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New taxonomy-related disclosures RTS published

Despite the delay to Level II[1] announced by the European Commission ("EC") at the beginning of the summer 2021, the last few months have been busy for sustainable finance!

The market was given plenty of valuable information on the direction of travel of the EU sustainable finance agenda – from the EC's announcement of the Renewed Sustainable Finance Strategy on 6 July 2021, to its answers later that same month to the Q&A raised earlier this year by the ESAs (ESMA, EIOPA, and EBA).

One reason for the delayed entry into force of Level II was the need to amend the SFDR Regulatory Technical Standards ("**RTS**") of February 2021 to include transparency requirements applicable to some financial products pursuant to the Taxonomy Regulation ("**TR**"). The ultimate goal: to create a single rulebook for sustainability disclosures under both the SFDR and the TR.

Now, the RTS we have all been waiting for have become available. On 22 October 2021, the ESAs finally published the Final Report[2] on sustainability-related disclosures, including taxonomy-related disclosures. This Final Report provides us with the amendments to the mandatory templates for financial products, reflecting the additional disclosures applicable to Article 5 and Article 6 products under the TR.

Many points that had kept the industry wondering for most of 2021 have been now clarified.

But before exploring the latest rules in detail, note that the SFDR-related disclosures remain largely unchanged (aside from some re-ordering of template sections).

An important point to note however is that the new templates have largely shifted focus, away from only the financial product category (whether Article 8 or Article 9 SFDR) and onto the question of whether or not the financial product makes sustainable investments, in which proportions and with what objectives. This change of focus is aligned with the revisions to the MiFID delegated acts published on 4 June 2021 requiring that the sustainability preferences of end investors be assessed as part of suitability assessments, notably in terms of a minimum percentage of sustainable investment by the financial product (among other factors).

One other notable change is that now, the ESAs indicate that all sustainable investments will be subject to the SFDR rules relating to the principle of Do No Significant Harm ("**DNSH**") (i.e. taking into account the Principal Adverse Impact ("**PAI**") indicators in Annex I of the RTS). This includes taxonomy-aligned investments, despite them already falling under the detailed DNSH rules of the TR Technical Screening Criteria. This removal of a previously proposed derogation comes as a surprise. **It means that the work undertaken so far by financial market participants to develop processes to retrieve the PAI indicators, either directly from investee companies or via third-party providers, is now even more**

crucial. In addition, the disclosures that use PAIs now encompass more information: not just on whether a financial product considers PAIs on sustainability factors, but also how it does this.

The main taxonomy-related changes are to the rules for calculating alignment (i.e. the rules to assess the "extent" to which economic activities invested in qualify as environmentally sustainable). Alongside clarifications on the treatment of certain asset classes, the most important of these changes relate to:

- **The treatment of sovereign exposures** (e.g. government bonds). In the absence of a reliable methodology to assess the taxonomy alignment of sovereign exposures, the initial position was to exclude these from taxonomy alignment calculations. However, as this would result in some financial products and asset classes being treated unfairly, the ESAs have decided to require that the taxonomy alignment of investments be disclosed in two ways: one that includes sovereign exposures in the calculation, and another that excludes them. This means more work for financial market participants, but enhanced transparency for end investors.

- **The KPIs to be used to disclose taxonomy alignment**. Under this new version of the RTS, the pre-contractual disclosures for financial products will have to use the same type of key performance indicator ("**KPI**") for all non-financial undertakings. By default, this will be turnover. The use of the alternative KPIs capital expenditure ("**Capex**") or operating expenditure ("**Opex**") must now be justified by the features of the financial product, which must show that using Capex or Opex results in a more representative calculation of taxonomy alignment. However, for periodic disclosures, the ESAs propose that taxonomy alignment should be shown for all three KPIs as a calculation basis for all of a product's non-financial undertaking investee companies. Here again, this means more work for financial market participants, and more harmonised information readily available to end investors.

Finally, the new RTS insist on the disclosure of whether an auditor or third-party reviewer has certified the demonstration that the economic activities funded by the product indeed qualify as environmentally sustainable in line with the detailed criteria of the TR (and, if so, the name of that auditor or third-party reviewer).

In summary, the new RTS generally intend to disclose more information to end investors, notably regarding the investments in environmentally sustainable economic activities relying on the TR. The goal is to provide **transparent and comparable** information with which investors can make better-informed investment decisions.

What's next?

The EC will now review the new RTS put forward in the Final Report and decide whether to endorse them within 3 months of their publication.

The final rules and bundled RTS are expected to enter into force in July 2022, leaving the industry around 8 months to prepare.

Given their complexity and technical nature, as well as the need to involve various stakeholders across your organisations (such as Sales, Legal & Compliance, as well as portfolio management teams) to prepare the related disclosures, we urge all of you to continue – or to begin – actively preparing for the Level II rules. In particular, we advise you to analyse (and complete, where possible) the latest mandatory pre-contractual and periodic templates of the RTS applicable to all financial products that promote environmental or social characteristics, and to financial products having sustainable investment as their objective.

[1] "Level II" refers to the Regulatory Technical Standards being developed as complementary rules to the SFDR and the Taxonomy Regulation.
[2] Final Report on draft Regulatory Technical Standards with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088.

Our dedicated ESG team is here to help you navigate the various sections of the Level II templates

Contact: sustainability@arendt.com
Our dedicated page on ESG_

your contacts

FABIENNE MOREAU
Counsel
Investment Management

Learn more_

ANTOINE PETER
Manager
Arendt Regulatory & Consulting

Learn more_

Arendt & Medernach SA
Registered with the Luxembourg Bar
RCS Luxembourg B 186371

arendt.com

41A avenue JF Kennedy
L-2082 Luxembourg
T +352 40 78 78 1
