

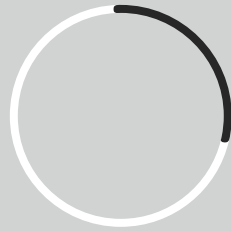
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How a new regulatory era
is being generated

Anticipated amendment of the SFDR and its Level II RTS: what does it mean in practice?



Marjorie André

Partner, investment management,
Loyens & Loeff
marjorie.andre@loyensloeff.com

Irina Stoliarova

Counsel, investment management,
Loyens & Loeff
irina.stoliarova@loyensloeff.com

Introduction

Luxembourg continues to be the leading hub for the establishment of investment funds in Europe. One of the most important current trends driving development in the Luxembourg fund industry is sustainable finance. This trend is not new and in recent years we have all observed a number of novelties and developments in this area. However, we should all expect that such developments will accelerate even more in the future. Yet, this is not without some challenges.

The current regulatory landscape in the sustainable finance and environmental, social and governance (ESG) field is and will continue to be challenging due to the significant amount of regulatory developments. The EU Commission has launched a number of initiatives and amendments which will be crucial for fund managers as the implementation of the ESG regulatory framework in their business and operations proves to be a long-term journey emphasising the importance of being well-informed.

The consultations on the Sustainable Finance Disclosure Regulation (SFDR) are definitely on everybody's mind considering their imminent implementation and application. So let us see what it means in practice and what challenges it may bring to the financial market participants.

Amendment of the SFDR

SFDR Level I Regulation started to apply as of 10 March 2021 and its Level II RTS commenced as of 1 January 2023.

From the beginning, it has not been an easy journey for market players to familiarise themselves with this new legal framework. The implementation of the whole set of the required SFDR disclosures either at financial product or entity level was quite challenging. The consultation on SFDR, which was open from 14 September 2023 to 22 December 2023, may be a lifejacket for market players that are still struggling with the SFDR compliance or comprehension. Considering that the aim of the consultation is indeed to improve the current legal framework following the feedback received from various market players.

The consultation covered various topics, including in particular: (i) current requirements of the SFDR, (ii) interaction with other sustainable finance legislation, (iii) potential changes to the disclosure requirements for financial market participants, and (iv) potential establishment of a categorisation system for financial products. The first two topics cover the SFDR as it is today, how the regulation is working in practice and the potential issues stakeholders might be facing in implementing it. The other two sections look into the future, assessing possible options to address any potential flaws. The financial market participants are more concerned about the future anticipated amendments to the SFDR that are described hereinafter.

Interestingly, the consultation questions whether the SFDR is actually the right place to include entity level disclosure obligations. This could imply that such disclosures could be



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removed from the SFDR and be replaced by the Corporate Sustainability Reporting Directive (CSRD) obligations.

With regard to the product level disclosures, the Commission questions whether it would be useful to have uniform disclosure requirements for all financial products, regardless of their sustainability claims. The Commission believes that by providing proportionate information on the sustainability profile of a product, (even for the ones which do not make sustainability claims) it could make it easier for investors to understand products' sustainability performance, as they would also get information about products that are not designed to achieve any sustainability-related outcome. Even though we tend to agree with such reasoning, it would however be quite burdensome in practice for products that do not make any sustainability claim.

Furthermore, the consultation on SFDR disclosed two broad-option strategies. The first one is a product categorisation system to be built on and developing the distinction between articles 8 and 9 and the existing concepts embedded in them (such as environmental/social characteristics, sustainable investment or do no significant harm). This option would be complemented by additional (minimum) criteria that would more clearly define products falling within the scope of each article. The second option is a product categorisation system following

a different approach and focusing on the type of investment strategy (promise of positive contribution to certain sustainability objectives, transition focus, etc), and hence moving away from the existing concepts. This would imply that concepts such as environmental/social characteristics or sustainable investment as well as the distinction between the current articles 8 and 9 of the SFDR may disappear altogether.

It is clear that depending on the adopted option, the impact would be tremendous. The first option would imply improving the existing legal framework to meet the target of the EU Sustainable Finance Action Plan. The second option, on the other hand, would bring a complete reshaping of the current regulatory framework. For the time being, the concepts are not entirely clear, but there would likely be different sustainability categories and products that would be classified depending on their investment strategy, for example, products providing solutions to sustainability-related problems or products with a specific sustainability-related theme or products with exclusion policies or transition focus. It is unclear whether financial products would need to choose only one category or not and what would be the minimum criteria for a financial product to fall under the one or the other product category.

If the second option were to be adopted, this would imply that work done up until

now would have to be re-evaluated and the operational processes and models would have to be reassessed. This will end up being quite costly since there would no longer be article 8 and 9 products, but rather a system based on the investment strategy of the financial product. Market players would obviously need time to digest new requirements, to understand what these new specific criteria would be, the level of disclosures and complexity of measurements. Nevertheless, in the long run, this approach might be easier to understand for investors and may turn out as more efficient, though this will come at a price.

As of now, adoption of the revised framework is planned for the second quarter of 2024, which is around the corner. So, this topic needs to be closely monitored!

Amendment of the SFDR RTS

Following a public consultation, the European Supervisory Authorities (ESAs) have developed a proposed Regulatory Technical Standards (RTS) on the content and presentation of disclosures under SFDR that includes the following changes from the current version of the RTS:

- Firstly, several new indicators for principal adverse impacts (PAI) of investment decisions on sustainability factors, focusing on the social adverse

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impacts, have been added. The ESAs have also made changes to the list of opt-in social indicators and to the other PAI indicators covering environmental adverse impacts. These changes generally purpose to align definitions with the ones in the CSRD, which is a welcomed initiative.

- Secondly, the draft RTS includes a requirement to disclose the thresholds or criteria for the PAI indicators that the financial product uses to determine that its sustainable investments comply with the 'do not significantly harm' (DNSH) principle.
- Lastly, the draft RTS incorporates new disclosures for financial products information provided in pre-contractual documents, on websites and in periodic reports on GHG emissions reduction targets, including intermediary targets, milestones and actions pursued. The new disclosures apply to products having GHG emissions reduction as their investment objective (article 9(3) SFDR). However, for products that passively track EU climate transition or Paris-aligned benchmarks, simplified disclosures apply.

Even though welcomed, these changes to the RTS should be fully coordinated with SFDR Level I Regulation review to guarantee legal certainty and to prevent overlapping. For example, the consultation on SFDR Level I Regulation review contemplates making changes to the scope of PAI reporting, so the introduction of additional mandatory PAI may create inconsistencies later on (which would favour moving these PAI from mandatory to optional). Hence another topic that would have to be regularly monitored.

The CSSF's supervisory priorities for fund managers in the area of sustainable finance

On 22 March 2024 the Luxembourg regulator (the CSSF) released its supervisory priorities in sustainable finance, which are bringing a few insights on the Luxembourg's regulator's priorities in this area.

The CSSF highlighted once again the importance of integration of sustainability and adequate consideration of sustainability risks in financial strategies as part of a long-term objective towards a more sustainable future. The CSSF is aiming, in support of its ambition, at fostering a cohesive implementation of the sustainable finance framework across the financial sector and

ensuring the integration of ESG requirements in the CSSF's supervisory practice.

In that respect, the CSSF emphasised that the primary responsibility of ensuring compliance with applicable requirements lies with the supervised entities and their board members, who should ensure that the integration of ESG factors in traditional governance, risk management and compliance tools are a focal point within their organisations, and endeavour to make suitable ESG education a priority for themselves and their personnel.

The CSSF confirmed that it will continue to monitor fund managers' compliance with the SFDR, the SFDR RTS and the Taxonomy Regulation. In doing so, the CSSF will focus on the areas described hereinafter.

The CSSF expects fund managers' organisational arrangements to take due account of the integration of sustainability risks, notably in terms of human resources and governance, investment decision or advice processes, remuneration and risk management processes and policies and management of conflicts of interest as required under SFDR.

SFDR, the SFDR RTS and the Taxonomy Regulation lay down transparency requirements regarding the provision

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of sustainability-related information in pre-contractual and periodic documentation of financial products, and the CSSF will continue to assess compliance with such requirements. The CSSF will also continue to assess and verify that sustainability-related disclosures made are consistent across the fund documentation, marketing material and verify compliance with product website disclosures' requirements.

Most importantly, the CSSF will undertake supervisory actions to ensure that portfolio holdings reflect the name, the investment objective, the strategy, and the characteristic displayed in the documentation to investors.

Finally, the CSSF reminds fund managers that it remains their responsibility to ensure that the information provided to the CSSF in the different data collection exercises is being kept up-to-date at any point in time. The CSSF will conduct further thematic on-site inspections on the integration of sustainability-related provisions in the organisation.

Conclusion and outlook

There are multiple challenges for investment funds, their managers, and initiators with a view to the compliance with the ESG-related regulatory requirements.

These challenges include uncertainty of interpretation, lack of available data necessary to comply with the disclosure requirements, anticipated revision of the existing legal framework (SFDR, Level II RTS), multiplication of only partially coordinated legislative texts, various deadlines that have to be complied with and consideration of multiple layers of EU and non-EU related ESG regulatory framework (depending on the location of the fund managers). All of these factors are not to be taken lightly.

Therefore, in view of the constant evolvement of the sustainability-related regulatory framework, fund managers need to be ready to embrace future changes and adjust swiftly.

One should also not forget about the new rules on corporate sustainability reporting brought forward by the CSRD. The first companies will have to apply the new rules for the first time in the 2024 financial year, for reports published in 2025. So stay tuned and be part of a better and greener future! ■