HERBERT SMITH FREEHILLS

ASSET MANAGEMENT E-BULLETIN

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10 December 2021 | London | Germany

Green light for the Taxonomy Climate Delegated Act – what Financial Market Participants need to know now

The Taxonomy Climate Delegated Act, the second level implementing act for the Taxonomy Regulation's first two environmental objectives (climate change mitigation and climate change adaption), was published in the EU Official Journal yesterday. Overshadowed by the prominent EU controversy on nuclear and gas, the Taxonomy Climate Delegated Act has quietly made it across the finishing line as the first of several sets of implementing provisions for the ambitious Taxonomy Regulation.

The EU Council's green light came just in time. As of 1 January 2022, financial services industry participants subject to the Sustainable Finance Disclosure Regulation ("**SFDR**") as well as companies subject to non-financial reporting obligations under the Non-Financial Reporting Directive will have to make certain disclosures regarding the first two Taxonomy Regulation objectives covered by the Taxonomy Climate Delegated Act. This briefing focuses on the Taxonomy disclosure obligations under SFDR applicable to so-called "Financial Market Participants" ("**FMPs**"), notably fund and asset managers, insurers, pension funds, banks and investment firms, which offer "Financial Products" subject to SFDR. Financial Products include funds, investment-based insurance products ("**IBPs**") and certain pension products and also extends to the portfolio management of segregated accounts. Under the SFDR, FMPs must make pre-contractual, periodic and website disclosures on sustainability risks and factors and on certain environmental and social aspects of their Financial Products.

- **Why the Taxonomy Climate Delegated Act is relevant for FMPs**
- **Additional Taxonomy disclosure requirements for many SFDR Financial Products**
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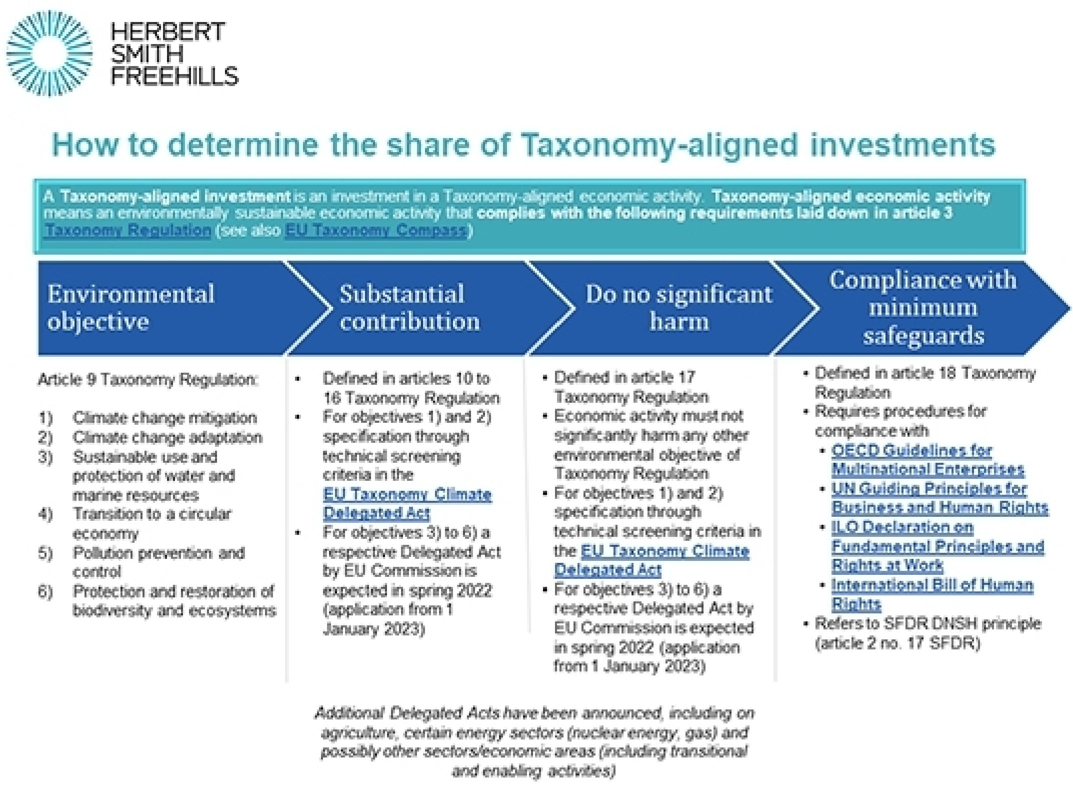
Why the Taxonomy Climate Delegated Act is relevant for FMPs

The Taxonomy Regulation serves to add further pre-contractual and periodic disclosures for all Financial Products under SFDR. From 1 January 2022, FMPs will need to disclose whether investments made by certain Financial Products are "Taxonomy-aligned", i.e. made into economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. Such disclosures must be included in pre-contractual information (e.g. in a fund prospectus, MiFID disclosure document or pre-contractual information for IBIPs) as well as in periodic reporting issued after 1 January 2022 (i.e. in a fund annual report or annual status report for IBIPs).

To determine the Taxonomy-alignment of a particular investment FMPs will first have to assess whether the economic activity financed by the investment qualifies as environmentally sustainable economic activity under the Taxonomy Regulation (such activities are usually called "Taxonomy-aligned economic activities"). The assessment process is based on the following four criteria:



The Taxonomy Climate Delegated Act provides details on two of these criteria for the first two Taxonomy Regulation objectives (climate change mitigation and climate change adaptation). It establishes which economic activities substantially contribute to these two Taxonomy objectives and do not significantly harm any other Taxonomy objective. For the time being, it is not comprehensive and focusses on key sectors such as energy, forestry, manufacturing, transport and buildings. Even so, it runs to a formidable 349 pages. The EU Commission's Taxonomy Compass, however, seeks to facilitate access to the detailed and technical provisions of the Taxonomy Climate Delegated Act.

Assessing whether an investment's underlying economic activities are Taxonomy-aligned is however only the first step. FMPs will also have to determine if and how such economic activity can be attributed to the respective investment. Articles 5 and 6 Taxonomy Regulation do not provide specific guidance on how to calculate this attribution. This will be part of the implementing provisions for SFDR ("**SFDR RTS**") which have recently been deferred by the EU Commission to 1 January 2023.

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Additional Taxonomy disclosure requirements for many SFDR Financial Products

It is often overlooked that the Taxonomy Regulation's additional disclosures are not limited to specific ESG products such as the "light green" and "dark green" Financial Products which qualify under to article 8 and article 9 SFDR. They also apply to Financial Products which are only subject to article 6 SFDR. The content of the disclosure, however, varies depending on the qualification of the Financial Product for Taxonomy Regulation purposes. Financial Products according to article 8 or article 9 SFDR which make sustainable investments with environmental objectives will have to disclose to which extent their investments are Taxonomy-aligned. Financial Products subject to article 6 SFDR will need to declare that their investments do not consider the Taxonomy Regulation. Article 8 and article 9 SFDR Financial Products pursuing social objectives or having social characteristics fall outside of the scope of articles 5 to 7 Taxonomy Regulation and therefore will not need to make any Taxonomy-related disclosures. There is a bit of uncertainty on how to deal with article 8 SFDR Financial Products having environmental characteristics but not making environmentally sustainable investments. Many market participants refer to the wording of article 6 Taxonomy Regulation which requires such Financial Products to disclose their investments' Taxonomy-alignment (which will in all cases be 0%). Other market participants rely on statements made by the European Supervisory Authorities ("**ESAs**") and the EU Commission which insinuate that such Financial Products do not have to make any Taxonomy disclosures. In its 5th Sustainable Finance Roundtable on 7 December 2021 EIOPA has taken the view that such Financial Products should make the same disclosure as article 6 SFDR Financial Products.

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Many open questions and only little guidance available

The financial services industry had hoped in vain for more guidance by the ESAs or the EU Commission prior to 1 January 2022. This has not been forthcoming. The European insurance supervisor EIOPA has recently stated, in its 5th Sustainable Finance Roundtable, that unlike in relation to the Taxonomy disclosures in non-financial reporting there will be no alleviation for Taxonomy-alignment disclosures under SFDR. FMPs will have to determine and disclose the Taxonomy-alignment of their investments based on all four criteria required for the assessment of the underlying economic activities (see the chart above). At the roundtable, EIOPA expressly excluded the possibility that FMPs limit their disclosures to "Taxonomy eligibility", i.e. to the share of investments financing economic activities which are described in the Taxonomy Climate Delegated Act. EIOPA also stated that the assessment of Taxonomy-alignment of economic activities is not expected to be based on estimates. In the absence of real data from investee companies or third party data providers, an economic activity should not be regarded as Taxonomy-aligned. This is different from the product level disclosures under SFDR for which the SFDR RTS permit the use of estimated data.

As mentioned above, knowing whether an economic activity is Taxonomy-aligned does not automatically determine the extent to which the investment financing this activity can be considered as Taxonomy-aligned for the purposes of the SFDR Taxonomy disclosures. Although the respective SFDR RTS will only apply from 1 January 2023, we expect that some FMPs may use the ESAs' proposals for investment-level Taxonomy-alignment as a guide for the disclosures to be made from 1 January 2022.

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Next steps on SFDR Taxonomy disclosures

While the EU Council may propose a Solomonic solution next week to solve the controversies on the integration of nuclear and gas, further guidance on Taxonomy disclosure obligations in the context of SFDR will have to wait until January or February next year. EIOPA has announced that the EU Commission intends to release the delegated act containing the SFDR RTS in January 2022, to be followed by EU Parliament and EU Council scrutiny. Following the release of the delegated act, the ESAs aim to update their February 2021 Supervisory Statement on SFDR application and publish a Q&A on practical SFDR application.

In the course of 2022, the EU Commission will also finalise the technical screening criteria for the remaining four environmental objectives for which disclosure obligations will apply from 1 January 2023. In addition, the Taxonomy Regulation and its delegated acts on technical screening criteria may and will evolve over time. The EU Commission announced that further delegated acts, or revisions of existing ones, will likely include other economic activities from different sectors and sub-sectors of the economy, as these become relevant and feasible to be integrated into the Taxonomy framework.

Even without further activities on the Taxonomy framework, 2022 is bound to be a busy year for FMPs. The first SFDR compliant periodic disclosures (including Taxonomy Regulation disclosures) will need to be made in 2022. Moreover, from 1 August 2022 fund managers will need to integrate sustainability risks and factors into their organisational structure. The same obligations will hit investment firms one day later, on 2 August 2022. In addition, from that date, anyone offering investment advice or insurance intermediation must duly consider sustainability preferences of its customers. In a next step, sustainability preferences are also integrated into the target market concept from 22 November 2022. Finally, by 30 December 2022 FMPs will need to disclose under SFDR whether they consider principal adverse impacts on sustainability factors at product level.

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KEY CONTACTS

Heike Schmitz
Partner
Germany
+49 211 9755 9012
Email

Nish Dissanayake
Partner
London
+44 20 7466 2365
Email

Marina Reason
Partner
London
+44 20 7466 2288
Email

Shantanu Naravane
Senior Associate
London
+44 20 7466 2077
Email

Grant Murtagh
Of Counsel
Germany, London
+44 20 7466 2158
Email

Janis Rentrop
Associate
Germany
+49 211 975 59103
Email