ESG update: European Commission SFDR guidance

In brief

On 26 July 2021, the European Commission published a set of long-awaited Q&A guidance on the EU Sustainable Finance Disclosure Regulation (SFDR).

In this issue

On 26 July 2021, the European Commission published a set of long-awaited Q&A guidance on the EU Sustainable Finance Disclosure Regulation (SFDR). The guidance was published in response to a request for a clarity by the European Supervisory Authorities on a number of specific points, many of which reflected issues raised by market participants that were left struggling to apply the Level 1 text of the Regulation from March this year.

The Commission's guidance will be relevant in particular to:

a. asset managers established outside of the EEA (e.g. in the UK, US or Switzerland) that market fund units into an EEA Member State under that jurisdiction's national private placement regime; and

b. any firm attempting to navigate Article 8 vs. Article 9 product characterisations, or that provides single managed account services within scope of the SFDR.

We have summarised in this alert some of the major points raised by the Commission's guidance.

Application of entity-level disclosures to third country AIFMs (e.g., UK/US/CH investment managers)

Background: entity-level vs. product level disclosures

Mandatory SFDR disclosures fall within two distinct categories: (i) entity-level disclosures; and (ii) product-level disclosures.

Entity-level disclosure standards require firms to post the following on their websites:

a. policies on their approach to sustainability risk;

b. data on whether, and if so how, they have regard to the "principal adverse impacts" on sustainability of their investment decisions or investment advice; and

c. how the firm's remuneration policies are consistent with the integration of sustainability risks.

Product-level disclosures, on the other hand, require firms to include disclosures on sustainability risks in pre-contractual disclosures (e.g., offering documents), describing:

a. The manner in which sustainability "risks" have been integrated into the firm's investment decisions or investment advice; and

b. The "likely impact" on the returns of financial products made available or advised on by the firm.

Firms that go one step further and consider the principal adverse impacts of their investment decisions on sustainability factors will need to make certain additional pre-contractual disclosures.

Position to date

Where non-EU investment managers market funds to EEA investors under the AIFMD regime, the Level 1 text of the SFDR makes clear that they are required to comply with the pre-contractual disclosure requirements referred to above. This is because the pre-contractual disclosure requirement cross-references Article 23 of the AIFMD, which applies to any AIFM that markets its funds to EEA investors under national marketing regimes permitted by AIFMD, regardless of whether the manager is established in the EEA or in a non-EEA jurisdiction.

Until now, many in the market have been working on the basis that although third country AIFMs are clearly required to comply with SFDR "product-level" disclosures in relation to funds they market to EU investors through national private placement (NPPR) regimes, there is no such clear authority for third country AIFMs being required to comply with entity-level disclosures.

This is partly a jurisdictional nexus issue; it would appear disproportionate for a third country manager marketing one or more individual funds into the UK to publish disclosures covering the manager's entire business at entity-level, not to mention that such an obligation would be challenging for Member State authorities to supervise or enforce. The view that third country managers are outside scope of SFDR entity-level disclosures was also driven by the manner in which AIFMD entity-level disclosures are generally interpreted, and the fact that only Article 6 of the SFDR on product-level disclosures cross-refers explicitly to Article 23 of the AIFMD.

Position following Commission Q&A guidance

Whilst the language in the Commission's guidance is somewhat confused (particularly as between sub-threshold and third country AIFMs), the Commission has opened the possibility that third country AIFMs should comply with both product-level and entity-level disclosures. For example, the Commission states that:

"Where an AIFM from a third country enters the market of a given Member State by means of a National Private Placement Regime, that AIFM must ensure compliance with Regulation 2019/2088, **including** the financial product related provisions." (Emphasis added)

What steps should third country AIFMs take?

Strictly, the interpretation and application of the SFDR will be a question for each Member State that a third country manager markets into. Therefore, third country investment managers should remain alert for any further clarity or guidance from regulators in relevant jurisdictions, such as the Irish CBI or Luxembourg CSSF.

In the meantime, however, the safest course of action in circumstances where funds are actively being marketed under an NPPR regime may well simply be to upload an entity-level disclosure that is compliant with the terms of the SFDR. The Commission's guidance does not appear to exclude third country investment managers from making entity-level disclosures solely in relation to those funds that they market under NPPR regimes, for example, so this is an approach that could be considered. Given the stage we are currently at in terms of implementation (i.e., the relevant Delegated Regulation is not yet in force), any entity-level disclosure can at present remain high-level in nature.

Registered (i.e., 'sub-threshold') AIFMs

The Commission's guidance states that both entity and product-level disclosure requirements are intended to apply to sub-threshold AIFMs, and that the provisions of the SFDR are to be applied "by analogy" where it is not otherwise clear that they sub-threshold AIFMs are strictly within scope.

Article 8 vs. Article 9 products

Unless a firm opts out of SFDR disclosure by taking the view that sustainability risk is not relevant to a particular product, there are effectively three tiers of disclosure that may apply depending on how the firm positions its products or single managed account services. A lower standard of disclosure applies to products and services in relation to which sustainability risk is simply "relevant", and a higher level of disclosure applies to products such as fund units or portfolio management services which actively "promote" or have as their "objective" ESG goals (these are referred to as Article 8 and Article 9 products respectively). Given that the market has to date had limited guidance on the scope of these product categorisations, a number of questions were posed to the European Commission on the distinction between Article 8 and 9 products in particular. We have summarised the Commission's guidance on this point below.

Distinction between Article 8 and 9 products

The European Commission makes the following observations on the distinction between Articles 8 and 9:

- Article 8 products have "a sustainability-related ambition lower than the ambition of financial products subject to Article 9"; and
- Where a product has an environmental objective and does not meet the do not significant harm criterion (as referred to in Article 2(17) of the SFDR), it will qualify as an Article 8 product.

Scope of Article 8

The Commission makes the following points in relation to the scope of Article 8:

- Article 8 is neutral in terms of the design of financial products. It does not prescribe specific elements such as the composition of investments or minimum investment thresholds, eligible investment targets, and nor does it determine eligible investing styles, investment tools, strategies or methodologies to be employed.
- Therefore, nothing prevents Article 8 products from continuing to apply current market practices, tools and strategies, or a combination thereof (e.g., screening, exclusion strategies, best-in-class/universe, thematic investing, redistribution of profits or fees etc.).
- Article 8 products may pursue a reduction of negative externalities caused by underlying investments, such as principal adverse impacts on sustainability factors.
- Nothing prohibits Article 8 products from investing in part in 'sustainable investments' as defined Article 2 of the SFDR.
- On the other hand, integration *per se* of sustainability risks, as defined by Article 2(22) of SFDR, is not sufficient for Article 8 to apply.

The Commission goes on to note the following points on the interaction between the manner in which products are promoted or marketed and the scope of the Article 8 categorisation:

- Article 8 means that where a financial product complies with certain environmental, social or sustainability requirements or restrictions laid down by law, including international conventions, or voluntary codes, and these characteristics are "promoted" in the investment policy, the financial product will be subject to Article 8.
- The term 'promotion' within the meaning of Article 8 encompasses, by way of example, direct or indirect claims, information, reporting, disclosures as well as an impression that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition in, but not limited to, pre-contractual and periodic documents or marketing communications, advertisements, product categorisation, description of investment strategies or asset allocation, information on the adherence to sustainability-related financial product standards and labels, use of product names or designations, memoranda or issuing documents, factsheets, specifications about conditions for automatic enrolment or compliance with sectoral exclusions or statutory requirements regardless of the form used, such as on paper, durable media, by means of websites, or electronic data rooms.
- Moreover, Article 8 products must refer to those elements in pre-contractual disclosures that relate to environmental and/or social characteristics that are binding during the entire holding period.

In summary, therefore, the Commission appears to be making the following points:

- The application of Article 8 should be determined on a case-by-case basis, without regard to the specific investment strategy pursued by the fund or product in question.
- There is nothing to suggest that the mere application of screens or exclusions, absent a decision by the manager in question to market or promote the product as sustainable in nature, would be sufficient to bring the product within scope of Article 8.
- However, the Commission also defines the scope of promotion particularly broadly, as can be seen by the list of examples set out above. Firms should pay particular attention to whether this broad scope of application, combined with pressure from

institutional investors to assign a higher standard of sustainability to financial products, could lead to conflict with recent concerns expressed by regulators such as the FCA around greenwashing.

Comments on Article 9

The Commission makes the following comments on the application of Article 9:

- An Article 9 product may invest in a wide range of underlying assets, provided these underlying assets qualify as "sustainable investments", as defined in Article 2(17) of the SFDR.
- However, Article 9 products may also include investments made for specific purposes such as hedging or liquidity which, in order to fit the overall financial product's sustainable investment objective, have to meet minimum environmental or social safeguards. In other words, investments or investment techniques pursued for such specific purposes must remain in line with the product's sustainable investment objective.
- In summary, this suggests that the Commission's expectation is for the majority of underlying investments contained within an Article 9 product to be "sustainable investments" as defined in the SFDR, but that there is scope for other investments and hedging instruments etc. to be made alongside pure sustainable investments. Unfortunately, the test that firms will need to apply to, say, hedging instruments to demonstrate that they are in line with the product's sustainable investment objective remains unclear.
- Since Article 9 remains neutral in terms of product design or approach to investment, the Commission notes that the relevant product documentation must include information on how the composition of underlying investments complies with the "sustainable investment" objective of the financial product, in order to comply with the "no significant harm principle".

Treatment of single managed accounts

The Commission makes two key points in relation to the application of the SFDR to single managed account services, as follows:

- Where website disclosures are required in relation to single managed accounts, there is a question as to how firms can maintain their confidentiality obligations to clients in view of the disclosures required. The Commission's view on this point is straightforward: transparency of the promotion of environmental or social characteristics and of sustainable investments on websites must: (i) ensure compliance with data protection law; and (ii) ensure client confidentiality. This appears to leave scope to keep website disclosures made in the context of single managed accounts confidential in some way.
- The Commission also considers the application of the SFDR to standardised portfolio solutions, noting that the definition of a "financial product" in Article 2(12) of the SFDR makes no distinction whether the products are tailored to the specific preferences or requirements of end investors. Nonetheless, where a financial market participant makes use of standardised product solutions, the Commission concedes that transparency of those solutions might be a way for complying with requirements on website disclosures laid down by the SFDR.

Comply or explain mechanism under Article 4 of the SFDR

Article 4(1) of the SFDR imposes a comply or explain mechanism, which requires financial market participants either to: (i) publish and maintain on their websites a statement on their due diligence policies with respect to the principal adverse impacts (PAIs) of their investment decisions on sustainability factors; or (ii) where they do not consider adverse impacts of investment decisions on sustainability factors, clear reasons for why they do not do so.

The Commission notes that financial market participants that decide not to apply the "comply mechanism" must provide clear reasons for why they do not consider "adverse impacts" of investment decisions on sustainability factors. By way of example, financial market participants must provide clear reasons for why they do not consider degradation of the environment or social injustice caused by their investments.

500-employee criterion

Under Article 4 of the SFDR, financial market participants are also required to publish a PAI statement where they either have 500 employees on an individual basis, or where they are the parent undertaking of a large group that exceeds 500 employees. The Commission confirms that the 500-employee criterion is intended to relate to the "large group" in its entirety; in other words, the calculation of the headcount takes into account the number of employees of a parent undertaking and of subsidiary undertakings regardless whether they are established inside or outside the Union. However, the PAI disclosure itself would solely relate to the activities of the parent undertaking.

Contact Us

Ansgar Schott
Partner
Zurich
ansgar.schott@bakermckenzie.com

Caitlin McErlane
Partner
London
caitlin.mcerlane@bakermckenzie.com