



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Sustainable finance and the asset management sector:

Disclosures, investment processes & risk management

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Foreword

As the pace of climate change intensifies, the speed of transition to net-zero emissions has taken on greater significance. Securities markets can assist in achieving this goal by engaging in less carbon intensive activities and by issuing products that meet sustainable criteria.

In addressing the topic of sustainable finance, the Central Bank of Ireland (the Central Bank) is conscious of a number of interacting and complementary priorities. Firstly, we are concerned with the risks to regulated firms' sound functioning, and more broadly, to financial stability, arising from increasingly commonly occurring climate events or from the transition to a sustainable economy. These are the prudential and financial stability risks associated with climate change. Secondly, but no less important, we are concerned with conduct related aspects. In particular, we want to ensure that investors are fully informed when making investment decisions. This is particularly relevant where investments or financial products are described as green or sustainable. We want to ensure that this is meaningful and accurate and based on reliable parameters that are consistently applied both within jurisdictions and across Europe. It is imperative that products are not mislabelled and that the flow of capital from investors is channelled towards genuinely sustainable activities. In this regard investment funds and bonds labelled green or sustainable are of particular importance.

Over the past few years, the European Union sustainable finance agenda has continued apace. The financial sector and financial regulators have been tasked with a key role in ensuring that the sector supports the transition to a sustainable economy. A key part of this is about identifying and disclosing related risks, with a view to ensuring that investors, when deciding on their investments, are furnished with the relevant and accurate data to understand both the risks and the

impacts associated with their investment options. Looking to the asset management sector, there has been key legislative initiatives. Notably these include the implementation of the Sustainable Finance Disclosures Regulation (SFDR) and the Taxonomy Regulation. This is in addition to other amendments to existing frameworks¹ to incorporate sustainability considerations into investment processes and risk management.

At their core, these legislative requirements are intended to provide increased transparency around Environmental, Social and Governance (ESG) characteristics and the integration of sustainability risks at a product and entity level via pre-contractual documentation disclosures, website disclosures, and periodic reporting. Successful implementation of these requirements is of critical importance as the market for investment products with an ESG focus continues to attract significant investor demand. In the funds sector, this demand is being met through the launching of new investment funds or the adaptation of existing funds to take into account an ESG focus. The popularity of these products, the potential incentive for them to be marketed as 'greener' than they are in practice and the current implementation stage of the disclosure regime in this area, all gives rise to potential for unclear or misleading disclosures to investors.

Ireland's asset management sector has a critical role to play to ensure that the sector is positioned to support a timely and effective transition to a more sustainable economy, and for this to happen, standards must be high. Fund Managers must continuously review fund documentation to ensure disclosure remains specific to the fund and that all SFDR and related requirements are complied with. In this regard, Fund Managers should provide clear and complete details on the ESG characteristics of a fund's portfolio. It is imperative that disclosures to investors are clear, accurate and not misleading.

Patricia Dunne,
Director of Securities and Markets Supervision

¹ Such as amendments to the UCITS Directive/ AIFMD and MiFID.

Introduction

The authorisation of investment funds is a key gatekeeper function for the Central Bank and forms an integral part of the Central Bank's supervisory strategy for the funds sector. The gatekeeper function aims to ensure Irish authorised investment funds comply with legislative and regulatory requirements and, significantly, that those funds are suitable for the intended investors.² This paper sets out the findings of a gatekeeper review of investment fund disclosures, highlights expectations around the implementation of the SFDR and the Taxonomy Regulation and provides a roadmap for how the Central Bank will supervise these requirements in the future.

The aim of publishing this paper is to assist market participants by informing them of the main disclosure issues encountered and outline risks that the Central Bank has observed in terms of potential greenwashing or areas where there has been a lack of transparency or clarity. The paper also outlines areas of good practice identified and sets out the Central Bank's expectations generally.

Defined terms used throughout this paper are set out in Annex I.

² In the case of funds designed for retail investors (UCITS or Retail Investor AIFs) the authorisation process involves a review of the fund's pre-contractual documentation (including prospectus and supplement (if relevant)) to ensure it is suitable for a retail investor.

In the case of funds designed for professional investors (Qualified Investor AIFs), these funds are authorised on the basis that (i) the parties involved are approved by the Central Bank in advance of the application and meet the necessary approval criteria set out in the AIF Rulebook and (ii) the appropriate confirmation is received confirming the contents of the relevant documentation complies with legislative and regulatory requirements.

Background on legislative requirements

In terms of sustainable finance, there have been two primary pieces of legislation which impact on the asset management / funds sector. These are the Sustainable Finance Disclosures Regulation (SFDR)³ and the Taxonomy Regulation⁴. These set out entity and product level disclosure requirements which are critical to ensure an investor can make an informed decision about an investment fund's sustainability-related information. In addition, however, there have also been other amendments to existing legislative requirements which will impact the parties involved in running an investment fund. Notably, the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD), as well as amendments to other frameworks such as MiFID which affect investment processes and risk management.

The SFDR level 1 requirements came into force on 10 March 2021, whilst level 2 requirements will apply from 1 January 2023. The Taxonomy Regulation requirements applied from 1 January 2022. These legislative requirements resulted in extensive updates to pre-contractual documentation, including prospectuses and supplements, for UCITS and Alternative Investment Funds (AIFs).

Additional details on the legislative requirements are set out in Annex II.

³ See Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. Available here:

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN>

⁴ See Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate Sustainable Investment, and amending regulation (EU) 2019/2088. Available here:

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN>

Central Bank's Approach

SFDR level 1 and Taxonomy Regulation

The Central Bank has sought to facilitate orderly implementation of the relevant requirements whilst ensuring that high standards of disclosure are maintained. To support this, in relation to the SFDR level 1 and Taxonomy Regulation requirements, the Central Bank established a streamlined filing process for pre-contractual document updates.⁵ Fund Managers were required to certify compliance with the requirements and the Central Bank carried out a review of a sample of the submissions received (the Gatekeeper Review) and engaged with those selected funds on a bilateral basis where queries arise in respect of the applications.

SFDR level 2

From 1 January 2023 additional requirements under the SFDR level 2 will apply. The Central Bank considers these new obligations to be instrumental in terms of the level of information that investors will now have about the products in which they invest. In order to facilitate the timely updating of fund documentation, the Central Bank has again adopted a streamlined filing process. Again a sample of submissions received will be reviewed retrospectively to ensure a high standard of disclosure.⁶

⁵ Further details in relation to the streamlined process for the SFDR level 1 is available here:

https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/sustainable-finance-disclosure-regulation-process.pdf?sfvrsn=eb31891d_4

Details in relation to the Taxonomy Regulation streamlined process is available here:

https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/taxonomy-regulation-sfdr-clarification-document.pdf?sfvrsn=3f06921d_4

⁶ Further details in relation to the streamlined process for the SFDR level 2 is available here:

https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/process-clarifications-for-ucits-and-aifs-pre-contractual-documentation-updates-in-relation-to-the-level-2-measures-in-relation-to-the-sustainable-finance-disclosure-regulation.pdf?sfvrsn=fc66951d_0

From January 2023, the Central Bank expects that any information provided to investors (via fund documentation, marketing material or otherwise) is fully aligned with the requirements of SFDR, the Taxonomy Regulation and related available guidance. Fund documentation must also be regularly reviewed and updated to ensure compliance with the requirements as well as the accuracy of information disclosed.

Evolution of the framework

While there have been some implementation challenges, in terms of questions around how to interpret particular requirements and data availability issues, there is greater clarity around the requirements and additional time was afforded to market participants to implement the SFDR level 2 requirements.⁷

In addition to the legislative requirements themselves, the following are relevant in order to understand how the Central Bank has been approaching implementation of these requirements:

- On 3 November 2021, the Central Bank issued a letter to regulated firms setting out supervisory expectations related to climate, environment and ESG issues.⁸ The supervisory expectations focused on five key areas including governance, risk management framework, scenario analysis, strategy and business model risk and disclosures.
- On 23 March 2022, the European Supervisory Authorities (ESAs) issued a statement which set out their supervisory expectation that relevant disclosures be provided irrespective of the delayed application of the SFDR RTS.⁹

⁷ See letter from the European Commission to the European Supervisory Authorities which confirmed implementation of the SFDR level 2 would be delayed.

Available here:

https://www.esma.europa.eu/sites/default/files/library/eba_bs_2020_633_letter_to_the_esas_on_sfdr.pdf

⁸ Available here:

<https://www.centralbank.ie/docs/default-source/news-and-media/press-releases/governor-letter-climate-expectations-november-2021>

⁹ See Updated Joint ESA Supervisory Statement on the application of the Sustainable Finance Disclosure Regulation, dated 24 March 2022.

- On 31 May 2022, the European Securities and Markets Authority (ESMA) published a supervisory briefing addressed to EU National Competent Authorities (NCAs) to promote common supervisory practices on the SFDR and other pieces of EU legislation.¹⁰ This was closely followed on 2 June 2022 by a publication of the ESAs which sets out clarifications on the SFDR RTS.¹¹
- These publications follow a number of recent regulatory updates on SFDR, including, the publication by the European Commission of a Q&A on 25 May 2022.¹²

Available here:

[https://www.esma.europa.eu/sites/default/files/library/jc_2022_12 -
updated supervisory statement on the application of the sfdr.pdf](https://www.esma.europa.eu/sites/default/files/library/jc_2022_12_-_updated_supervisory_statement_on_the_application_of_the_sfdr.pdf)

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Available here:

[https://www.esma.europa.eu/sites/default/files/library/esma34-45-
1427 supervisory briefing on sustainability risks and disclosures.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-45-1427_supervisory_briefing_on_sustainability_risks_and_disclosures.pdf)

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Available here:

[https://www.esma.europa.eu/sites/default/files/library/jc_2022_23 -
clarifications on the esas draft rts under sfdr.pdf](https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf)

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Available here:

[https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_13139
78.pdf](https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf)

Ireland's Fund Sector

In terms of SFDR classification, Ireland's funds sector is broken down as follows:¹³

SFDR Classification	Number of Funds (including sub-funds)	Assets Under Management (€)
Article 6	5,831	€2.6 trillion (approx. 73.37%)
Article 8	1,276	€893 million (approx. 24.91%)
Article 9	183	€61.5 million (approx. 1.72%)
Total	7,290	Approx. €3.6 trillion

Investment funds classified as either Article 8 or Article 9 products under the SFDR remain a small but significant part of Ireland's funds sector (while the majority of funds have classified themselves as Article 6 products). However, the proportion of Article 8 and Article 9 products is expected to grow over time given investor demand for investment products which are considered sustainable.

¹³ Fund data as at 29 July 2022 (unaudited data – therefore these are intended to be instructive rather than conclusive figures).

Gatekeeper Review

The purpose of the Central Bank's Gatekeeper Review was to ascertain whether, taking into account the requirements of the SFDR level 1 and Taxonomy Regulation, the disclosures in fund documentation provide investors with clear information to assess the sustainability characteristics of a fund, as well as to ascertain what sustainability risks may exist in a particular fund. A sample of submissions received through the streamlined process were subject to review. The submissions reviewed included a range of UCITS management companies and AIFMs (covering all three product categorisations under the SFDR).

Overview of findings

The extent of compliance with SFDR level 1 and Taxonomy Regulation disclosures varied significantly across the sample. A significant challenge observed related to the lack of granularity and high-level nature of the disclosure obligations under the SFDR level 1 and Taxonomy Regulation. This issue is addressed when the SFDR level 2 disclosure requirements become applicable as these are more prescriptive in nature.

The key findings are as follows:

Nature of finding	Relevant Requirement	Finding
SFDR classification	Paragraph 28, ESMA Supervisory Briefing	Fund documentation should clearly disclose the relevant SFDR classification (either Article 6, 8 or 9) without giving the impression of a "label" to investors. Where an existing investment fund proposes a change in its SFDR classification, the post authorisation submission should include a detailed rationale and justification explaining the basis for the proposed change.

		Central Bank Expectations: Adequate consideration must be given to what this change in classification may mean for existing investors in the fund (and what communication to investors may be appropriate as a result). Fund Managers should keep such classifications under regular review to ensure their ongoing accuracy. Although changes to SFDR classifications may take place, Fund Managers should be able to stand over the classification applied to their funds and so the Central Bank would not expect numerous changes to a fund's SFDR classification to take place.
Generic sustainability risk and/or taxonomy alignment disclosures	Article 6 of the SFDR and Article 5 and Article 6 of the Taxonomy Regulation	Some of the funds assessed only included generic sustainability risk and/or taxonomy alignment disclosure. The primary rationale given was that such disclosure avoids repetition and duplication across all fund documentation and is consistent with other general disclosures that were included throughout that fund's documentation. Central Bank Expectations: Disclosures must be specific to the investment fund in question. Fund Managers should keep such disclosures under regular review to ensure their accuracy.
Quantification of taxonomy-alignment	Article 5 and Article 6 of the Taxonomy Regulation	Only a small number of funds provided a percentage proportion of investments in environmentally sustainable economic

		activities.¹⁴ In these cases, detailed information on the economic activities that qualify as environmentally sustainable was provided in support of the allocated proportion. It was clear that in these cases significant consideration had gone into the proportion to apply and detailed supporting information was provided which outlined the assessment of particular investments in this regard as well as how the investment would meet the sustainability characteristics to qualify as Taxonomy-aligned. A large proportion of the assessed funds indicated that they were not in a position to describe the proportion of a fund's investments that are in Taxonomy-aligned. Since the Commission's SFDR Q&A response of 25 May 2022, there has been a significant improvement in the level of SFDR and Taxonomy-related disclosure. However, some applicants persist in including negative justifications and / or ambiguity, notwithstanding that the Commission has clarified that these are not permissible. Central Bank Expectations: Disclosures around the quantification of taxonomy-alignment must improve. Fund Managers should keep such disclosures under regular review to ensure their accuracy.
Integration of sustainability risks	Article 6 (1) of SFDR	Funds generally provided a detailed outline of the reasons why sustainability

¹⁴ Note that the review of documentation took place prior to the European Commission's clarifications of how Article 5 of the Taxonomy Regulation should be applied.

		risks were not relevant thereby fully addressing these requirements. In some cases, this requirement appears to have been addressed by including statements that sustainability risks are integrated rather than providing any specific information to outline how this is achieved. In addition, in a number of cases, funds included statements that returns may be impacted by investment in certain products and that this will be factored into the investment decision-making process. However the disclosure did not provide specific information on how the impact on returns has been assessed. Central Bank Expectations: Where applicable, funds should provide a detailed outline of the reasons why sustainability risks are not relevant or provide an outline of how such risks are integrated into the investment decision making process. Funds should also include information on how the approach taken will impact returns. Such disclosures must be specific to the investment fund in question. Fund Managers should keep such disclosures under regular review to ensure their accuracy.
Pre-contractual product disclosures – Benchmark Indices	Article 8 (1)(b) of SFDR	In a number of funds, the disclosure provided lacked the expected detail in terms of how the designated index was consistent with the environmental and/or social characteristics the fund promotes. In certain instances, this requirement was

		further undermined by the insertion of statements to the effect that neither the Fund Manager nor the Investment Manager would monitor the composition of the Benchmark Index against the screening criteria applied on the basis that the index provider is responsible for screening investments in the index. In some cases, it appears that UCITS management companies/AIFMs do not intend to carry out monitoring of an Investment Manager's ESG approach on an ongoing basis but rather will rely on an annual assessment of the application of the ESG strategy. Central Bank Expectations: Such practices are not considered appropriate and instead the Fund Manager should have processes in place to monitor, on an ongoing basis, the relevant index provider or delegate Investment Manager.
Naming convention for funds	Paragraph 19, ESMA Supervisory Briefing	Of the funds assessed, the naming conventions were consistent with the fund disclosure outlined in its investment objective and strategy. However, it is nevertheless important to note that funds' names should not be misleading. In this regard, the use of terms such as "ESG", "green", "sustainable", "social", "ethical", "impact" or any other ESG-related terms should be used only when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the

		fund's investment objectives and policy and its strategy as described in the relevant fund documentation. The use of the word "impact" or "impact investing" or any other impact related term should be used only by funds whose investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Central Bank Expectations: Fund Managers should ensure that fund names are not misleading. Fund Managers should keep their Funds' naming conventions under regular review to ensure their continued appropriateness.
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Supervisory Roadmap

The aim of publishing the findings of the Central Bank's Gatekeeper Review is to inform the funds sector of the main disclosure issues encountered to date and outline the risks that the Central Bank has observed in terms of potential greenwashing or areas where there is a lack of transparency or clarity. In addition to disclosure related matters, the Central Bank sees merit in outlining a non-exhaustive list of areas of interest which may form part of a supervisory roadmap into the future. Market participants should pay particular attention to these matters as they progress their implementation of the requirements. These areas of interest are in addition to other initiatives which are planned, including the ESMA Common Supervisory Action (CSA) on sustainability risks and disclosures which is planned for 2023.

Adaption of Risk Management Frameworks

Fund Managers are required to consider sustainability risks and factors when undertaking investment due diligence and take sustainability risks into account in their organisational procedures, resources, the management of conflicts of interest and risk management policies. Fund Managers must appropriately manage sustainability risks arising from the investments of the funds under their management in a similar manner as other relevant risks such as market, interest or credit risk. As noted previously, the Central Bank issued a letter on 3 November 2021 setting out its expectations of all regulated firms regarding climate and other ESG issues.¹⁵

Article 8 'Guardrails'

The definition of an Article 8 product under the SFDR does not contain minimum investment thresholds or any prescribed composition of investments. In addition, for this cohort of funds the definition of 'promotion' provided for is very broad.¹⁶ The Central Bank has

¹⁵ Available here:

<https://www.centralbank.ie/docs/default-source/news-and-media/press-releases/governor-letter-climate-expectations-november-2021>

¹⁶ See European Commission Q&A document related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088). Available here:

previously indicated that it is supportive of additional work in this area at a European level, including looking at minimum sustainability criteria for financial products that promote environmental or social characteristics.¹⁷ It is anticipated that the European landscape may continue to evolve in this regard with additional clarity for how investment funds should approach this area. Notwithstanding the broad nature of Article 8 funds, Central Bank supervisory engagement will focus on funds with a low proportion of their portfolio promoting environmental and / or social characteristics and therefore may give rise to ‘greenwashing’. We may also examine those funds which have changed their classification under the SFDR and consider further the rationale provided at the time of the change. Fund Managers need to carefully consider the relevant fund’s classification under the SFDR to ensure that it is aligned with both the letter and the intention of the legislative requirements.

Marketing Material

Sustainability-related disclosures should be consistent across fund documentation and marketing material to ensure an investor can draw an informed perspective on those disclosures. Where necessary the Central Bank will assess the consistency of information disclosed in fund documentation (such as the prospectus and the fund rules / articles of association) and that of marketing material (including all marketing communications addressed to investors or potential investors).

Fees & Costs

The fees and costs associated with ‘green’ investment products should be transparent and proportionate and investors should not be subject to undue costs. For example, the fees and costs associated with Article 8 and Article 9 funds should not be disproportionately higher than Article 6 funds (without a legitimate rationale for such higher

https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf

¹⁷ See remarks by Deputy Governor Derville Rowland at the Managed Funds Association Global Summit 2021 on 9 November 2021. Available here:

<https://www.centralbank.ie/news/article/speech-derville-rowland-managed-funds-association-global-summit-2021-09-november-2021>

costs). Fund Managers should be mindful of the types of third party service providers which such funds utilise and whether / how such services are overseen by the fund / Fund Manager and what 'value add' such services provide to the fund in question.

Securities Lending

The Central Bank is interested in funds that engage in securities lending whilst also promoting environmental and/or social characteristics and/or having sustainable investments as their objective. In particular, whether these investment funds are in a position to meet their environmental and/or social characteristics if they have lent out shares and those shares end up taking contradictory positions (such as via the exercising of associated voting rights or because the shares were lent to short sellers which take an opposing view).

Fund Service Providers

In assessing SFDR compliance, the Central Bank will also consider the role played by certain fund service providers, such as depositaries. This could, for example, include whether depositaries include ESG-related investment restrictions in the monitoring of the instructions from the Fund Manager (or the Investment Manager as its delegate). We may also consider how a depositary would categorise a breach of an ESG-related investment restriction and the circumstances in which they would report such breaches to the Central Bank or, for example, in financial statements.

Conclusion

Investors have high expectations for the asset management / funds sector with regard to sustainable finance. It is critical that the sector is positioned to support a timely and effective transition to a more sustainable economy, and for this to happen, standards must be high.

The information in this paper, including the findings of the gatekeeper review of investment fund disclosures (including good practices) and Central Bank expectations around the implementation of the next phase of SFDR is designed to inform and assist industry in ensuring that investors and the market can have a high degree of trust and confidence in green and sustainable products produced and sold from this jurisdiction.

Annex I: Defined Terms

‘ESG’ means:

Environmental, social and governance.

‘Fund Manager’ means:

The UCITS Management Company or Alternative Investment Fund Manager (AIFM) as relevant.

‘Investment Manager’ means:

An entity appointed to carry out discretionary investment management activity as a delegate of the Fund Manager.

‘Sustainability Characteristics’ means:

Environmental and social features.

‘Sustainability Factors’ means:

Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

‘Sustainable Investments’ means:

An investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to

tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

‘Sustainability Risks’ means

An environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

‘Principal Adverse Impacts’ means

Impacts of investment decisions and advice that result in negative effects on sustainability factors.

‘Taxonomy-aligned’ means

The investments underlying the financial product are in economic activities that qualify as environmentally sustainable.

Annex II – Further Background

Sustainable Finance Disclosures Regulation

The SFDR lays down sustainability disclosure obligations for manufacturers of financial products and financial advisers toward end-investors. It does so in relation to the (1) integration of sustainability risks and (2) consideration of adverse sustainability impacts in the investment processes, and (3) provision of sustainability-related information with respect to financial products. Depending on the specific requirement, the information must be published in a variety of locations including on websites, in pre-contractual documentation as well as in periodic reports.

Effective implementation of the SFDR has implications for investor protection and market integrity in the first instance, which in turn may have implications for financial stability. In particular, the objectives of the SFDR are to strengthen protection for end investors; improve disclosures to them; to reduce greenwashing and to provide comparable sustainability reporting to investors. The SFDR introduces harmonised rules with regard to sustainability at Union level and across financial services sectors.

In addition, the consideration of sustainability factors in the investment decision-making and advisory processes can realise benefits beyond financial markets. It can increase the resilience of the real economy and the stability of the financial system. In doing so, it can ultimately impact on the risk-return of financial products. It is therefore essential that financial market participants and financial advisers provide the information necessary to enable end investors to make informed investment decisions.

Under the SFDR, the disclosure requirements differ depending on whether a product is classified as an ‘Article 6’, ‘Article 8’ or ‘Article 9’ product. Significant additional disclosure requirements are mandated for products subject to Article 8 and Article 9 of the SFDR:

- [Article 8](#) applies to a financial product that "*promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices*".
- [Article 9](#) applies to a financial product that "*has sustainable investment as its objective*" with "*sustainable investment*" defined under Article 2 (17) of the SFDR. Furthermore, the SFDR recognises three different variations of Article 9 SFDR products and tailors the disclosure requirements based on whether: i) an index has been designated as a reference benchmark; ii) no such index has been designated; and iii) whether the financial product has a reduction in carbon emissions as its objective.

These product types or classifications were not intended to be product labels.

Taxonomy Regulation

The Taxonomy Regulation establishes the framework for an EU classification system of environmentally sustainable activities, for the purposes of establishing the degree to which an investment is environmentally sustainable. It sets out four overarching conditions that an economic activity has to meet in order to qualify as environmentally sustainable, including a substantial contribution to one or more of the six environmental objectives; and tasks the European Commission with establishing the actual list of environmentally sustainable activities by defining technical screening criteria (TSC) for each of the six environmental objectives through delegated acts.

The Regulation lays down taxonomy-related transparency requirements for (1) Financial Market Participants (FMPs) offering financial products within the scope of the SFDR ('product-level disclosures') and (2) non-financial and financial undertakings (including asset managers) which are subject to the obligation to publish non-financial statements under the 'non-financial reporting directive' (entity disclosures).

The Taxonomy Regulation applies to Article 9 products under the SFDR that invest in an economic activity that contribute to an ‘environmental objective’ (within the meaning of the SFDR definition of ‘sustainable investment’) and applies to ‘Article 8’ products under the SFDR that promote environmental characteristics. Nevertheless, the extent to which the Fund Manager takes into account the EU criteria for environmentally sustainable economic activities is at their discretion. The proportion of such funds disclosing a minimum percentage of taxonomy-alignment other than 0% (as a percentage of the total products within scope of SFDR) is likely to be low initially but will grow over time. Article 6 products under the SFDR must disclose the extent to which the EU criteria for environmentally sustainable economic activities are, or are not integrated into investment decisions.



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