European Commission Q&A on Sustainable Finance Disclosures Regulation

30 July 2021

The European Commission (the "Commission") recently issued the long-awaited answers to questions raised by the European Supervisory Authorities earlier this year on the Regulation on Sustainability-related Disclosures in the Financial Sector ("SFDR"). This Update covers answers to questions that relate to some key areas of legal uncertainty under SFDR. While the explanations are welcome, a number of answers do not provide the clarity expected.

SFDR applies to non-EU AIFMs. In line with market understanding, the Commission confirmed that, under its interpretation of SFDR, "financial market participants" that are in the scope of SFDR include non-EU alternative investment fund managers ("AIFMs") that are subject to the EU Alternative Investment Fund Managers Directive ("AIFMD") by virtue of marketing their funds on the basis of national private placement regimes in EU Member States (where available). On this basis, non-EU AIFMs will make the same product-related disclosures in relation to the funds that are marketed in the EU as those made by EU AIFMs. There is still some uncertainty on the application of "firm" level obligations to non-EU AIFMs, in particular regarding the requirement to obtain and publish data on "principal adverse impacts" (or to publish an opt-out statement)—an obligation arguably only directed at EU AIFMs, given its links to the Commission's corporate sustainability reporting requirements for EU companies—and to publish website information on the firm's approach to integration of "sustainability risks". In practice, we expect that competent authorities will mainly focus on the application of SFDR to non-EU AIFMs in relation to the information given to investors for funds that are marketed in their state, and non-EU AIFMs will continue to be guided by the expectations of EU investors in this respect.

SFDR applies to sub-threshold EU AIFMs. The Commission has taken the view that SFDR applies to sub-threshold EU AIFMs, namely smaller AIFMs that are required to be registered with competent authorities but are not subject to the full scope of the AIFMD. In the Commission's view, sub-threshold AIFMs should apply the requirements for disclosure and on-going reporting under SFDR—which follow the equivalent requirements for full scope AIFMs in the AIFMD—"by analogy" by reference to pre-contractual and periodic disclosures under national law.

Calculation of the 500-employee threshold in connection with the opt-up under Article 4 of SFDR. Under Article 4 of SFDR, financial market participants with fewer than 500 employees can opt out from the requirement to consider the principal adverse impacts of investment decisions on sustainability factors. The Commission has explained that the calculation of the 500-employee threshold should take into account the number of employees of a parent undertaking and of subsidiaries regardless of whether they are established inside or outside of the EU. Where a financial market participant is a parent undertaking and exceeds the threshold, it cannot opt out. A subsidiary undertaking may itself be a financial market participant that must consider principal adverse impacts of investment decisions on sustainability factors (if it exceeds the 500-employee threshold) or may opt in to consider principal adverse impacts of investment decisions on sustainability factors (if it is below the 500-employee threshold), regardless of the approach taken by its parent undertaking.

Products under Article 9 of SFDR may only make sustainable investments. Products under Article 9 of SFDR are products with sustainable investment as their objective. Sustainable investments are investments that have a specific environmental or social objective and at the same time meet the SFDR's "do no significant harm" test (which is that the investment has no significant impact on all other environmental or social objectives). The Commission has indicated that funds qualifying under Article 9 should have an investment strategy to make only sustainable investments, with a proportion of other investments only available for hedging or liquidity purposes—which themselves will have to meet minimum environmental or social safeguards. Therefore, a fund with an environmental objective but which is not able to demonstrate that it meets the "do no significant harm" test with respect to all of its investments would not qualify under Article 9, and instead qualify as an Article 8 fund.

Broad scope of Article 8 of SFDR. Products under Article 8 of SFDR are products that promote environmental or social characteristics. Given the different ways in which a fund can be said to "promote" environmental or social characteristics, the scope of this Article has been subject to different interpretation.

Whilst the Commission provides answers to a number of questions on the scope of Article 8, it appears that there will continue to be a degree of flexibility as to whether or not a fund sponsor categorises a fund within Article 8. In particular, in the Commission's view:

- Article 8 funds use a wide variety of ESG-related "market practices, tools and strategies", such as screening, exclusion strategies, best-in-class and thematic investing. Funds under Article 8 may "pursue reduction in negative externalities caused by the underlying investments" (a fund that seeks a particular outcome, such as climate change mitigation) but are not required to do so—meaning that a fund

may be within Article 8 by promoting, for example, that it applies a "negative screen" of unacceptable investment classes and by measuring and pursuing various ESG themes (such as diversity or carbon emissions) in its assets. The Commission states 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 "those characteristics are promoted in the investment policy", the financial product can be subject to Article 8.

- Environmental and social characteristics should be "binding during the whole holding period".

- "Promotion" in Article 8 has a wide meaning, and the Commission makes the broad statement that it includes "information on the adherence to sustainability-related financial product standards and labels…or compliance with sectoral exclusions or statutory requirements".

- Integration of "sustainability risks", which are environmental, social and governance factors that could cause a material adverse impact on an investment, is not sufficient in itself for Article 8 to apply.

In our view, the exact scope of Article 8 remains unclear. In particular, it is unclear to what extent the reference of particular ESG aspects in promoting the fund brings the fund within the scope of Article 8. The Commission's guidance suggests that there continues to be flexibility for firms to categorise products within Article 8. Whilst the Commission's guidance suggests that a fund should promote environmental or social characteristics, such as compliance with "voluntary codes" (which would include the widely adhered-to UN Principles for Responsible Investment ("PRI")), as a "binding element" of the fund's investment policy, it also suggests that simple promotion of the product's consideration of environmental or social characteristics as "targets, objectives or a general ambition" is sufficient.

To some degree, the Commission's equivocal approach is understandable, with the Commission not wishing to cut back the scope of Article 8 in a way that undermines its aim to address "green-washing". Further regulatory guidance on this topic seems unlikely. As a result, firms wishing not to qualify under Article 8 should be careful not to over-promote their consideration of environmental or social characteristics (by, for instance, their adherence to the PRI) in their marketing documents and may consider instead referring to such matters in privately negotiated side letters with investors. Moreover, it should be possible to include express language labelling a product as not within the scope of Article 8, depending on the level of promotion of environmental or social characteristics. We expect that regulatory enforcement under Article 8 is more likely to be focussed on unsubstantiated claims for ESG considerations in the retail

funds sector, but in the longer term, regulatory enforcement may also be of relevance in the institutional funds sector.

* * *

Please do not hesitate to contact us with any questions.

FRANKFURT

Patricia Volhard
pvolhard@debevoise.com

Jin-Hyuk Jang
jhjang@debevoise.com

LONDON

John Young
jyoung@debevoise.com

Eric Olmesdahl
eolmesdahl@debevoise.com