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EU Sustainable Finance Disclosure Regulation—Impact on Private Fund Managers

By Anne-Gaelle Delabye and Stuart Fross

As of this writing, the European Union's Sustainable Finance Disclosure Regulation (SFDR or Level 1 regulation[1]) is in effect from March 10, 2021 (Effective Date[2]). US fund managers raising capital in Europe now need to make disclosures as to just how "green" and/or "social" they are.[3] In the funds industry, mandatory disclosures under SFDR should be made on the management company level (for example, by the asset managers about their own policies) and on the product level (for example, funds' investment strategies) through several channels: the manager's website; pre-contractual disclosures made to investors, such as those in the private placement memorandum; and periodic reports, such as the annual financial statements of a fund. SFDR may be looked at as having two objectives: (1) to preclude "green washing," and (2) to encourage "green" and/or "social" investing. SFDR encompasses a broad range of entities and products well beyond the investment management industry (including insurance and banking). This article focuses on the implementation of SFDR in the funds industry.

Context

SFDR is a step towards the implementation of the commitments of the European Union under the UN 2030 Agenda, the United Nations Sustainable Development Goals (SGDs)[4] and the Paris Agreement in order to transition capital flows towards environmentally and socially sustainable economic activities.[5] In December 2019, the European Union announced the European Green Deal, a transformative effort to make Europe the first carbon neutral continent by 2050 accompanied by an action plan affecting every aspect of the EU economy. SFDR is one part of a package of regulatory measures brought in by the European Union to create a harmonized sustainable finance framework for the European financial services industry.[6] SFDR is the mechanism by which financial services are to be harnessed to this cause. By year end, it will become a uniform disclosure regime relating to the integration of sustainability risks into investment processes, on the consideration of adverse sustainability impacts of investments, on sustainable investment objectives, or on the promotion of environmental or social characteristics, in investment decisionmaking and in advisory processes.

In this context, within the European Union, it has been determined that the "prudent man rule" now needs to incorporate sustainability risks into investment decisions. In this context EU lawmakers have found that

> financial market participants and financial advisers should integrate in their processes, including in their due diligence processes,

> and should assess on a continuous basis not only all relevant financial risks but also including all relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment or advice. Therefore, financial market participants and financial advisers should specify in their policies how they integrate those risks and publish those policies.[7]

Thus, the EU lawmakers set out to harness the asset managers' fiduciary duty to their clients towards the cause of transitioning the European Union to a more sustainable economy. Further, to make these concepts less abstract, SFDR mandates incorporation of sustainability risk management into the compensation arrangements (that is, the bonuses) of portfolio managers to funds (and in respect of other identified staff). In short, SFDR means to affect the thinking and the compensation of the employees of fund managers.

SFDR Applies to You

SFDR applies to EU "financial market participants" and "financial advisers," terms that incorporate asset managers including alternative investment fund managers (AIFMs) and management companies of undertakings for collective investment in transferable securities (UCITS management companies).[8] It also will apply to: (1) US registered investment adviser (RIA) delegates of AIFMs and UCITS management companies; and (2) US investment managers that manage funds offered in an EU member state by means of a "national private placement."[9]

While funds whose shares are on offer in Europe today are plainly in the scope of SFDR, closed-ended funds that have completed their offerings prior to the Effective Date are in a regulatory twilight zone as of this writing. The SFDR is in effect, and yet it is simply not possible to make "pre-contractual" disclosures, with respect to subscriptions accepted prior to the Effective Date.[10] The industry is hoping for a formal recognition that pre-contractual disclosure is not required by funds whose offerings are closed by member state regulators, over time. This being said, other SFDR requirements (including website disclosures and periodic reports disclosures) still apply to these funds and their AIFMs, even though marketing of these funds ceased prior to the Effective Date.[11]

The Implementation Calendar

While pre-contractual disclosure, and to a certain extent, website disclosures, already apply, this kind of disclosure is the tip of the regulatory "iceberg" and is the first level of SFDR. Implementation of Level 1 regulation is currently done by financial market participants and financial advisers on a principles-based approach. Calendar year 2021 is considered as a transition year due to SFDR's implementation through a phased approach. By year-end, however, the final regulatory technical standards (RTS or Level 2 regulation[12]) will be endorsed by the European Commission, and a detailed format for precisely reporting just how "sustainable" each fund is, will have been implemented. While some of the pre-contractual disclosures and periodic reports will have to comply with Level 2 regulation as from January 2022, Level 2 regulation will have its full impact when the first principal adverse impacts (PAI) statements (as detailed below) are due on June 30, 2022. The second PAI statement with information relating to specific reporting periods (including PAI indicators) will be due June 30, 2023.[13]

Accordingly, US managers must now consider just how sustainable each of their funds is in light of the principles provided for in Level 1 regulation, and be prepared to follow the current draft RTS, follow the final implementation of the RTS, and have their back-offices ready to report in relation to the RTS when adopted over the course of this year. Many industry respondents to the public consultation launched by European Supervisory Authorities (ESAs) on April 23, 2020[14] commented on the challenging timelines of SFDR, particularly in the

absence of final publication of Level 2 regulations. In line with the ESAs' Supervisory Statement,[15] EU regulators encourage financial market participants and financial advisers to use draft RTS that have been published as a reference for the purposes of applying the provisions of the relevant articles of SFDR in the interim period.

Meanwhile, we are to wait until the European Union fully applies the Taxonomy Regulation,[16] which will include additional disclosures for investments in defined activities. While the regulatory regime recently has been completed with the so-called "April package" on April 21, 2021, which includes the draft EU Taxonomy Climate Delegated Act,[17] a proposal for a new Corporate Sustainability Reporting Directive,[18] and six amending delegated acts[19] on fiduciary duties, investment and insurance advice, further evolution is still to be expected.

Sustainable Investments, Sustainability Risk and Sustainability Factors Defined

The concept of a sustainable investment is not limited to combatting climate change (that is, having an environmental objective), but encapsulates a broad agenda of potential social objectives, subject always to "good governance practices," defined as follows:

> an investment in an economic activity that contributes to an **environmental objective**, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to **a social objective**, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow **good governance practices**, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.[20]

In sum, sustainable investments have two possible objectives—environmental or social—but always must be accompanied by good governance.

Sustainability risk is defined as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment". Meanwhile, sustainability factors mean "environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."

Disclosures Required for Asset Managers

SFDR requires the following:

- *A new sustainability risks policy*. AIFMs and UCITS management companies must publish on their websites information about the integration of sustainability risks in their investment decision making process.[21]
- *A business decision on adverse sustainability impact*. Further, AIFMs and UCITS management companies must disclose if they incorporate sustainability risks in their due diligence process, how they do so, or if they do not, why not (including if they do not, when they might do so, in certain circumstances).[22] For those AIFMs and UCITS management companies that do consider sustainability risks, at least some of the time for some of their funds, they must disclose: (a) their policies on identification and prioritization of adverse sustainability impacts and indicators; (b) identified principal PAIs and actions taken

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or planned; (c) brief summaries of their engagement policies; and (d) their adherence to responsible business conduct codes, their due diligence standards and, where relevant, "the degree of their alignment with the objectives of the Paris Agreement."

- *An updated remuneration policy*. AIFMs and UCITS management companies must update their remuneration policy to include information on how their bonus plan is consistent with the integration of sustainability risks. This link between sustainability policy and remuneration policy may not be an easy leap to make, particularly as the manager's approach to incorporating sustainability risk and factors in remuneration will be public through website disclosure. While the level of details to be published on one's website is not specified in Level 1 regulation or Level 2 regulation, fund managers will be left to balance their disclosure obligations and staff retention.
- For each fund (whether ESG or non-ESG fund), AIFMs and UCITS management companies must:
  a. Assess the likely impacts of sustainability risks on the returns of each fund they manage or (for funds that do not embrace ESG) set out the reasons for which they do not consider sustainability risks to be relevant for returns of a particular fund;
  b. Disclose whether and how each fund takes principal adverse impacts on sustainability factors into consideration (if a sustainability due diligence policy is in place) or disclose an express negative statement for each fund;
  c. Review all marketing materials for all funds to ensure that they are in line with SFDR requirements.

PAI Statement Regime—What Does It Mean?

The assessment of the sustainability risks impacting the managers' results and the definition of the strategic sustainability target for their activities is based on the necessity to disclose quantitative and qualitative metrics and information, allowing a clear identification of adverse impacts of investments on sustainability. All of this will need to be documented in a PAI statement.

The Draft RTS require AIFMs and UCITS management companies to publish quantitative disclosures on 14 key indicators[23] (nine indicators related to climate and environment, while the remaining five will cover social, employee, human rights, anti-corruption, and anti-bribery factors) for assessing adverse sustainability impacts of their investment decisions. There are additional indicators applicable to investments in sovereigns and supra-nationals, and investments in real estate assets.[24] In addition to these key indicators, AIFMs and UCITS management companies must report with respect to at least one additional climate or environmental indicator[25] and one additional social, employee, human rights, anti-corruption or anti-bribery indicator.[26]

In terms of qualitative disclosures, draft RTS require the inclusion of:

- A summary of the PAI Statement including the name of the asset manager, the fact that PAI are considered, the relevant reference period (that is, the period from January 1 to December 31 of the preceding year) and a summary of a maximum of two pages;
- A description for the reference period of adverse impacts of investment decisions on sustainability factors that qualify as principal, actions taken during the reference period and that should be taken following the reference period, and historical comparisons with previous reference periods;
- A description of policies to identify and prioritize principal adverse sustainability impacts, the allocation of responsibility for the implementation, the date of their approval, 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 recognized standards for due diligence and reporting, and where relevant, the degree of alignment with the objectives of the Paris Agreement.

Disclosures Required at Fund Level—What Kind of Fund Are You?

In a nutshell, funds in scope will need to assess the relevance of sustainability risks. Higher standards of disclosure apply to funds where sustainable finance is part of the investment strategy; that is, ESG funds. On another note, funds where sustainability risks are considered as relevant but not part of the investment strategy will be subject to a lower standard of disclosure. Some funds may side-step the bulk of the SFDR's compliance obligations by disclaiming all ESG factors as excluded from their investment strategy.

Non ESG Funds

All AIFMs and UCITs management companies have to categorize each of their funds in relation to sustainability risks in one of three categories, named for the SFDR "Article" that describes each fund type. Some funds will fall under Article 6 by reason of being funds that do not deem sustainability risks to be relevant. As to those "Article 6 Funds," pre-contractual disclosure is required as to the reasons that sustainability risk is not considered as part of the investment decisionmaking process.

For those Article 6 funds that do consider sustainability risks as part of the investment decision making process, the manager must disclose how sustainability risks are incorporated and the likely impact of those risks on investment returns. Pre-contractual disclosures will need to be made in the offering materials of the fund, typically in the form of a prospectus (for UCITS) or AIFMD Article 23 disclosures, typically included in or attached to the private placement memorandum (PPM) (for AIFs). We think that a number of US fund managers will look to Article 6 as something of a "safe haven." For example, the authors have seen a significant number of private credit funds credibly disclaiming sustainability risks as not affecting the creditworthiness of their portfolio companies within the time span of their term loans.

ESG (or ESG Friendly) Funds

There are two categories of ESG funds, those that (1) promote environmental or social sustainability (Article 8 Funds) or (2) have sustainable investment as an objective (Article 9 funds). Article 8 Funds and Article 9 Funds should provide enhanced disclosures in their prospectus or PPM. Draft RTS specify the form and content of the information to be disclosed, including through the use of reporting templates to be attached as an annex to the prospectus (for UCITS) or the PPM (for AIFs). Firms that have funds in scope Article 8 or Article 9 will find that pre-contractual disclosure and PAI reporting will be quickly overshadowed by the process of making the detailed disclosures mandated by the RTS.

AIFMs and UCITS management companies of ESG Funds are further required to publish and maintain additional sustainability disclosures on their websites.

SFDR also requires the publication of disclosures in annual reports with quantitative and qualitative indicators which demonstrate how the fund meets its environmental or social characteristics or its sustainable investment objectives. The draft RTS provide a reporting template for ESG funds, which need to be annexed to the fund's annual report. This reporting template will be a significant undertaking, certainly the first time through.

"Article 8 Funds" are those that promote environmental or social objectives with respect to

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portfolio companies that follow good governance practices. Sustainable investment is not the objective of the fund, but it remains an important aspect of the investment process. As to these Article 8 Funds, draft RTS specify the content and format of pre-contractual disclosure addressing six specific points:

1. The environmental or social characteristic promoted by the fund and the sustainability indicators used to measure the attainment of each of the characteristics promoted by the fund;
2. The fund's investment strategy;
3. The fund's asset allocation;
4. Whether the fund takes into consideration PAI on sustainability factors for the fund;
5. The sources of more information on the fund that can be found online; and
6. Whether a specific index has been designated as a reference benchmark and its alignment with each of the characteristics promoted by the fund.

"Article 9 Funds" have a sustainable investment as their objective and a reference index has been designated.[27] An Article 9 Fund that has designated a reference benchmark is required to provide additional disclosures (that is, how the relevant index is aligned with the investment objective of the fund and a clear explanation pursuant to which it is demonstrated that the relevant index differs from a general market index). An additional layer of regulation will apply to Article 9 funds that have a reduction in carbon emissions as an objective. For Article 9 Funds, Draft RTS specify the content and format of pre-contractual disclosures addressing seven specific points:

1. The sustainable investment objective of the fund and the sustainability indicators used to measure the attainment of this objective;
2. The fund's investment strategy;
3. The fund's asset allocation;
4. Whether the fund takes into account PAI on sustainability factors for the fund;
5. The sources of more information on the fund that can be found online;
6. Whether a specific index has been designated as a reference benchmark and its alignment with the objective of the fund; and
7. For a fund that 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.

Risks to US Managers If Fund Does Not Live Up to Its SFDR Declarations

US Fund managers that have Article 8 or Article 9 Funds will need to take stock of their obligations under SFDR while being mindful that Investment Advisers Act Rule 206(4)-8 might apply to any material misstatement or omission.[28] While SFDR may be aspirational, the Advisers Act prohibits any statements that even accidentally (that is, negligently) mislead investors. That the SEC recently launched a "Climate and ESG Task Force" to proactively identify ESG misconduct further bespeaks caution.[29] US advisers will want to consider in this context that non-green trades by a green fund (without any allegation of economic harm) has led to past enforcement.[30] Within the European Union itself, SFDR's implementation to date has not been accompanied by specific enforcement mechanisms. This being said, each Member State is obliged under the SFDR to designate its competent national supervisory authority and vest it with all necessary supervisory and investigatory powers.[31] Accordingly, the authors expect that the EU rules applicable to prospectus misstatements would also apply. Given the extraordinary depth of detail in the PAI Statement disclosure that will soon be required, now is the time for US managers to take stock of their obligations in respect of their Article 8 and Article 9 funds.

Practical Tips

SFDR is a significant undertaking for managers who have "green" or "social" within their investment strategies and that intend to or have raised capital in Europe. After a first deadline on March 10, imposing a principles-based compliance approach with SFDR, you have until the end of the year to get ready to collect data and reporting in new ways under the RTS from January 1, 2022. Given that the final RTS likely will be adopted toward the end of the year, there is no choice but to read into the draft RTS. For the rest of the "street," Article 6 offers something of a safe-haven and even a glance at the draft RTS may discourage some US fund managers from venturing from Article 6. For those advisers in the realm of Article 8 or Article 9, the intersection of SFDR and US securities laws counsels "under promising" in all investor communications, and, ultimately, allowing the highly detailed reporting under the RTS to speak for itself during investor due diligence.

Ms. Delabye is a partner of Ogier, Luxembourg. **Mr. Fross** is a partner of Foley & Lardner, LLP. This publication may be considered advertising for legal services under the laws and rules of professional conduct of the jurisdictions in which Foley or Ogier practices. The information herein should not be used or relied on in regard to any particular facts or circumstances without consulting a lawyer.

NOTES

1. Regulation (EU) 2019/2088 of the European Parliament and of the Council of November 27, 2019 on sustainability-related disclosures in the financial services sector.
2. Most of SFDR obligations (including disclosures on website and pre-contractual disclosure obligations) commenced March 10, 2021. SFDR is supplemented with further details in regulatory technical standards (RTS) that are supposed to enter into force on January 1, 2022.
3. Indeed, SFDR is not just about environment, but also about social and governance considerations.
4. Defined in the Resolution adopted by the UN General Assembly on September 25, 2015 - Transforming our world: the 2030 Agenda for Sustainable Development (A/RES/70/1).
5. Paris Agreement is an agreement within the United Nations Framework Convention on Climate Change (UNFCCC), on climate change mitigation, adaptation, and finance, adopted at the 21st Conference of the Parties of the UNFCCC on December 12, 2015.
6. The overall regime includes the following:
   - Taxonomy regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of June 18, 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088);
   - the Benchmarks Regulation (Regulation (EU) 2016/1011 of the European Parliament and of the Council of June 8, 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014); as well as amendments to the
     - — AIFMD (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010);
     - — UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast); and
     - — MiFID II (Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU).

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[7] Recital 12 of the SFDR.

[8] The authors note that all SFDR obligations for AIFMs, UCITS ManCos and their delegates in this article also apply to self-managed funds.

[9] The authors anticipate that US RIAs whose funds have been purchased in the EU by means of a "reverse solicitation" may be expected to take the view that SFDR pre-contractual disclosure does not apply to them.

[10] The authors understand that national regulators have communicated with industry participants on the issue of the application of SFDR to funds that no longer offer their shares, with feedback that is not uniform, as of this writing.

[11] Managers of venture capital funds are also within scope of SFDR.

[12] Final Report on draft Regulatory Technical Standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a(3), Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088 developed by European Supervisory Authorities (ESAs) through the Joint Committee (JC) dated February 2, 2021 and published on February 4, 2021.

[13] ESA Letter Citation-Joint European Supervisory Authorities' Supervisory Statement on the application of the Sustainable Finance Disclosure Regulation of 25 February 2021 and the Joint Committee of the European Supervisory Authorities letter on the Priority issues relating to SFDR application of January 7, 2021.

[14] Joint ESA consultation on ESG disclosures - From 23 April 2020 to 01 September 2020.

[15] Joint European Supervisory Authorities' Supervisory Statement on the application of the Sustainable Finance Disclosure Regulation of 25 February 2021.

[16] Taxonomy regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of June 18, 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088).

[17] Commission Delegated Regulation (EU) …/… of XXX supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives (provisional version - C(2021) 2800/3).

[18] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM(2021) 189 final).

[19] *See* EU Commission's Website on sustainable finance.

[20] The draft RTS published on 4 February 2021, including a draft of a mandatory reporting template for use for a statement of "universal adverse indicators" when considering "(1) adverse impacts on the climate and other environment-related adverse impacts and (2) adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters." The authors note a variation between the RTS scope for good governance (inclusive of anti-corruption and anti-bribery) and the scope of good governance under SFDR (inclusive of tax compliance).

[21] The level and detail of this disclosure must be enhanced by December 30, 2022 to include a "a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors" and annual report disclosure of the same.

[22] Disclosure is mandatory from June 30, 2021 for all firms employing 500 or more employees and for their parent undertakings. The 500-employee number is an average, measured during the "financial year," presumably starting with December 31, 2020 year ends.

[23] Previous draft RTS provided for a list of 32 mandatory indicators—this reduced list of indicators is a relief for the industry.

[24] *See* Table 1 of Annex 1 of the draft RTS.

[25] *See* Table 2 of Annex 1 of the draft RTS.

[26] *See* Table 3 of Annex 1 of the draft RTS.

[27] The Draft RTS acknowledge that not all funds are index based. As to actively managed funds, under the draft RTS it will be possible to "derogate" from the index requirements.

[28] The Advisers Act Advertising Rule 206(4)-1 may also apply to private offering memoranda used in the European Union, if not filed with a regulator, and if deemed to be "made" by the Adviser and not by the Fund. *See*, Advisers Act Rule 206(4)-1(e) (precluding misleading disclosures in an advertisement defined as a communication made by the adviser to any person).

[29] *See*, SEC Press Release March 4, 2021 announcing the formation of the Climate and ESG Task Force of the Division of Enforcement, *https://www.sec.gov/news/press-release/2021-42*.

[30] Investment Advisers Act Release No 2761; Investment Company Act Release 2844 (July 30, 2008) (Failure to properly implement "ESG" type screening violated Section 206(2) of the Advisers Act, even in the absence of economic harm).

[31] In Luxembourg, see bill of law N° 7774 implementing, *inter alia*, the SFDR.

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