

ESMA Supervisory Briefing on Best Practice for SFDR Disclosures—A New Phase of Regulatory Supervision and Enforcement?

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On 31 May 2022, the European Securities and Markets Authority (“ESMA”) published a [supervisory briefing](#) on best practices for disclosures under the Regulation on sustainability-related disclosures in the financial services sector (“SFDR”). The purpose of this briefing is to ensure convergence across the European Union in the supervision of investment funds with sustainability features, and to combat greenwashing by investment funds. The briefing marks a more active approach of national competent authorities (“NCAs”) regarding compliance with SFDR, and we would expect more audits of SFDR disclosures and enforcement actions to be taken by NCAs in Europe going forward.

Even though ESMA encourages NCAs to take a proportionate approach in their supervision, considering elements such as the type of assets the fund manager intends to invest in, the complexity of the investment policy and strategy of the fund and the type of investors in the investment fund, the tone of the briefing is clearly one towards stricter and more stringent supervision and enforcement. ESMA reminds NCAs that the supervision should not impede the cross-border distribution of funds and it is therefore to be hoped that NCAs in investor target countries will not object to views taken regarding SFDR classification by home regulators of the AIFM.

Key aspects of the supervisory briefing are summarized hereafter:

Supervision of Fund Documentation and Marketing Material

On the basis of the general requirement for information to be accurate, fair, clear, not misleading, simple and concise, ESMA emphasizes that, with respect to funds that classify and disclose pursuant to Article 8 SFDR, the disclosure of criteria for the selection of underlying assets should be limited to those criteria that are binding on the fund manager in the investment-decision process.

Further, ESMA considers “nonbinding” exclusion strategies as problematic greenwashing potential. Hence, nonbinding elements that are in addition to binding

criteria should not be mentioned in the Article 8 SFDR disclosure. We would hope that additional elements that inform the general ESG strategy but that are nonbinding in that they still leave some discretion with the fund manager can still be disclosed outside of the Article 8 templates, *e.g.*, for example in the main body of the PPM or in the general ESG policy.

Compliance of Pre-Contractual Disclosures

With respect to pre-contractual disclosures NCAs should verify compliance with each point of disclosure under Article 8 and 9 SFDR using, for example, a checklist. NCAs should verify in particular that the main body of the PPM makes a prominent statement referring to the sustainability information to be found in an annex and the strategy to attain the objectives is clearly identified in the annex and is part of the investment policy.

ESMA also expects that Article 9 SFDR funds would disclose the “principal adverse impact” (“PAI”) considerations of investment decisions referred to in Article 7 SFDR, even though it is not mandatory. But because Article 9 SFDR funds can only make “sustainable investments” as defined in Article 2(17) SFDR, these funds have to conduct the “do not significantly harm” (“DNSH”) test in order to qualify their investments as “sustainable” within the meaning of Article 2(17) SFDR. For DNSH test the SFDR Delegated Regulation requires a description of how the 14 indicators for adverse impacts in Table 1 of Annex I and any relevant indicators in Tables 2 and 3 of that Annex, are taken into account. Unlike the PAI test, the DNSH test does not require to take into account all PAI indicators but only the ones that the managers deem relevant.

Consistency of Information

Sustainability-related disclosures must be consistent across the fund documentation and the marketing materials, and NCAs should assess them on a risk-based approach taking into account the following elements:

Presentation of Disclosures

Disclosures should have a clear indication under which Article of SFDR the fund is classified. Sustainability-related disclosures should not include boilerplate language with complex legal disclaimers. ESMA claims that the repeated use of the same or similar standard text across different funds is a “warning sign”. This is certainly problematic in practice where the use of templates entails a certain standardization of the disclosure language. Moreover, fund sponsors are often specialized with respect to one investment strategy/asset class and hence have set up ESG strategies and tools based on such strategy for all their fund products.

Given the legal uncertainties in particular as to the exact scope of funds classifying under Article 8 SFDR and the exact meaning of “promotion” of an environmental or social characteristic disclaimers appear appropriate. In fact it is important to make investors aware of the risk of different interpretations and administrative practices.

Fund Name

NCAAs are expected to screen funds’ names, and terms such as “ESG”, “green”, “sustainable”, “social”, “ethical”, “impact” or any other ESG-related terms should be used only when supported “in a material way” by evidence of sustainability characteristics, themes or objectives. In particular, using the term “sustainable” or “sustainability” would imply that the fund is disclosing under Article 9 SFDR or Article 8 SFDR if making sustainable investments. “Sustainable” should only be used for funds actually holding sustainable or taxonomy-aligned investments and “impact” is only permitted for funds actively targeting non-financial returns. Although ESMA confirms that there are no rules specifying minimum quantitative criteria for financial products to disclose sustainability features under SFDR, some member States have taken the initiative of setting thresholds at a national level to ensure that financial products names with sustainability features are not misleading.

Investment Objective and Policy

For funds classifying under Article 8 or 9 SFDR ESMA requires that the sustainable objectives or characteristics are clearly identified and expressions such as “the fund pursues ESG objectives in general” without any further specification are to be avoided.

Investment Strategy

For funds classifying under Article 8 and 9 SFDR, the investment strategy should be linked to the sustainable objectives or characteristics pursued by the fund and explain how it helps to achieve them. It should also clearly state how the strategy is linked to the formulated sustainable objectives or characteristics and how it helps to achieve them. ESMA provides a list of examples of key elements of which at least some need to be covered in the description of the investment strategy in order to qualify as Article 8 or 9 SFDR, as the case may be. The examples of key elements are: investment universe (including limits and thresholds), screening criteria applied, specific ESG characteristics/themes or, where relevant, nonfinancial impact pursued and use of benchmark or stewardship approach).

Compliance with Website and Disclosures’ Obligations

ESMA expects NCAAs to verify the website disclosures made by, and to verify compliance with the periodic disclosures’ obligations for, funds disclosing under Article 8 and 9 SFDR.

Additional Supervisory Actions

Eligibility Test by Depositaries

ESMA also expects depositaries to be involved in monitoring ESG-related investment restrictions in the course of their general oversight function. ESG investment restrictions should be included in the eligibility checks made by the depositary prior to acquisitions. Giving depositaries' more control functions (and hence responsibility) this may increase the complexity in setting up EU structures in practice.

Portfolio Analysis

ESMA encourages the NCAs to envisage different types of supervisory actions to ensure that portfolio holdings reflect the name, the investment objective, the strategy and the characteristic displayed in the documentation to investors. For example, if a fund "claims to make" sustainable investments, the NCAs may directly perform an analysis of the compliance with the requirements for sustainable investments by the portfolio itself and may engage with fund managers by requiring explanations and or documentation to validate the composition of their portfolios. Further, NCAs may involve the funds depositaries in the context of their controls on investment restrictions and assess the reporting from management companies, AIFMs and external auditors. It seems from these considerations, that ESMA requires that the fund's investments continue to be "sustainable" (as defined under SFDR) throughout the term. This could be problematic in cases where the fund manager has no control over the assets; and while it can commit to make sustainable investments it is much harder to commit that the investments will all remain sustainable throughout the term.

Supervision of the Integration of Sustainability Risks by Fund Managers

In addition, the briefing contains some guidance on how NCAs should supervise the integration of sustainability risks by AIFMs and UCITS managers in their portfolio and risk management process and overall governance structure. ESMA suggests that NCAs verify fund managers' compliance by checking the pre-contractual fund disclosures referred to in Article 6 SFDR and by performing sample checks. This should include desk-based and/or on-site reviews of fund managers' integration of sustainability risks into investment due diligence, risk management, remuneration, HR, governance, internal reporting and record-keeping, conflicts of interest, delegation monitoring, accounting and valuation, costs and fees, reporting and internal control functions.

Regulatory Interventions in Case of Breaches

Regulatory interventions in case of breaches are subject to national laws but the SFDR requires from Member States that they implement supervisory powers for NCAs to effectively monitor the compliance with SFDR. ESMA provides a list of non-exhaustive examples of greenwashing cases where it expects regulatory interventions:

- Legally required SFDR disclosures have not been made at all after the application of the new rules;
- SFDR disclosures are viewed as severely misleading. This should be particularly the case when consistency checks would highlight a situation where there is a significant discrepancy between what the fund actually invests in and what has been disclosed to investors in pre-contractual disclosure documentation;
- Sustainability risks have not been integrated throughout the organization despite an appropriate period of time after entry into force of the AIFMD and UCITS amendments in this respect;
- The periodic disclosures of a financial product disclosing under Article 8 or 9 SFDR does not match (or fulfill) the characteristics or objectives shown in the fund documentation; and
- A financial product disclosing under Article 9 SFDR with a sustainable investment objective shows in periodic disclosures that significant proportions of investments do not comply with the sustainable investment criteria of Article 2(17) SFDR.

In particular, the last point raises concerns from a practical perspective: as stated already above ESMA seems to take the view that for an Article 9 classification, the fund's portfolio needs to be "sustainable" at all times. In other words, if a fund classifying under Article 9 SFDR happens to make investments that turn out to no longer be sustainable due to external developments outside the fund manager's control, the fund manager has to expect regulatory measures. Those could be the requirements to downsize the classification or to sell the relevant assets, both of which are problematic.

Generally, the ESMA briefing to NCAs raises a number of questions. While it is understandable and welcome that ESMA is pushing for a consistent application of the rules by all EU NCAs, it is to be hoped that NCAs when exercising their regulatory authority will make use of the guidance as to proportionality and also take into account that these rules are very new and that there are still a number of uncertainties. A too rigid supervisory practice at this stage involving a high risk of liability exposure could

have a discouraging effect on fund sponsors and reduce the so welcomed new appetite for launching products with strategies that classify and disclose according to Article 8 or 9 SFDR.

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Please do not hesitate to contact us with any questions.

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