

Matrix for the Sustainable Finance Disclosure Regulation (SFDR)¹

Allen & Overy have worked with ISLA representatives of the ESG Steering Group to create a matrix, to aid firms with determining their requirements for The Sustainable Finance Disclosure Regulation (SFDR).

The flow chart provides a high-level guide for a firm determining whether and how to comply with SFDR. This document is not intended as a substitute for seeking legal advice, and provides an introductory overview only, which is not comprehensive and remains subject to change. Each firm should consider its obligations under SFDR and whether/how to comply in the context of its own business.

Question for Member Firm	Answer
<p>1. In the course of your activities, do you (strictly speaking) conduct any portfolio management for MiFID II purposes?</p> <p>N.B. (a) It is assumed for the purposes of this document that only portfolio management is potentially relevant to member firms' business, and other reasons why a firm could be caught by SFDR (e.g. because of advisory activities) are not applicable.</p> <p>(b) Where an agent lender, operating exclusively in the UK from a UK entity, is conducting portfolio management only in respect of UK clients and funds, with no EU nexus, SFDR should not apply; on that basis, such a firm would not need to make any SFDR disclosures by the 10th March 2021 deadline.</p>	<p>If YES:</p> <ul style="list-style-type: none"> You should comply with SFDR in relation to those portfolio management activities. However, you are not technically required to comply with SFDR in relation to other aspects of your securities lending activities (although you may do so, if you wish). <p>If NO:</p> <ul style="list-style-type: none"> SFDR is not relevant to your lending/borrowing arm. If you wish, you could voluntarily comply with SFDR, e.g. for commercial reasons – further advice should be obtained on this option, if relevant. Where this option is chosen, it should be clear that you are making the disclosures on a voluntary basis only and are not required to do so. There is no "opt in" mechanism for firms who are not caught by the rules. <p>N.B. Your clients may have their own SFDR obligations, which could impact the contractual obligations they require you to comply with.</p>
<p>2. If you say YES to Question 1, you have a business decision to make as to whether you wish to take:</p> <ul style="list-style-type: none"> OPTION 1 – only comply with SFDR in relation to your portfolio management activities; or OPTION 2 – voluntarily comply with SFDR in relation to your lending/borrowing more generally. 	<p>This is a business decision for firms</p>

¹ 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.

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<p>3. For any activities caught by SFDR, you need to consider how they should be categorised for SFDR purposes. At a very high level, the categories can be summarised as follows:</p> <ul style="list-style-type: none"> • <u>Article 8 ("light green")</u> – a financial product which promotes environmental or social characteristics (amongst other characteristics); • <u>Article 9 ("dark green")</u> – a financial product which has sustainable investing as its investment objective (albeit not necessarily 100% of the portfolio); and • <u>Article 6 ("vanilla")</u> – a financial product which does not fall within the above categories. <p>N.B. For the purposes of SFDR, portfolio management is a "product".</p>	<p>By way of context, this categorisation has been challenging to the industry, in particular since there is no guidance on where to draw the line between the categories.²</p> <p>N.B. (a) A scenario may arise where the requirements of an ISLA member's client, necessitate restrictions on the member's product (for example, the exclusion of ethically problematic investments, when the ISLA member conducts portfolio management, i.e. certain types of Cash Collateral re-investment) which may require the member to characterise it as "light green" under SFDR, i.e. an Article 8 product. Pending further regulatory guidance: (i) the determination as to whether a portfolio mandate is light green or not, should be made on a case-by-case basis, looking at the relevant facts; (ii) a member firm should consider all aspects of the mandate for this purpose, including features or requirements of the mandate proposed or required by the underlying client (e.g. "sin stock" exclusions); (iii) the current expectation in the market is that there may be a fairly low threshold before a product falls into the Article 8 category under SFDR.</p> <p>It should be noted, however, that this is not certain and it cannot be ruled out that the regulator will take different views, as the industry continues to wait for regulatory guidance on SFDR generally.</p> <p>(b) In the absence of regulatory guidance at the time of writing, our understanding is that many firms are taking a risk-adverse view on this and assuming that it is not likely to matter that the beneficial owner has given instructions or proposed a particular requirement, i.e. you look at what is finally agreed between client and portfolio manager to determine whether a product is Article 8 or not.</p>

² In particular, we note the letter sent by the ESAs to the European Commission requesting (among other things) clarification on "*the meaning of "promotion" in the context of products promoting environmental or social characteristics*", i.e. for the purposes of Article 8 SFDR. See https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_applicatio_n.pdf

Question for Member Firm	Answer
<p>3.1 If a firm has taken Option 1 above, it should only consider its portfolio management activities in this categorisation exercise.</p>	<p>This involves an assessment as to whether your mandates meet the threshold requirements in Article 8 and 9, taking into account the draft Level 2 guidance (Regulatory Technical Standards).³</p> <p>If you are not clear on this, you may wish to take legal advice.</p> <p>NOTE FROM ISLA:</p> <p>Article 8 – Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures. At the time of writing and due to a lack of regulatory guidance around the definition of ‘promotion’, ISLA conclude that general securities lending activity does not ‘promote’ environmental or social characteristics, in accordance with Article 8; however ISLA recommend that members seek individual counsel on this matter.</p> <p>Article 9 – Transparency of sustainable investments in pre-contractual disclosures. ISLA does not feel that day-to-day activity captured within securities lending has sustainable investment as its objective unless specified by the asset owner/manager; however, we would advise that members seek individual counsel on this matter.</p>
<p>3.2 If a firm has taken Option 2, it should consider its securities lending more generally in this categorisation exercise.</p>	<p>As above.</p>

³ We note that the draft Regulatory Technical Standards only come into effect from 1 January 2022, and it is possible the text will change in the meantime.

Question for Member Firm	Answer
<p>4. <u>Next steps</u></p> <p>Once you are clear on the categorisation of your financial products, you can formulate a checklist and project plan as to what you need to do under SFDR, including:</p> <ul style="list-style-type: none"> • New and/or updated policies and procedures; • Pre-contractual disclosures to clients; and • Website disclosures. 	<p>This project can be approached with an initial phase focusing on the SFDR requirements which apply from 10 March 2021 ("Day 1"). The initial phase would cover:</p> <ul style="list-style-type: none"> • Preparatory work; • Preparation of website disclosures to be posted on Day 1; • Preparation of appropriate pre-contractual disclosures required for Day 1; and • Preparation of additional disclosures for any products falling within the scope of Article 8 or 9, required for Day 1. <p>The second phase of the project would consider, and progress the firm's compliance with, the SFDR requirements following Day 1, taking into account the final Level 2 text and any future regulatory guidance.</p> <p>N.B. In relation to the new principle adverse impact ("PAI") regime imposed by SFDR, a portfolio manager with more than 500 employees can temporarily "opt out" of the PAI disclosure regime, meaning on/from 10 March 2021, the manager can publish a statement on its website as contemplated by Article 4(1)(b) of SFDR. However, this option falls away on 30 June 2021 and the manager must comply with the regime from that date as per Article 4(3) of SFDR.</p>