May 2022 Update on SFDR Compliance

31 May 2022

The European Securities and Markets Agency (ESMA) this week published a Commission Decision and Annex containing a set of answers on the Sustainable Finance Disclosure Regulation ((EU) 2019/2088) (SFDR) and the Taxonomy Regulation ((EU) 2020/852), which the European Commission adopted on 13 May 2022. The answers are to a series of important questions raised by ESMA in a document published on 13 May 2022. The Commission has generally given clearly reasoned answers to the questions, although a number of uncertainties still remain. The following are the key areas of interest for private fund sponsors that are in scope of SFDR.

Can firms make PAI disclosure for specific funds only, having opted out at firm level? SFDR requires larger firms (firms with more than 500 employees) to measure and report on principal adverse impact ("PAI") factors in their investment portfolios. For smaller firms, there has been no clear route for them to consider PAI factors only in relation to a sub-set of their funds, such as those funds raised since SFDR originally applied, or those funds where the sponsor can in practice consider PAI factors (e.g. because it does not have access to the necessary data). In the questions posed to the Commission, ESMA asked whether firms can opt out as a general matter, but still disclose, in the website disclosure, that they consider PAI factors for certain funds only. The Commission confirmed that a firm that opts out of considering PAI may launch a financial product that "pursues a reduction of negative externalities caused by the investments underlying that product" (in other words, may consider PAI factors), but the firm must make it clear in its (website) firm level disclosure that it has taken this approach. This is a pragmatic response, but will require firms who take this approach to update their website disclosure.

Does ongoing reporting under SFDR apply to legacy funds? A key question that ESMA posed the Commission is whether Article 6 (disclosure of sustainability risks in pre-contractual disclosures), Article 7 (statements in relation to consideration of principal adverse impacts in pre-contractual disclosures), Article 10 (website disclosures) and Article 11 (periodic reports) of SFDR, apply to financial products (including managed account mandates), in each case for products (or mandates) that were no longer made available to investors or clients on 10 March 2021. In answering this

question, the Commission confirmed, for such products, that the periodic reporting must comply with Article 11 of SFDR, and such products must also comply with the rules on information given on environmental or social characteristics and on sustainable investment objectives on websites in Article 10 of SFDR. The Commission's principle here seems clear, which is that all existing products must deliver periodic reports with the contents required under SFDR, regardless of whether the product was marketed after 10 March 2021. However, on the basis that periodic reporting only applies to funds within scope of Article 8 or Article 9 of SFDR, it is unclear if a sponsor is required to determine that its closed funds are within scope of Article 8 or 9 of SFDR, and how the sponsor should make that determination, as the vast majority of funds which closed prior to 10 March 2021 have not provided pre-contractual disclosure information in accordance with Article 8 and 9 and have not made a determination to that effect. The application of the Commission's response to non-EU managers that marketed their funds in the EU is also unclear. Industry practice may develop in this area.

What is the scope of the requirement in Articles 8 and 9 for funds to make investments which follow good governance practices? Funds within scope of Articles 8 and 9 of SFDR must demonstrate (among other conditions) that their investments follow "good governance" practices, indicating that firms that promote environmental or social characteristics must consider to some degree broader governance considerations. ESMA asked if a financial product in scope of Article 8 or 9 of SFDR does not invest in companies with good governance; whether it is able to continue to classify itself under Article 8 or 9 of SFDR. In response to this question, ESMA confirmed that, if an Article 8 or Article 9 fund does not invest in companies with good governance, the fund would be in breach of Article 8 or Article 9. The circumstance of a fund not investing in companies with good governance is not completely clear, and may well depend on how a firm has set out its policy to pursue good governance in its investments. ESMA also confirmed that the "good governance" condition only applies to investments in "companies", and therefore does not apply to investments in government bonds. A fund of fund sponsor will need to develop a policy to promote "good governance" in its investments, and in practice we think the better view is that this is to be restricted to making initial and ongoing checks on the approach taken by the general partners responsible for managing the underlying investments.

Questions relating to the application of the Taxonomy Regulation to funds within scope of Articles 8 and 9 SFDR. ESMA also asked questions in relation to the application of the requirement in the Taxonomy Regulation on funds in scope of Article 8 or 9 of SFDR to disclose information on the proportion of the funds' portfolio that qualifies as environmentally sustainable investments under the Taxonomy Regulation. Specifically, for a fund in scope of Article 8 of SFDR which promotes environmental characteristics but does not commit to invest in environmentally sustainable investments, ESMA asked whether such a fund is obliged to disclose information on the

alignment of its portfolio under the separate Taxonomy Regulation, and, if it then invests in environmentally sustainable investments, whether the fund is obliged to disclose information on Taxonomy alignment.

Is a fund within the scope of Articles 8 and 9 SFDR required to make investments aligned with the EU Taxonomy? The Commission confirmed that there is no obligation for a fund in scope of Article 8 or Article 9 to invest in Taxonomy aligned environmentally sustainable investments, notwithstanding that the fund intends to invest in environmentally sustainable investments. This is a helpful clarification that funds in scope of Article 8 or Article 9 may qualify their own investments as environmentally sustainable, where such investments are out of scope of, or, presumably, do not meet the strict tests in the Taxonomy Regulation. This includes "brown to green" investments (investments made with a view to qualifying them as environmentally sustainable in the future) or non-EU investments which cannot meet the strict criteria in the Taxonomy for "do no significant harm".

Do Article 8 funds that do not disclose an intention to make sustainable investments need to report the alignment of their portfolio under the EU Taxonomy? The Commission confirmed that Article 8 funds that promote environmental characteristics must disclose the degree of their expected Taxonomy alignment in the pre-contractual disclosures, regardless of whether the fund commits to invest in environmentally sustainable investments. Similarly, Article 8 products that make sustainable investments in economic activities contributing to an environmental objective must include information on Taxonomy alignment in the periodic report, regardless of commitments made in the pre-contractual disclosure. This includes products that only committed to invest with social objective, but subsequently invest in economic activities with an environmental objective.

This is an important point, where the Commission has arguably taken a controversial view. In relation to the steps a fund should take to assess Taxonomy alignment of the portfolio, the Commission confirms that funds can only disclose information on Taxonomy alignment where they have reliable data – but it is not a pre-requisite that the underlying investment itself is under an obligation to report Taxonomy-aligned information for the fund to report on Taxonomy alignment of that investment. The Commission also states that estimates of taxonomy alignment (on the basis of information from other sources, such as proxies) "should only compensate for limited and specific parts of the desired data elements, and produce a prudent outcome." The Commission's comments leave some uncertainty as to the efforts that a fund should take to measure Taxonomy alignment of the portfolio, but it is clear that an over-arching and long term aim of the Commission is to encourage as much reporting on Taxonomy alignment as possible.

Lastly, the Commission confirmed that, where a fund fails to collect sufficient data on Taxonomy alignment, the pre-contractual and periodic disclosures must indicate zero Taxonomy alignment. In this context, the Commission seems to discourage funds from using "narrative explanations on lack of reliable data", stating that funds should not "include negative justifications, such as explaining a lack of the alignment by lack of data", as that would undermine the purpose of the Taxonomy alignment disclosure.

Are investment advisors in scope, irrespective of whether they do not advise on financial products under SFDR? SFDR applies to investment advisers in relation to the recommendations they give to their clients, potentially including private fund sponsors established as investment advisers. The Commission has confirmed that SFDR applies to investment advisers in respect of advice given on individual securities (such as equities or bonds), as well as advice on financial products (such as funds), noting that it is more difficult in practice for financial advisers to integrate SFDR concepts such as sustainability risks when giving an investment recommendation on an individual security, because SFDR, as a framework, only governs financial products. Therefore, all EU financial advisers regulated by MiFID (and therefore in scope of SFDR), regardless of providing advice with respect to financial products or financial instruments – including private equity sponsors within scope, will need to incorporate disclosure on sustainability risks in their investment recommendations. It is worth noting here that UK private equity sponsors structured as "adviser-arrangers" are out of scope of SFDR.

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Please do not hesitate to contact us with any questions.

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