

Latest RTS for taxonomy and SFDR – detailed product disclosure regime

30 November 2021

1. Speed read

As the start date for the EU Taxonomy Regulation looms, the ESAs have published their final draft of the RTS for the taxonomy's product disclosure requirements. This sets out the detailed disclosures required to be made by firms to indicate how aligned a relevant product is to the taxonomy – i.e. what is green vs what is not.

This briefing gives a snapshot on what changes were made in the final RTS.

For a copy of our previous briefings on the RTS, [click here](#)¹.

2. How did we get here?

The Sustainable Finance Disclosure Regulation 2019/2088 (**SFDR**) was adopted on 27 November 2019 – it began to apply in a phased way from 10 March 2021².

The **Taxonomy Regulation** entered into force on 12 July 2020, and is formally known as Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment³. Among other things, it introduces a detailed product disclosure regime for products in scope of SFDR, via both directly applicable requirements and amendments to SFDR. It will also apply in a phased way, beginning on 1 January 2022.

Under SFDR, the European Supervisory Authorities (**ESAs**) were mandated to develop Level 2 requirements or Regulatory Technical Standards (**RTS**). After a slightly protracted process, a final report on a draft RTS for SFDR was published by the ESAs on 2 February 2021 (**SFDR RTS**)⁴.

The ESAs were separately mandated to develop an RTS for the taxonomy-related product disclosure requirements. To this end, on 15 March 2021, the ESAs published for consultation a draft RTS for the detailed product disclosure regime in the Taxonomy Regulation (**Draft Taxonomy RTS**)⁵. This essentially amended the SFDR RTS to cover taxonomy-related points.

3. Final proposed RTS for taxonomy and timing

The ESAs have now published, on 22 October 2021, their final report on this taxonomy-related RTS, amending their original proposals in certain respects and publishing updated templates to be used by relevant firms when making their pre-contractual and periodic disclosures under SFDR and the Taxonomy Regulation (**Final Taxonomy RTS**)⁶.

The European Commission will now consider the Final Taxonomy RTS and decide whether to endorse it.

In terms of next steps:

– We understand the Commission proposes to issue both the SFDR RTS and the taxonomy-related RTS in one instrument. Although the precise timing for this is unclear, it is expected by the end of 2021.

– It is also expected that the detailed requirements imposed by the RTS for the purposes of the SFDR and the taxonomy product disclosure regime will begin to apply in a phased way, beginning on 1 January 2023 – this was proposed by the Commission in a letter dated 29 November 2021⁷.

– Although similarly unclear, it is presently expected that the Level 1 requirements under the taxonomy product disclosure regime will begin to apply from 1 January 2022.

For further advice on this “timing mismatch” and how it may be managed, please get in touch with your usual A&O contact.

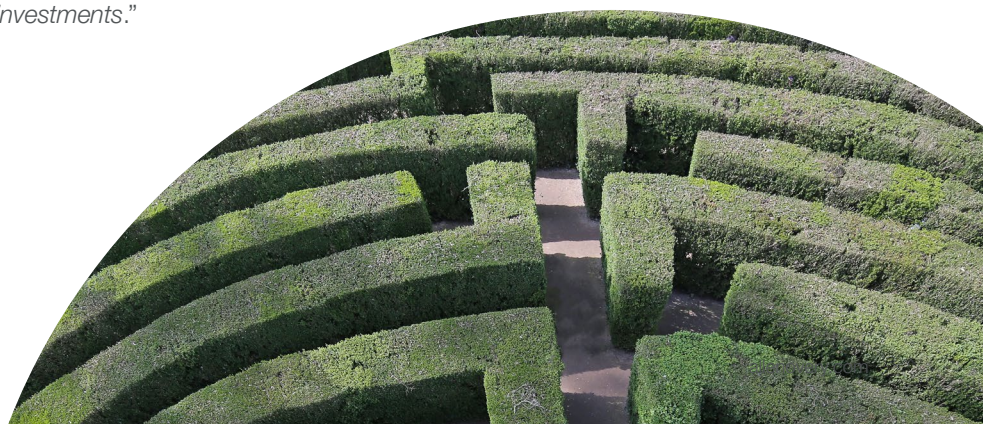
4. What changed in the final taxonomy RTS

The Final Taxonomy RTS included a number of amendments to the ESAs original proposals, although the final version remains controversial in some respects. There are also significant concerns in the industry as to how the RTS can be complied with in practice in the absence of sufficient data/reports from investee companies. In addition, the ESAs unfortunately did not take the opportunity to answer or resolve some of the key industry questions relating to the SFDR, which therefore remain outstanding.

Some of the key changes made in the Final Taxonomy RTS are as follows:

- **New templates** – Updated pre-contractual and periodic disclosure templates (the **Templates**) have been issued, with both cosmetic changes and certain changes of substance, as summarised below.
- **Removal of industry concession** – The Draft Taxonomy RTS gave the industry ‘a break’ on a small but operationally significant point. Essentially, it said that a taxonomy-aligned investment could be automatically considered a “sustainable investment” under SFDR, without further consideration of the SFDR mandated “do not significantly harm” (**DNSH**) test. In the Final Taxonomy RTS, this concession is no more. The ESAs have decided that their approach was not consistent with the Level 1 requirements: “As a result, the DNSH related rules will be applied to all sustainable investments including the taxonomy-aligned investments.”

- **Sovereign bonds** – To accommodate the vexed question as to how firms could or should report taxonomy alignment where a particular portfolio includes sovereign bonds, the Final Taxonomy RTS has proposed a solution. Essentially, a firm must now include two pie charts to show the taxonomy alignment of the product: one to include sovereign exposure and a second which will not. In other words, in this second pie chart, sovereign debt would not be included in either the numerator or denominator. In this regard, the Templates state as follows: “As there is no appropriate methodology to determine the Taxonomy-alignment of sovereign bonds, the first graph shows the Taxonomy-alignment in relation to all the investments of the financial product including sovereign bonds, while the second graph shows the Taxonomy-alignment only in relation to the investments of the financial product other than sovereign bonds.” The Final Taxonomy RTS also notes this is to “[avoid] the problem of perception that could otherwise arise because of potentially low KPIs where financial products have high exposures to sovereigns. The low KPIs would be caused by the lack of a reliable methodology to derive taxonomy-aligned activities funded by sovereign exposures.”



– **Derivatives** – When calculating the alignment of a portfolio with the taxonomy, derivatives should not be included in the numerator. By way of reasoning: *“The ESAs note the feedback received on the topic of derivatives in the KPI for taxonomy-alignment. Bearing in mind that the ESAs want to ensure that taxonomy-aligned investments directly fund taxonomy-aligned economic activities, the ESAs have decided not to include derivatives in the numerator of the KPI. While there may be legitimate cases for derivatives to be recognised for directly contributing to taxonomy-aligned economic activities, out of an abundance of prudence the ESAs prefer to exclude derivatives for the time being. This issue may be reconsidered in the future once there may be more evidence in this area to allow a different conclusion.”*

– **Auditor/third party assurance as to taxonomy alignment** – Although no third party assurance is mandated, the Templates require a firm to say whether or not it has been provided. They must therefore include an *“indication of whether the compliance of the investments with the taxonomy will be subject to an assurance by auditors or a review by third parties and, if so, the name of the auditor(s) or third party(ies)”*. The reasoning for this is that: *“The ESAs believe that in order to disclose “how” investments underlying the financial product are made in economic activities that qualify as environmentally sustainable under the TR [Taxonomy Regulation], the disclosure on asset allocation of the financial product should include an indication of whether the environmentally sustainable economic activities’ compliance with the criteria in Article 3 of Regulation (EU) 2020/852 has been subject to an assurance provided by an auditor or a review by a third party, and if so, the name of that auditor or third party (for pre-contractual disclosures, whether it will be subject to assessment by auditors or third parties).”*

– **Short positions and netting** – When calculating the alignment of a portfolio with the taxonomy, netting can be used in the numerator, *“to ensure a fair representation of the economic exposure to securities in the numerator. The ESAs recognise that this would be aligned with the European Commission’s proposed Delegated Act for Article 8 TR [Taxonomy Regulation] entity-level disclosures”*. Netting should be done using the methodology used to calculate net short positions laid down in Article 3, paragraphs 4 and 5 of the Regulation (EU) No 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps.

– **Multiple KPIs** – The ESAs noted that various feedback had been received on its original proposals as regards KPIs, including the following: *“Most non-industry respondents, including NGOs, advised the ESAs to require the disclosure of [taxonomy alignment using] all three indicators: turnover, CapEx and OpEx.”*

In terms of where it landed, this was a slightly mixed bag, with one position for pre-contractual disclosures and another for periodic disclosures:

“The ESAs take note of the feedback received on the important issue of how the taxonomy-alignment KPI should be calculated for these product disclosures. Bearing in mind the objective of SFDR of transparency and comparability, the ESAs believe that requiring for pre-contractual disclosures the calculation of the taxonomy-alignment based on turnover by default, with the possibility to disclose capital expenditure or operational expenditure as an alternative when this is justified by the features of the financial product, while requiring the KPI to be calculated using all three indicators in the periodic disclosures offers the best balance between comprehensibility and comprehensiveness of the disclosures.”

To be clear, for periodic reports, a firm must therefore provide a disclosure as to a product’s alignment with the taxonomy in the form of a bar chart with three bars and the following note in the left-hand margin of the template:

“Taxonomy-aligned activities are expressed as a share of:

- *turnover reflecting the share of revenue from green activities of investee companies*
- *capital expenditure (CapEx) showing the green investments made by investee companies, e.g. for a transition to a green economy; and*
- *operational expenditure (OpEx) reflecting green operational activities of investee companies.”*

– **Social** – Firms must disclose the minimum share of social sustainable investments within a relevant product.

– **Where data is not available** – Recital 6 of the Final Taxonomy RTS indicates that, where disclosures are not yet made under Article 8 of the Taxonomy Regulation (i.e. for investee companies in which an SFDR product invests), firms can source such data from third party data providers. As per the Draft Taxonomy RTS, Recital 4 then goes on to provide how firms should proceed in respect of “investee companies that are not subject to the disclosures required by Article 8 of Regulation (EU) 2020/852”, e.g. non-EU companies. In this case it states that: “public reporting of data should be prioritised, followed by privately obtained data, either directly from investee companies or from third parties, in each case provided the information is equivalent to the disclosures made in accordance with that Article.” What will be considered “equivalent”, however, is unclear.

– **Must an Article 9 product (and its product provider) consider Principal Adverse Impacts (PAI)?** – The Draft Taxonomy RTS suggested the answer of the ESAs to this question was “yes”. This is based on the disclosure requirement in Article 24 of the Draft Taxonomy RTS for Article 9 products, being especially clear when considered as against the equivalent wording for Article 8 products found in Article 17. However, as shown below, this suggestion was removed in the Final Taxonomy RTS (emphasis added):

	Draft Taxonomy RTS (15 March 2021)	Final Taxonomy RTS ⁸ (22 October 2021)
Article 9 products	<p>“Article 24</p> <p>Identification of principal adverse impact consideration section for financial products with the objective of sustainable investment [i.e. Article 9 products]</p> <p>The section referred to in point (d) of Article 20(3) shall explain that the financial product contributes to a sustainable investment objective by considering principal adverse impacts on sustainability factors as referred to in Article 7(1)(a) of Regulation (EU) 2019/2088.”</p>	<p>“Article 22</p> <p>Identification of principal adverse impact consideration section for financial products with the objective of sustainable investment [i.e. Article 9 products]</p> <p>The section referred to in point (b) of Article 20(3) shall:</p> <p>(a) explain whether the financial product considers principal adverse impacts on sustainability factors;</p> <p>(b) explain how such principal adverse impacts are considered; and</p> <p>(c) include a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed pursuant to Article 11(2) of Regulation (EU) 2019/2088.”</p>
Article 8 products	<p>“Article 17</p> <p>Identification of principal adverse impact consideration section for financial products that promote environmental or social characteristics [i.e. Article 8 products]</p> <p>The section referred to in point (d) of Article 13(3) shall explain whether the financial product promotes environmental or social characteristics by considering principal adverse impacts on sustainability factors as referred to in Article 7(1)(a) of Regulation (EU) 2019/2088.”</p>	<p>“Article 14a</p> <p>Identification of principal adverse impact consideration section for financial products that promote environmental or social characteristics [i.e. Article 8 products]</p> <p>The section referred to in point (b) of Article 13(3) shall:</p> <p>(a) explain whether the financial product considers principal adverse impacts on sustainability factors;</p> <p>(b) explain how such principal adverse impacts are considered; and</p> <p>(c) include a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed pursuant to Article 11(2) of Regulation (EU) 2019/2088.”</p>

In our view, this is strictly correct to the extent that SFDR does not expressly prescribe or mandate an answer to the question noted above. In practice, however, it is difficult to see how a firm with an Article 9 product could avoid considering PAI. Accordingly, in our view, the answer to the question noted above must in fact be “yes, in practice”.

For example:

- PAI is closely related to the “DNSH requirement, which is one of the tests for a “sustainable investment” and therefore a mandatory component of an Article 9 product; and
- under the Final Taxonomy RTS, reporting on PAI indicators is mandatory for Article 9 products – this is clear in the RTS itself, but also clear from Recital 19 in the SFDR RTS: “Financial products that have a sustainable investment objective must also consider adverse impact indicators as part of their disclosures of no significant harm to sustainability objectives.”

We note also the following:

- in the Final Taxonomy RTS, the ESAs referred to the following (emphasis added): “general SFDR RTS relating to the principle of Do No Significant Harm (DNSH) (which require taking into account the adverse impact indicators of Annex I of the RTS)...”; and
- in the SFDR RTS they stated: “In addition to disclosing how the financial market participant has taken into account the indicators for adverse impact in Annex I, the DNSH reporting must also show...”.

In light of these types of comments, it remains difficult to conclude that it is open to an Article 9 product or its product provider to “opt out” of the PAI regime as contemplated by Article 4(1)(b) and Article 7(2) of SFDR, even if this route is otherwise open given the product provider’s size.

For a copy of a compare between the Final Taxonomy RTS (22 October 2021) and the Draft Taxonomy RTS (15 March 2021), please get in touch with one of the authors.



5. Key reference materials

- For a copy of SFDR, [click here](#), or for a consolidated version, [click here](#).
- For a copy of the Taxonomy Regulation, [click here](#).
- For a copy of the Draft Taxonomy RTS (dated 15 March 2021) for the product disclosure requirements under the Taxonomy Regulation, [click here](#).
- For a copy of the Final Taxonomy RTS (dated 22 October 2021) discussed in this bulletin, [click here](#).
- For a copy of a compare between the Final Taxonomy RTS (22 October 2021) and the Draft Taxonomy RTS (15 March 2021), please get in touch with one of the authors.

References

¹ <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/sfdr-and-taxonomy-regulation-deadlines-a-compliance-checklist-for-private-banks-wealth-managers-and-advisers>

¹ <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/sfdr-and-taxonomy-regulation-deadlines-what-asset-managers-need-to-know>

¹ <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/great-fund-insights-new-sfdr-principle-adverse-impacts-pai-regime-key-points>

² <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>

³ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852>

⁴ https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

⁵ https://www.esma.europa.eu/sites/default/files/library/jc_2021_22_-_joint_consultation_paper_on_taxonomy-related_sustainability_disclosures.pdf

⁶ https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf

⁷ See https://www.esma.europa.eu/sites/default/files/library/com_letter_to_ep_and_council_sfdr_rts-j.berrigan.pdf

⁸ In terms of timing, note the following under the Final Taxonomy RTS to reflect the timing for Article 7(1) of SFDR being 30 December 2022 (emphasis added):

“Article 2 Entry into force and application

- 1. This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.*
- 2. This Regulation shall apply from [1 January 2022] in respect of the environmental objectives referred to in points (a) and (b) of Article 9 of Regulation (EU) 2020/852 and from 1 January 2023 in respect of the environmental objectives referred to in points (c) to (f) of Article 9 of that Regulation.*
- 3. By way of derogation from paragraph 2, points (b) and (c) of Article 14a, points (b) and (c) of Article 22, point (e) of Article 59 and point (f) of Article 65 shall apply from 30 December 2022.”*