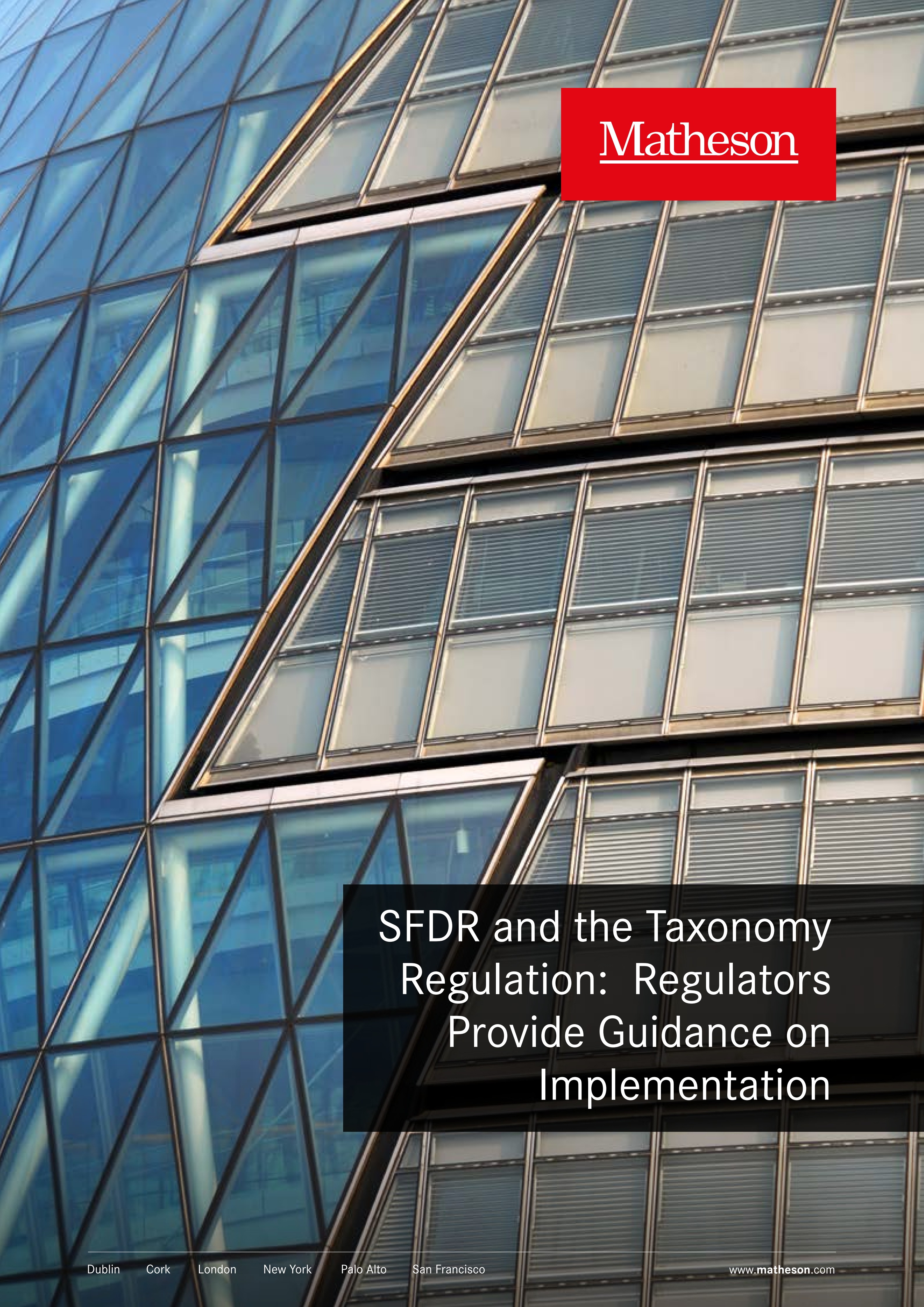

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SFDR and the Taxonomy Regulation: Regulators Provide Guidance on Implementation

April 2022

The long-awaited updated supervisory statement on the application of the Sustainable Finance Disclosure Regulation ("**SFDR**") was recently published by the European Supervisory Authorities ("**ESAs**"), followed by a meeting between Irish Funds industry representatives (including Head of our Asset Management and Investment Funds Department, Tara Doyle) and the Central Bank of Ireland ("**Central Bank**") to discuss implementation issues.

We have set out below the updates to the supervisory statement and a summary of the discussions with the Central Bank at the 5 April meeting.

ESAs' Updated Supervisory Statement

On 25 March 2022, the ESAs updated their joint supervisory statement on the application of the SFDR, replacing their initial statement published in February 2021 (the "**ESAs' Supervisory Statement**"). The purpose of the ESAs' Supervisory Statement is to provide national competent authorities ("**NCAs**") and financial market participants ("**FMPs**") with guidance on how to comply with the requirements of the SFDR and the Taxonomy Regulation in the interim period between the application date of the Level 1 requirements (10 March 2021 in the case of the SFDR and 1 January 2022 with respect to the first two environmental objectives set out in the Taxonomy Regulation) and the application date of the Level 2 regulatory technical standards ("**RTS**") to be adopted under the SFDR / Taxonomy Regulation (expected to be 1 January 2023). The aim is to ensure the consistent application and supervision of the SFDR / the Taxonomy Regulation.

The ESAs recommend that NCAs and FMPs use the interim period until 1 January 2023 to prepare for the application of the RTS while also applying the relevant measures of the SFDR and the Taxonomy Regulation according to the relevant application dates set out in the ESAs' Supervisory Statement. FMPs should have regard to the content of the draft RTS published in February 2021 and October 2021 in applying the relevant provisions of the SFDR and the Taxonomy Regulation during the interim period, although the ESAs note that the draft RTS may be subject to change.

In relation to the disclosures required under Articles 5 and 6 of the Taxonomy Regulation (requiring in-scope funds to disclose the extent to which underlying investments are in environmentally sustainable economic activities), the ESAs expect that during the interim period FMPs will provide an "explicit quantification" through the numerical disclosure of a percentage of the extent to which investments underlying the financial product are Taxonomy-aligned. The ESAs state that estimates should not be used but, where information is not readily available from the public disclosures by investee companies, FMPs may rely on equivalent information on Taxonomy alignment obtained directly from investee companies or from third party providers.

The numerical disclosure may be accompanied by a qualitative clarification explaining how the fund addresses the determination of the proportion of Taxonomy-aligned investments, for example by identifying the sources of information. Such clarification should not disclose more information than what is required by Article 5 Taxonomy Regulation.

The annex to the ESAs' Supervisory Statement sets out the following guidance on the application timelines in the SFDR:

Principal adverse impact reporting	Entities which choose to or are required to comply with the entity-level disclosures for principal adverse impacts ("**PAIs**") under Article 4 SFDR should update their PAI statement to reflect the final RTS from 1 January 2023. The first information relating to a reference period should be disclosed in the PAI statement published on or before 30 June covering a reference period of 1 January 2022 to 1 December 2022.
Periodic disclosures	Annual reports of Article 8 and Article 9 SFDR funds published after 1 January 2022 must comply with the periodic disclosure requirements in Article 11 SFDR irrespective of the reference period covered. The draft RTS may be used as a reference until the RTS application date of 1 January 2023.

Central Bank Expectations

During the first quarter of this year, the Central Bank conducted a spot check on submissions received via the streamlined process for filing of disclosures related to SFDR and the Taxonomy Regulation. On 5 April 2022 the Central Bank met with representatives of the Irish Funds ESG Policy, Legal and Regulatory Working Group to discuss initial feedback on the review's findings.

The Central Bank reviewed 35 submissions over a number of UCITS management companies and AIFMs, comprising 11 Article 6 funds, 17 Article 8 funds and 7 Article 9 funds.

Article 6 Requirements

The Central Bank noted that some funds had deemed sustainability risks not to be relevant and was generally satisfied with the detailed explanations provided for why those risks were not relevant. However, in relation to funds for which sustainability risks were relevant, the Central Bank raised concerns about the generic nature of those disclosures.

The principal concern of the Central Bank was the lack of specificity in disclosures responding to the requirement to disclose the manner in which sustainability risks are integrated into investment decisions and the results of the assessment of the likely impact of those risks on the returns of the funds. In the former case, some managers simply stated that the risks were integrated, rather than explaining the manner in which they were integrated and in the latter case, some managers stated that the returns of the fund might be impacted rather than the providing information on how that impact has been assessed.

Article 8 and 9 Requirements

The Central Bank noted concerns relating to some of the Article 8 funds sampled, which designated an index as a reference benchmark, in terms of their compliance with the requirement to disclose information on whether and how the index is consistent with the environmental or social characteristics which the fund promotes. In particular the Central Bank noted that some funds had included statements to the effect that the composition of the index against the screening criteria would not be monitored by the fund's manager or investment manager, on the basis that the responsibility for screening investments in the index rested with the index provider.

The Central Bank was also concerned that some managers had disclosed that they would not be monitoring their investment manager's ESG approach on an ongoing basis, but would be relying on an annual assessment of the application of the ESG strategy.

The Central Bank did not believe it was appropriate to respond to queries raised during the review by referencing prior reviews of the disclosure by the Central Bank or other European regulators, noting that it was important that standards of ESG disclosures continue to improve.

While a focus of the review was the potential for incorrect classification of funds, the Central Bank noted that good responses had been received in respect of some funds reviewed when explanations were sought for why the fund was classified as an Article 6 fund rather than an Article 8 fund.

Taxonomy Alignment

The Central Bank noted that only three of the funds sampled had complied with the requirement in the Taxonomy Regulation to disclose the extent to which underlying investments are in environmentally sustainable economic activities by including a specific percentage proportion. In contrast almost 80% of the funds reviewed indicated that they were not in a position to quantify their Taxonomy alignment. The Central Bank expressed particular concern at this aspect of market practice in light of the requirement expressed in the ESAs' Supervisory Statement that funds include an explicit quantification of the extent to which underlying investments are Taxonomy aligned.

The Central Bank provided further anonymised information about the three funds which were able to provide a percentage Taxonomy alignment, noting that the Central Bank had interrogated the disclosures and was ultimately satisfied that good information on the economic activities had been provided in support of the percentage and very detailed explanations and examples were also provided as to the assessment of how particular investments met the sustainability characteristics.

The Central Bank noted industry's concerns around the issues and challenges with the availability and accuracy of data on the economic activities of underlying investments, but noted that some managers had been able to include a specific numerical disclosure. The Central Bank noted the imperative to improve the quality of disclosures across the industry and the desirability of moving everyone to a common standard. In this regard, the publication of the ESA's Supervisory Statement was a development the Central Bank had to take into account.

European Developments

The Central Bank also took the opportunity to note relevant European developments. In addition to referring to the impact of the ESAs' Supervisory Statement on the Central Bank's ongoing review of ESG disclosures, the Central Bank noted that the European Securities and Markets Authority's ("**ESMA**") planned supervisory briefing was expected to be finalised shortly and while the timing had not yet been determined, or indeed whether the briefing would be published, it would also impact on the Central Bank's ongoing review of disclosures. The Central Bank noted that in addition to its focus on promoting supervisory convergence through portfolio analysis and case discussions, ESMA was also focussing on the naming convention of funds. As a general principle, ESMA considers that the use of ESG-related terminology in a fund name should be supported in a material way by minimum criteria that are reflected in the fund's investment objective, policy and strategy.

The Central Bank also noted that the delegated acts under the UCITS Directive, AIFMD and MiFID had been modified to clarify the obligations of UCITS management companies, AIFMs and MiFID firms to integrate sustainability risks and would be applicable from 1 August 2022.

Next Steps

The Central Bank's current intention is to prepare a report summarising the findings of its sample review. It is important to note that the impressions shared with industry at this meeting were very much initial impressions and may evolve as the Central Bank considers the responses received from managers of the reviewed funds, the impact of the ESAs' Supervisory Statement, the imminent ESMA supervisory briefing and other relevant European developments.

In response to queries regarding the need to further update disclosures, the Central Bank indicated an initial view that for Article 8 and Article 9 funds, any updates to disclosures informed by the sample review report (including any explicit quantification of Taxonomy alignment, where relevant) could be incorporated into the filings they would make to incorporate Level 2 measures by 1 January 2023, unless the disclosures were otherwise being updated in the meantime. The Central Bank noted that for Article 6 funds, no 1 January 2023 deadline applied and so it would be appropriate to make any necessary amendments the next time the documents are being updated. The Central Bank also indicated that any new funds would have to comply with the current disclosure expectations immediately.

The Central Bank is also open to further engagement with industry to better understand any challenges that the implementation of the EU Sustainable Finance Action Plan presents. The Central Bank intends to progress a thematic review of FMPs' implementation of the requirements later in the year, which will be informed by the sample review and the published report.

On 6 April 2022, the European Commission adopted the SFDR / Taxonomy Regulation RTS, which will now be subject to a three month scrutiny period by the European Parliament and the Council of the EU.

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