SUSTAINABLE FINANCE DISCLOSURE REGULATION AND EU TAXONOMY - A year in review

Compliance with SFDR and EU Taxonomy - guiding notes for your impact fund

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COMPLIANCE WITH SFDR AND EU TAXONOMY - GUIDING NOTES FOR YOUR IMPACT FUND

SFDR
The Transparency Pillar for EU Impact Financial Market Participants

The publication of the (EU) 2019/2088 **Sustainable Finance Disclosure Regulation (SFDR)** marks a key milestone in the 2018 EU Action Plan on financing sustainable growth.

Why is SFDR so important for the impact investing market and to whom does it apply? **SFDR offers transparency to investors as it provides a common sustainability disclosure framework**. It is applicable to financial market participants and financial products with sustainability objective(s) or characteristic(s) ranging from impact funds to impact bonds.

Entities and financial advisers are now required to disclose information on how their impact objectives, sustainability risks, adverse impacts, and safeguards are integrated within the investment process.

Innpact has supported various fund managers and their impact funds on their alignment journey with SFDR across all stages of the investment process.

Let us support you in this sustainability journey.

ASSET MANAGERS
Public and private impact funds and bonds

FINANCIAL ADVISORS
Financial advice on any product considering sustainability

INSTITUTIONAL INVESTORS
Pension schemes and funds targeting ESG factors or objectives

INSURANCE FIRMS
Insurance products targeting ESG factors or objectives

SFDR
Facets of Financial Product Requirements

SFDR Article 8	**Discouraged** fund terms: impact sustainable sustainability **Acceptable** Fund terms: ESG	• Promotes ESG • Abides to the **DNSH principle**, **Minimum Safeguards**, and follows **good governance** practices	• Considers **ESG risks** within the investment process • **Index** - comply or explain basis • **PAIs** - comply or explain basis
SFDR Article 8+	**Acceptable** Fund terms: sustainable sustainability	• Promotes **social and/or environmental characteristics** with some socially and/or environmentally sustainable investments aligned to the Taxonomy • Abides to the **DNSH principle**, **Minimum Safeguards**, and follows **good governance** practices	• Consideration of **ESG risks** within the investment process • **Index** - comply or explain basis • **PAIs** - comply for sustainable investments or explain basis
SFDR Article 9	**Acceptable** Fund terms: ESG green social impact sustainable	• Targets **(a) sustainable investment objective(s)** • **Socially and/or environmentally sustainable investments** aligned to the Taxonomy • Abides to the **DNSH principle**,	**Minimum Safeguards**, and follows **good governance** practices • Consideration of **ESG risks** within the investment process • **Index** - comply or explain basis • **PAIs** - comply

Taxonomy aligned

Taxonomy

The environmental extension to SFDR

The EU 2020/852 **Taxonomy Regulation (Taxonomy)** represents the **Environmental Pillar** of the EU Action Plan and can be considered as the **environmental extension to SFDR**.

This is because given the currently available delegated acts – Climate Change Mitigation and Adaptation - the Taxonomy is only available for all SFDR "green" funds (Art. 8+ or Art. 9) with environmentally sustainable investments. The remaining **environmental and social delegated acts** are currently under development by the European Commission and are expected in **January 2023**.

Impact funds falling under the scope of the Taxonomy, in addition to SDFR disclosure requirements, are expected to **dive deeper into the environmental characteristics of their investments**.

Based on the extensive track record in Impact Management and Measurement **(IMM),** Innpact can support you in identifying the relevant Environmental Taxonomy Objective, implementing the respective Technical Screening Criteria and **DNSH** practices.

EU Taxonomy Regulation

Socially Sustainable Investments
Expected: January 2023

- **Horizontal dimension:** minimising negative impacts
- **Vertical dimension:** Implementing adequate standards of living & basic infrastructure

Environmentally Sustainable Investments
Expected for other four objectives: January 2023

- **Climate Change Mitigation** (available)
- **Climate Change Adaptation** (available)
- Sustainable Use & Protection of Water & Marine Resources
- Transition to a Circular Economy
- Pollution Prevention and Control
- Protection & Restoration of Biodiversity & Ecosystems

EU regulatory updates in sustainable finance are very frequent, expecting impact fund managers falling under the scope of SFDR and Taxonomy to appropriately classify their impact fund given their investment strategy, and closely monitor the ESG regulatory timeline.

SFDR & Taxonomy
Market Pitfalls and Tips

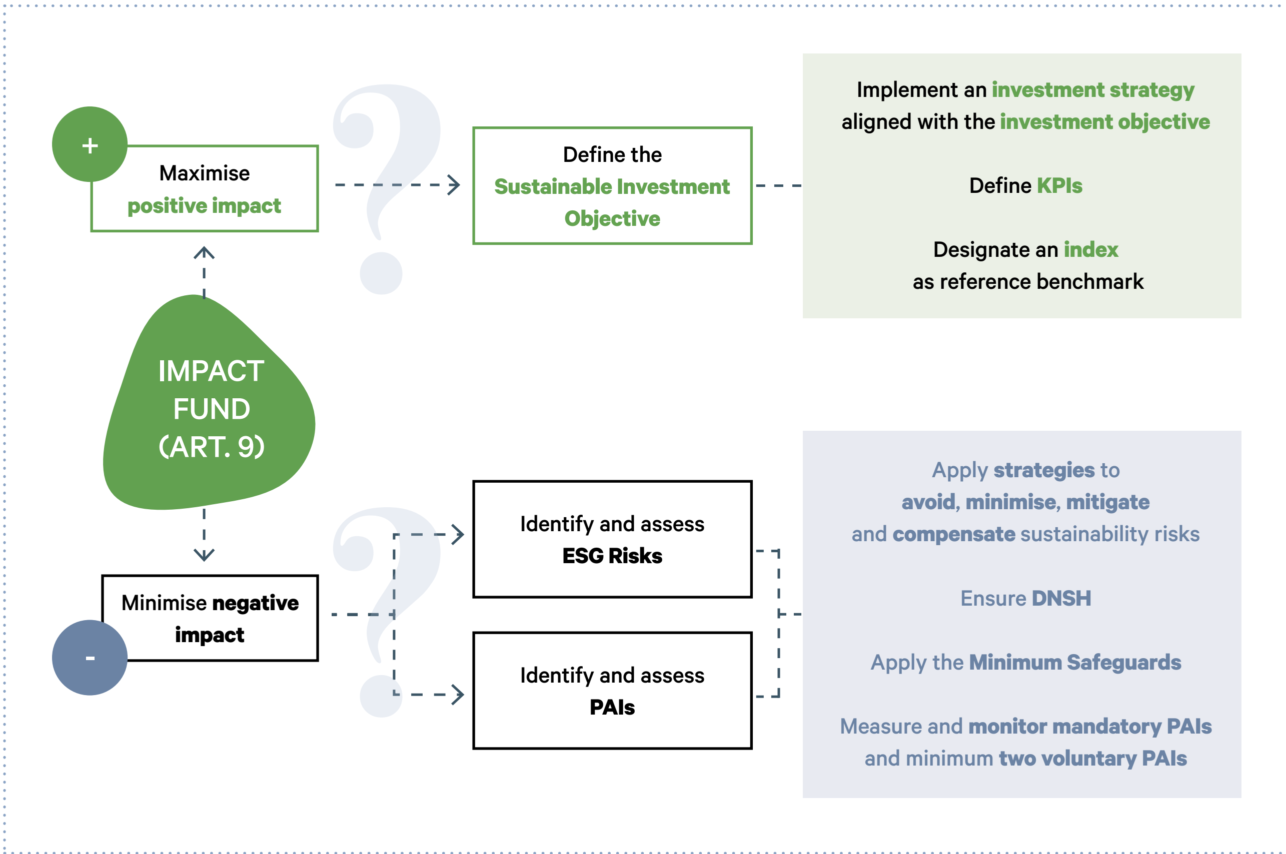
When it comes to integrating and reporting on SFDR and Taxonomy, **impact fund managers face several challenges** such as identifying the appropriate financial product classification, sustainability risk management framework and/or ESG mitigation strategies.

Depending on the type of challenge encountered, it is advisable to follow a **dual-faced approach** based on:

- **maximising positive impact generation**
- **minimising negative impact.**

Maximisation of positive impact requires a transparent impact thesis led by a purposeful red-thread, while the minimisation of adverse impact needs a robust ESG risk management framework and do not harm practices.

Let us help you in facing these challenges.



Advised Sustainability Risk Practices

- Settings and context
- Risk framework in alignment with international standards and best market practices
- Risk identification and prioritisation
- Risk assessment and mitigation strategies
- ESG risk matrix categorising material risks identified after assessment
- Risk reporting and disclosures

Why Sustainability Risk Practices are Important

- Develop and identify strategic value drivers
- Bolster the corporate strategy of a business
- Help determine risk exposures
- Improve risk response design, including mitigation strategy
- Better develop outcomes which include value creation and value protection
- Enhance ESG performance across business

SFDR & Taxonomy
Market Pitfalls and Tips

Impact Fund with a Climate Mitigation or Adaptation Objective, **and no alignment to the Paris Agreement**

Confusing description on the sustainability objective and **no clear split of % of sustainable investments**

Numerous **irrelevant KPIs**

Elaborate on the link between the Climate Change Objective and the Paris Agreement

Provide a clear portfolio allocation based on:
- Geography
- Sector
- % of sustainable investments
- % of non sustainable investments (explain)

Identification and reporting of key indicators – 2 to max 5. additional indicators for information only

SFDR & Taxonomy
Market Pitfalls and Tips on Negative Impact

Categorising the financial product as an impact fund (Art. 9 SFDR) **but not reporting on all mandatory PAIs**

No consideration of **Minimum Safeguards** – UN Guiding Principles, Fundamental ILO Conventions, International Bill of Human Rights, OECD Guidelines

When Taxonomy compliant, **no implementation of DNSH** practices specific to relevant Technical Screening criteria

As outlined by the European Commission, lack of data availability cannot be a justification. **When in doubt, use proxies instead**

Review the Minimum Safeguards and their relevance to the investment strategy. Minimum Safeguards are be to be included in the **Investee Exclusion List**

Identify and implement the **Substantial Screening criteria** presented by the **Taxonomy Compass** specific to the TSC

SFDR & Taxonomy
Market Pitfalls and Tips on Sustainability Risks

Lack of strong **ESG risk procedures**

Lack of **ESG risk integration into risk management** framework across risk types

Failing to align **ESG risk with investment strategy**

Focus on **E&S risk** management practices, **excluding G** considerations

ESG risk policy that includes how to identify ESG risks, what method of risk evaluation is appropriate, and how to implement risk mitigants

ESG risk alignment method that is comparable to international standards

ESG risk template that helps monitor risk levels

Include G considerations in the risk matrix and ESG Policy

SFDR & Taxonomy Timeline

EU SFDR

JANUARY 1ST 2022

EU SFDR RTS*
- Start of the first reference period for PAIs to be reported at entity-level by 30 June 2023
- Periodic product disclosures as per Article 11 of SFDR

AUGUST 2022

UCITS & AIFMD Delegated Acts
- Sustainability related provisions under UCITS and AIFMD DAs apply

MiFID / IDD*** Delegated Acts
- Sustainability related provisions under MiFID II and IDD DAs apply

JANUARY 1ST 2023

EU SFDR RTS
- Application of SFDR RTS and mandatory templates for Website & Pre-contractual Disclosures, Periodic Reports for Article 8 and Article 9 Funds

(To be approved by EU Parliament and Council)

EU SFDR RTS
- Application of SFDR RTS product disclosures for all Environmental Taxonomy objectives

JUNE 2023

EU SFDR RTS
- PAI reporting at entity-level on the first reference period

Dates may be subject to change.

EU Taxonomy

JANUARY 1ST 2022

Taxonomy - Application of Delegated Acts on Climate Change Mitigation & Adaptation
- Application of relevant Technical Screening Criteria
- Collection of Data

Article 9 and Article 8+** Funds targeting climate mitigation and/or adaptation
- Pre-contractual & Website Disclosures, Periodic Reports

JANUARY 2023

Taxonomy Complementary Environmental Delegated Acts
- Application of Delegated Act covering the four remaining Taxonomy objectives and relevant Technical Screening Criteria
- EU Commission proposed to classify nuclear/gas power investments as sustainable (to be approved by EU Parliament and Council)

Social Taxonomy (to be confirmed)
- Application of additional disclosures under SFDR (Pre-contractual disclosures, Periodic Reports)

**RTS is the Regulatory technical standards bundled into the draft Commission Delegated Regulation published on 6 April 2022, now under scrutiny by the EU Parliament and the Council.*

***"Article 8+ funds" denotes Article 8 funds making sustainable investments, as usually defined by the fund industry.*

****IDD stands for the Insurance Distribution Directive or Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.*

FAQs

Is the definition of an Art. 8+ fund a commonly accepted definition in the market or is this Innpact's definition?

There is no Art. 8+ definition as such in the SFDR, but the industry uses this term to differentiate between two versions of Art. 8 where an Art. 8 fund does not have any sustainable investments and an Art. 8+ fund has some sustainable investments. The idea of an Art. 8+ exists in the reporting template, but not within the regulation.

When is the percentage allocation to "sustainable investments" assessed – at the time of initial investment or at the time of the reporting dates?

When selecting the portfolio allocation, you need to know if the sustainable investments will allow for a majority or minority of your investments. Funds may have a percentage of assets invested in cash classified as not sustainable investments. In this case, for transparency reasons cash is categorised as non-sustainable whether it is invested in the money market (i.e. not sustainable investments) or not unless the latter is a green money market instrument. In the reporting chart you will have to explain what the top ten sustainable investments that contribute to sustainable investments are. This percentage is allowed to change over time.

Is it possible for a fund to launch as an Art. 9 fund and scale down?

It is possible, but not recommended. It is better to start with an Art. 8 and then move up to Art. 8+ or 9. Before moving up to Art. 9, it is advised to test several PAIs and Taxonomy in advance.

Is it possible to opt out of these regulations? (i.e. small funds, genuine impact funds addressing under-served markets).

No, this is not possible. These regulations are implemented for transparency and to avoid green and impact washing. No matter the size of the entity or financial products, those falling under the scope are required to comply.

How detailed does the reporting on the PAIs at a product level have to be?

Reporting on PAIs needs to be very detailed. Granular figures are needed to complete the list of mandatory indicators and one additional for each E and S categories. Each indicator is to be reported on for each deal, every year. For example, you need to quantify GHG emissions, scope 1, 2 & 3. Every investee company needs to have this data. Proxies are accepted in case of missing values (i.e. for scope 3 GHG emissions).

Can we target several sustainability objectives, or do we need to pick one per fund?

Yes, you can target multiple sustainability objectives in the same fund as long as they are supported by methodology and KPIs.

Do you have to conduct an ESG DD for all investments irrespective of size of investment?

Even if this is costly, it is a must. You need to do this as they all need to be eligible, especially for the Minimum Safeguards and good governance practices.

What happens if we cannot answer all Taxonomy DNSH questions?

This means that even if eligible for the Taxonomy, the investment cannot be classified as aligned (Taxonomy alignment = 0%).

If an Art. 9 fund with environmental objectives invests in emerging markets where companies are not required to disclose Taxonomy eligibility, can this fund then report not to be Taxonomy eligible?

No. This is an EU transparency requirement regardless of investee countries' legislations.

Contact our SFDR and Taxonomy Experts

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Innpact is a leading impact finance specialist providing advisory and third-party fund management services.

Our team, based in Luxembourg and Mauritius, has unrivalled expertise in designing impact funds and blended finance vehicles.

We work with fund managers, sponsors and investors around the world on impact investing projects totaling more than $8 bn targeting the Sustainable Development Goals.

We provide our services with motivation, dedication and smile, being faithful to our mission and our values.

Dedicated to Impact Finance.