requirements or website disclosures under Articles 10 and 11 of SFDR.</p>

Product classification: threshold issues

Other	Light green	Mid Green/Article 8+	Dark Green
SFDR: “Article 6”	SFDR: “Article 8”	SFDR: “Article 8”	SFDR: “Article 9”
Any product which is not light/mid or 8+/dark green (A8/9)	Products which “promote environmental and/or social characteristics” provided investee companies follow good governance practices	Products which commit to making (at least some) “sustainable investments”	Products whose objective is “sustainable investment” (and only invests in “sustainable investments”) or reduction in carbon emissions

‘Article 8’ disclosures apply to financial products that promote, among other characteristics, E and/or S characteristics, provided that the investee companies follow good governance practices with respect to sound management structures, employee relations, remuneration and tax compliance. To fall within Article 8, the fund has to intend to do more than include material ESG factors into investment analysis and decisions (which would fall under Article 6 ‘Other’) by committing to binding investment criteria to proactively allocate capital to specific assets based on E and/or S criteria. An Article 8 product has to promote E and/or S characteristics that are binding during the whole holding period. In other words, these form part of the investment policy of the fund that applies throughout the term of the fund. Article ‘8+’ products are those which commit to making some ‘sustainable investments’ alongside their promoted E and/or S characteristics.

Article 9 relates to a smaller sub-set of products that have a specific sustainable embedded investment objective (e.g., an impact investment fund, where investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return). Article 9 funds must be investing fully in investments that already qualify as ‘sustainable’, so, for example, a transitional strategy to move assets to become sustainable would only be disclosed under Article 9 when all the assets in the portfolio are sustainable and meet the relevant SFDR criteria. Alongside sustainable investments, Article 9 products may also include investments “for certain specific purposes such as hedging or liquidity”, which “in order to fit the overall...sustainable investments’ objective, have to meet minimum environmental or social safeguards”. Therefore, although the large majority of investments in an Article 9 product must be in sustainable investments, there is room to include other investments that meet environmental or social safeguards (including the DNSH test) and “neutral investments”. The [Commission’s April 2023 Q&A](#) clarified that funds that passively track Paris-Aligned Benchmarks or Climate Transition Benchmarks would be sufficient for an Article 9 categorisation.

An Article 6 financial product is one that is neither Article 8 or 9.

What is a ‘sustainable investment’?

Article 2(17) SFDR defines Article 9 ‘sustainable investment’ as one that:

- is invested in an economic activity that contributes to an E or S objective;

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- does not significantly harm (DNSH) any of those objectives; and
- ensures that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

We have outlined some pertinent issues on qualifying as a ‘sustainable investment’ in the table below. These are relevant for both Article 9 products and Article 8 products that partly make sustainable investments and that have to explain in pre-contractual and periodic reports how sustainable investment does not cause significant harm, including how the adverse impact indicators and minimum safeguards were taken into account.

Issue	Comment
<p>The SFDR does not prescribe specific criteria or minimum requirements that qualify concepts such as ‘contribution’, ‘do no significant harm’ or ‘good governance’.</p>	<p>The Commission’s April 2023 Q&A states that this policy choice means FMPs must carry out their own assessment for each investment and disclose their underlying assumptions. Also that a transition plan aimed at mitigating harm to E or S objectives may not in itself be sufficient to qualify as a sustainable investment under SFDR.</p>
<p>The relevant disclosures should explain how the indicators for PAI have been taken into account for the DNSH test. For example, “scope 1 greenhouse gas emissions” and “water usage and recycling.”</p> <p>For the DNSH test for the purpose of meeting the “sustainable investment” definition, no thresholds are currently provided and a degree of judgement must therefore be used.</p> <p>However, firms must have regard to the PAI indicators in Table 1 of Annex I and any relevant indicators in Tables 2 and 3 (as per the indicators for the template to be used for Article 4 PAI entity-level website statements).</p>	<p>This would involve, for instance for a real estate holding, using the mandatory indicators for real estate (on exposure to fossil fuels and energy efficiency (Table 1 of the Annex I template)) and picking one or more of the 5 additional real estate indicators for climate/other environmental (Table 2) along with any other indicators that may be relevant.</p> <p>In addition and where feasible, comparing impacts with similar metrics in the Climate Delegated Act and Complementary Climate Delegated Act in respect of the EU Taxonomy, explaining substitution of any of the indicators with an alternative where necessary.</p>
<p>Investments in ‘environmentally sustainable economic activities’ pursuant to the TR automatically qualify as SFDR ‘sustainable investments.’</p>	<p>The position differs for an investment through a funding instrument that does not specify the use of the proceeds, such as a general equity or debt, where the manager would have to check additional SFDR elements to ensure the whole investment in that undertaking is considered ‘sustainable’.</p>

Funds that passively track an EU climate benchmark fall under scope of Article 9(3) SFDR and are deemed to have sustainable investment as an investment objective.

The position is different where a fund has a reduction in carbon emissions as its objective (also under Article 9(3) SFDR) and no such tracking, in which case the manager will still have to comply with the Article 2(17) SFDR 'sustainable investments' test.

The Taxonomy Regulation and how it affects SFDR disclosures

The Taxonomy Regulation provides a framework for qualifying an investment as a 'Taxonomy-aligned' environmentally sustainable investment in parallel to SFDR. It establishes an EU-wide classification or taxonomy intended to provide businesses and investors with a common language to identify to what degree economic activities can be considered environmentally sustainable. Note that neither the SFDR nor the Taxonomy Regulation oblige firms with Article 8 or 9 products to make Taxonomy-aligned investments.

An economic activity is sustainable if it:

- contributes substantially to one or more of the E objectives;
- DNSH to any other environmental objective;
- complies with technical screening criteria; and
- complies with certain safeguards.

Assessment is against six 'environmental objectives': 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 Taxonomy Regulation imposes supplemental disclosure obligations on FMPs as follows:

- for Article 8 or 9 SFDR products: (i) information on the 'Environmental Objective(s)' (as per the six set out in Article 9 TR) to which the underlying investment contributes; and (ii) a description of how and to what extent the underlying investments are in economic activities that qualify as environmentally sustainable (under Article 3 TR); and
- for Article 8 SFDR products, an additional disclaimer - that the DNSH principle applies only to products that take into account the sustainable economic activity (and other investments do not).

The Commission's [May 2022 Q&A](#) confirmed that Article 8 funds that promote environmental characteristics must disclose the degree to which the fund's investments are in economic activities that are Taxonomy-aligned in the pre-contractual disclosures, regardless of whether the fund commits to investments in environmentally sustainable investments. Where an FMP "fails to collect data" on the degree of Taxonomy alignment, "the pre-contractual and periodic product related disclosures must indicate zero." Recent guidance provides that complementary (i.e., additional) assessments and estimates can be used to assess the Taxonomy alignment of companies out of scope or not yet reporting under the Taxonomy or CSRD. This should alleviate some of the difficulties FMPs face in accessing sustainability data.

For other products under SFDR (i.e., not falling under Articles 8 or 9), a negative disclosure is required to confirm that all out-of-scope financial products are indeed out of scope, using prescribed wording as follows: “The “do no significant harm” principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable activities. The investments underlying the remaining proportion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.” The TR also applies to companies that are required to publish a non-financial statement under the Accounting Directive and those companies will be required to include additional information in their non-financial statements on how and to what extent their activities are associated with environmentally sustainable economic activities.

The TR criteria for when an economic activity can qualify as environmentally sustainable or ‘Taxonomy-aligned’ differs from the ‘sustainable investment’ SFDR definition.

Taxonomy Regulation: environmentally sustainable investments	SFDR: sustainable investment
Substantial contribution to one or more of the six environmental objectives	Contribute to an E or S objective
DNSH to other environmental objectives	DNSH to those objectives
Complies with technical screening criteria	
Compliance with minimum safeguards (i.e., 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)	Investee companies follow good governance practices

PAI statements

The PAI statement is set out in the level 2 RTS Annex I template, mandated for large firms (and which otherwise firms can choose to opt in to). We have highlighted a few practical points for firms completing this template, as set out in the table below.

Practical points on completing PAI statements		
<p>Consideration of adverse sustainability impacts at entity level to cover:</p> <ul style="list-style-type: none"> (i) summary; (ii) description of principal adverse sustainability impacts; (iii) description of policies to identify and prioritise them; (iv) engagement policies; and (v) adherence to international standards on due diligence; alignment with Paris Agreement (where relevant) 	<p>FMPs to complete all fields that relate to the indicators relating to PAI of their investment decisions on sustainability factors (Table 1); plus:</p> <ul style="list-style-type: none"> (i) one or more additional climate and other environment-related indicators (Table 2); (ii) one or more additional indicators for social and employee matters, in respect of human rights, anti-corruption and anti-bribery matters (Table 3); and (iii) information on any other indicators used to identify and assess additional PAI on a sustainability factor. 	<p>Sovereign/supranational bonds and real assets only need to be assessed against their dedicated indicators (mandatory and from the additional indicators that are relevant) and any others that are chosen from the supplementary lists</p>
<p>When information for the indicators is not readily available, FMPs are to detail their best efforts used to obtain the information direct from investee companies, or by carrying out additional research, making use of third party data providers or external experts, or making reasonable assumptions</p>	<p>Engagement policies: to cover brief summaries of the applicable engagement policies (including for listed companies) to reduce PAI and how those policies will be adapted where there is no reduction of other PAI over more than one reporting period</p>	<p>Historical comparison to be made, with the previous reporting period and subsequently, up to the last 5 previous periods</p>

Website disclosures and privacy concerns

Website disclosures are to be published on a “prominent easily accessible area of the website.” There have been concerns with how this public information intersects with confidentiality obligations and privacy rules. The Commission’s [July 2021 Q&A](#) notes that website disclosures “must ensure compliance with Union and

national law governing the data protection, and where relevant, also ensure confidentiality owed to clients”. Therefore keeping website disclosures confidential in some way (e.g., behind logins) may be acceptable if there are confidentiality/privacy concerns. For instance, website disclosures could be: (i) caveated by way of a prominent disclaimer making it clear to whom the site materials are (or are not) directed; (ii) the manager implements procedures reasonable designed to guard against directing information to those to whom the relevant rules prohibit; or (iii) the website requires users to login to access the information and the login registration process requires the user make any relevant representations. In addition, the Commission says that transparency of the “standardised product solutions” that FMPs make use of might be a way for complying with requirements on website disclosures. In other words, standardised website disclosures may be possible even with respect to individual services such as managed accounts.

Supplemental obligations under MiFID and AIFMD

Under the AIFMD Delegated Regulation and the MiFID Delegated Acts firms have (from August/November 2022) to ensure that sustainability risks and sustainability factors are integrated with a manager’s organisational, risk management and product governance processes. On a practical level, this means an AIFM, for instance, would have to:

- take into account sustainability risks and (when relevant under Article 4 SFDR) adverse impacts of investment decisions on sustainability factors in its DD policies;
- have the necessary resources and expertise for the effective integration of sustainability risks (noting that senior management is responsible); and
- consider conflicts relating to integration of sustainability risks. They would also need to consider conflicts relating to integration of sustainability risks (e.g., from remuneration or personal transactions of relevant staff that could give rise to greenwashing, mis-selling or misrepresentation of investment strategies and conflicts of interest between different AIFs managed by the same AIFM).

The MiFID Delegated Directive (which individual member states have to give effect to) provide for firms that distribute funds under a MiFID authorisation or who appoint a third party distributor to:

- carry out a mandatory assessment of sustainability preferences (including a client’s preference for investment in Taxonomy-aligned investments) of their clients and take these into account when selecting financial products to be offered;
- prepare a report explaining how the recommendation meets a retail client’s investment objectives, risk profile, capacity for loss bearing and sustainability preferences; and
- integrate sustainability preferences into the product oversight and governance processes.

This provision arises in the context of distribution and marketing and affects a manager, as a product “manufacturer”, and where it employs a placement agent or other firm as a product distributor, that distributor, in discharging their regulatory and/or contractual duties, especially with respect to target market identification and monitoring. Firms have to assess an investor’s investment objectives, time horizon and individual circumstances before asking for their potential sustainability preferences. They must also distinguish between products that promote ESG characteristics and those that pursue sustainable investment objectives.

Other topics

We have set out in the table below additional topics and anticipated developments in EU sustainable finance, also likely to impact the private funds industry but which, in the interests of trying to be as succinct and focussed as possible, we have not covered in any detail. In many cases there are similar initiatives in other regions, including the UK and the US – covering, for instance, proposals on fund names with sustainable investment terms, ESG ratings and broader measures to tackle greenwashing.

<p>Corporate Sustainability Reporting Directive (CSRD)</p> <p>The CSRD came into force on 5 January 2023 and mandates large issuing companies to make ESG-related disclosures (first reports to be published in 2025). CSRD widens the scope of companies that are subject to the rules, so that listed SMEs are now included (unless they are “micro-entities”).</p>	<p>Corporate Sustainability Due Diligence Directive (CSDDD)</p> <p>The proposed CSDDD seeks to establish a corporate due diligence duty (as well as duties for directors) on companies in relation to actual and potential human rights adverse impacts and environmental adverse impacts. The proposal is currently in the legislative process and timing is uncertain.</p>
<p>Green leases and sustainability certificates for buildings</p> <p>Green leases generally refer to lease agreements that incorporate environmentally friendly provisions and sustainability practices (e.g., energy efficiency measures and waste management), aiming to reduce the environmental impact of buildings. The purpose of sustainability certificates, such as LEED or BREEAM, is to award buildings that meet specific environmental criteria, showcasing their green performance and commitment to sustainable practices. Strictly speaking, Green leases and sustainability certificates for buildings are not EU regulations, but rather evolving industry standards that interact with other sustainable finance legislation, such as SFDR and the TR.</p>	<p>EU green bond standard</p> <p>The proposed European green bond regulation will create voluntary standards for private and sovereign issuers, including non-EU issuers, to help finance sustainable investments. One key element of the proposal is that the funds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy.</p>
<p>ESAs progress reports on greenwashing</p> <p>In May 2023 the ESAs put forward a common high-level understanding of greenwashing applicable to market participants across their respective remits: financial markets, banking, and insurance and pensions. The ESMA Progress Report helps to better understand greenwashing and provides market participants and regulators with a shared reference point in dealing with this phenomenon.</p>	<p>Securities and Markets Stakeholder Group (SMSG)’s <u>responses to ESMA on ESG</u></p> <p>Following the SMSG’s submission to the ESA’s joint call for evidence on greenwashing, ESMA submitted four additional questions to SMSG requesting their input. SMSG have suggested that the current definition of greenwashing in European legislation is too narrow in scope and that there should be greater focus on ESG as a whole, rather than just the environmental</p>

<p>A final report is expected by end May 2024 and will consider final recommendations, including on possible changes to the EU regulatory framework.</p>	<p>aspects which is the focus on many existing regulations.</p> <p>SMSG have also taken the viewpoint that greenbleaching, where funds downplay their ESG credentials, should not be considered a misrepresentation.</p>
<p>ESMA consultation on guidelines on fund names using ESG or sustainability-related terms</p> <p>The purpose is to tackle greenwashing risk in funds, by using quantitative thresholds for the use of ESG and sustainability-related terminology in fund names, to ensure that marketing communications are fair, clear and not misleading and that fund managers are acting honestly. This is expected to be finalised in Q3 2023.</p>	<p>ESG rating providers</p> <p>In June 2023 the Commission adopted a proposal for a regulation to improve the reliability, comparability, and transparency of ESG rating providers, who provide ESG information and analytics for investment strategies, risk management and rating activities. This market will now be brought under the remit of ESMA, to ensure the integrity of ESG rating providers' operations and prevention of risks of conflicts of interests at the provider level.</p>
<p>A Commission Recommendation on how transition finance interplays with the existing sustainable finance framework and how companies, investors and intermediaries can voluntarily use it to finance their transition to a climate-neutral and sustainable economy. This draft non-binding guidance supports awareness (including of member states and supervisory authorities) of those interested in raising or providing transition finance and how the various tools can be used for both investing in transition and managing climate change risks. The Platform on Sustainable Finance and ESAs will be helping inform developments in this area.</p>	<p>EU Taxonomy Delegated Acts (including amendments to the Climate Delegated Act and Environmental Delegated Act) on activities and associated criteria for the six taxonomy environmental objectives. In addition to expanding on the economic activities that substantially contribute to the objectives of climate change mitigation and adaptation, the Commission sets out new criteria for economic activities making a substantial contribution to one or more of the non-climate environmental objectives (namely 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).</p>

Please do not hesitate to speak to one of the authors of this guide, or your usual Goodwin contact, if you have any questions or want to discuss how the EU sustainable finance legislation may impact your fund structures and investments.



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Appendix

SFDR product categorisation and disclosure requirements

Considerations	Categorisation/ SFDR definition	Consequences
<ul style="list-style-type: none"> • General coverage of ESG matters in fund's due diligence process/investment case/investment committee review/decision-making • Manager could have its own policy/framework for integrating ESG into investment processes and/or taking account of sustainability risks (at corporate and portfolio level) and/or be a signatory or adhering to any one or more of the international ESG frameworks or guidelines 	<p>ARTICLE 6 Products that either integrate financially material ESG risk considerations into the investment decision-making process, or explain why sustainability risk is not relevant, but do not meet the additional criteria of Article 8 or 9 products</p>	<ul style="list-style-type: none"> • Basic pre-contractual disclosures on integration of sustainability risks in investment decisions and likely impact on returns (or if the firm does not consider the sustainability risks to be relevant, an explanation of the reasons) • No product-specific disclosures on website • No specific reporting • Negative disclosure under Taxonomy Regulation • Additional pre-contractual disclosures if a firm considers principal adverse impact (PAI) on sustainability factors for each financial product (or a statement that it does not and the reasons)
<ul style="list-style-type: none"> • There has to be a binding nature to how ESG characteristics are embedded in the investment process and promoted in the strategy • This covers a variety of tools and strategies, e.g., screening, exclusion strategies, best in class/universe, thematic investing, certain redistribution of profit or fees • Would expect the majority of investments to meet the ESG criteria/specified exclusions (no minimum specified) • Includes products which commit to making some 'sustainable investments' alongside their promoted E and/or S characteristics 	<p>ARTICLE 8 Promotes E and/or S characteristics (and may invest in sustainable investments, but do not have sustainable investment as a core objective)</p>	<ul style="list-style-type: none"> • Detailed pre-contractual disclosures (mandatory templates from January 2023): in addition to the above, information on how the E and/or S characteristics are met and if an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics • Detailed product-specific website disclosures • Detailed reporting (mandatory templates from January 2023) • Taxonomy Regulation disclaimer/additional disclosures
<ul style="list-style-type: none"> • Article 2(17) SFDR defines Article 9 'sustainable investment': <ul style="list-style-type: none"> – invested in an economic activity that contributes to an E or S objective; – DNSH any of those objectives; and – ensure that the investee companies follow good governance practices, • Fully invest in qualifying assets (subject to limited exceptions) 	<p>ARTICLE 9 Sustainable investment objective (or reduction in carbon emissions (Article 9(3)))</p>	<ul style="list-style-type: none"> • Detailed pre-contractual disclosures (mandatory templates from January 2023): in addition to the above, disclosures to evidence how the investments DNSH to any E or S characteristics • Detailed product-specific website disclosures • Detailed reporting (mandatory templates from January 2023) • Taxonomy Regulation disclaimer/additional disclosures

Regulatory timeline

10 Mar 2021	30 Jun 2021	1 Jan 2022	30 Dec 2022	1 Jan 2023	30 June 2023
<ul style="list-style-type: none"> ● ■ Article 3 – Policies on integration of sustainability risks 	<ul style="list-style-type: none"> ● ■ Article 4 – Mandatory consideration of PAI for FMPs having more than 500 employees 	<ul style="list-style-type: none"> ● ■ ■ Article 11 – Periodic Reports for Article 8 and 9 Products 	<ul style="list-style-type: none"> ● ■ ■ Article 7 – PAI Disclosures at Product Level (including pre-contractual disclosures) 	<ul style="list-style-type: none"> ● ■ ■ Article 8 and 9 – disclosure templates apply 	<ul style="list-style-type: none"> ● ■ Article 4 – First detailed PAI statement under RTS (reference period: 1 Jan 31 – Dec 2022)
<ul style="list-style-type: none"> ● ■ Article 4 – Consideration of Principle Adverse Impact (PAI) statement ('comply or explain') 		<ul style="list-style-type: none"> ● ■ ■ High level disclosure on Taxonomy alignment with the products under SFDR (for climate objectives) 		<ul style="list-style-type: none"> ● ■ Template for annual reporting 	
<ul style="list-style-type: none"> ● ■ Article 5 – Remuneration Policies 				<ul style="list-style-type: none"> ● ■ ■ Disclosure on Taxonomy alignment with SFDR products (for all environmental objectives) 	
<ul style="list-style-type: none"> ● ■ Article 6 – Integration of sustainability risks in investment decisions 					
<ul style="list-style-type: none"> ● ■ Article 8 – Promotion of E and S characteristics 					
<ul style="list-style-type: none"> ● ■ Article 9 – Sustainable Investment objectives 					
<ul style="list-style-type: none"> ● ■ Article 10 – Website Disclosure on Article 8 and 9 Products 					

Level: ● Entity ● Product **Disclosure:** ■ Website ■ Pre-contractual Disclosure ■ Periodic Reports