The EU Commission Finally Provides Answers to Outstanding Key Questions on SFDR Interpretation

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The EU Commission (the "Commission") recently published its long-awaited answers to questions raised in September 2022 by the European Supervisory Authorities (the "ESAs") on the legal interpretation of the Sustainable Finance Disclosure Regulation (the "SFDR"). The answers provide clarification on significant points of interpretation in the SFDR, in particular in relation to the concept of "sustainable investment" and the meaning of "to consider" principal adverse impacts.

These points are of particular relevance to sponsors that market their funds in the EU with promotion of environmental or social themes, as the guidance helps delineate further the SFDR concepts of "reduction in carbon emissions as a sustainable objective" and of "sustainable investments", which prospectively apply to funds within scope of Article 8 of SFDR (which applies to funds that promote environmental or social characteristics) or Article 9 of SFDR (which applies to funds with sustainable investment as their objective).

THE DEFINITION OF "SUSTAINABLE INVESTMENTS" (FOR FUNDS UNDER ARTICLES 8 AND 9 OF THE SFDR)

Classification of an Investment in a Company as a Sustainable Investment Is Based on an Assessment of Its Overall Activities, Even if Not All the Company's Activities Are Sustainable.

In September 2022, the ESAs raised the question as to whether an investment in a company which has several economic activities, only one of which contributes to an environmental or social objective, would be considered a "sustainable investment" (under the definition of that term in the SFDR) in whole or in part.

In response, the Commission stated that the SFDR, in the definition of sustainable investment, does not prescribe any approach to determine the contribution of the investment to an environmental or social objective, meaning that the financial market participant must determine and disclose to investors its own methodology for this

assessment. The Commission also stated that the reference to "economic activities" in the definition of sustainable investment "seems to target cases in which funds are allocated to a specific project or activity, or to a company engaged in one single type of activity", but equally that firms can invest in equity or debt in sustainable investments that do not specify the use of proceeds, and concludes that "the notion of sustainable can therefore also be measured at the level of a company and not only at the level of a specific activity". This appears to confirm that firms can classify an investment in a company as a sustainable investment based on an assessment of its overall activities, albeit that not all the company's activities are sustainable.

The SFDR Does Not Prescribe a Specific Approach or Set out Minimum Requirements in Relation to the Concept of "Contribution"

On further interpretation of the concept of sustainable investment, the ESAs also raised questions last year as to whether the investee company should in itself contribute to an environmental or social objective (directly, by its business model) or whether it is sufficient for the company to carry out an activity in a sustainable manner (indirectly, by an attribute of its business) and whether an economic activity that is covered by a transition plan (such as a plan to reach climate neutrality) can be said to contribute to the environmental objective of climate change mitigation. This was perhaps the most controversial question originally raised by the ESAs.

In response, the Commission stated that, in its interpretation of the text, the SFDR does not set out minimum requirements for the "contribution" test and that firms must therefore carry out their own assessment and make appropriate disclosure. The Commission's answer here reflects a broad interpretation of the SFDR text.

Investments Subject to Transition Plans Are Not Sustainable Investments

In responding to the final question on sustainable investments that are subject to transition plans, the Commission concluded that "referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient". The Commission's interpretation here is significant and does not allow companies to be classified as "sustainable investments" where the "whole investment" is subject to a transition plan. Firms which use a transition plan as the basis for qualifying an investee company as a sustainable investment—such as "brown to green" property development—will therefore need to reconsider their approach. However, it appears that funds can still qualify companies as "sustainable investments" where part of the company's activities is causing (or may cause) harm, such as a high level of emissions, and where the fund has a transition plan in place to address it. This is consistent with the principle under the SFDR that a fund/the company should disclose the indicators,

and related thresholds, that it uses to determine harm (or the risk of harm) at the outset and on an ongoing basis.

REDUCTION IN CARBON EMISSIONS

Funds under Article 9 of the SFDR Which Have a Reduction in Carbon Emissions as an Objective Can Adopt a Passive or Active Investment Strategy

Article 9(3) of the SFDR requires financial products that have the objective of reduction in carbon emissions to disclose how that objective is achieved in view of the objectives of the Paris Agreement and information on its alignment with a benchmark.

The Commission confirmed that funds with an active or passive investment strategy can be within scope of Article 9(3) and that funds in scope are not required to use the Paris-Aligned Benchmark or Climate Transition Benchmark. The Commission also gives further guidance for funds that passively track Paris-Aligned Benchmarks and Climate Transition Benchmarks.

Funds under Article 8 of the SFDR Can Promote the Reduction of Carbon Emissions without Being Considered or Required to Make "Sustainable Investments"

The ESAs also asked whether a financial product that "promotes" carbon emissions reduction as an "environmental characteristic" (under Article 8 of the SFDR) is distinct from a product that has carbon emissions reduction as its "objective" (the type of financial product referred to in Article 9(3) of the SFDR).

Helpfully, the Commission confirmed here that there is a distinction between a product that promotes carbon emissions reduction as part of its investment strategy (which would fall under Article 8 of the SFDR) and a product that has the objective of making sustainable investments to reduce carbon emissions. The Commission reiterated the importance of clear disclosure in the marketing materials, in particular not to mislead investors into "believing that the product pursues sustainable investment, where the promotion of carbon emissions reduction is only a mere characteristic of the product's investment strategy".

REPORTING ON PRINCIPAL ADVERSE INDICATORS UNDER ARTICLE 7 OF THE SFDR

"Considering" Principal Adverse Indicators Requires Disclosure of Actions Taken

The SFDR requires larger firms to publish information on how they "consider" principal adverse indicators ("PAI") in the SFDR. The ESAs asked whether consideration of PAI

only requires firms to disclose the relevant impacts of their investments (such as the level of GHG emissions) or whether it also requires disclosure of actions taken by the firm to address the PAI (such as engagement with investee companies).

In response, the Commission quoted recital 18 of the SFDR, which refers to firms integrating in their processes (including in due diligence processes) procedures for considering PAI, including information on sustainability-related stewardship responsibilities or other shareholder engagements, and the Commission concluded that "the description related to the adverse impacts shall include both a description of adverse impacts and the procedures put in place to mitigate those impacts".

OPTING OUT OF PAI REPORTING UNDER ARTICLE 4 OF THE SFDR

Clarification on the Employee Threshold for Firms That May Opt out of PAI Reporting

The SFDR permits firms with fewer than 500 employees to opt out of the obligation to report on how they have considered and reported on PAI.

The Commission provided clarification on the interpretation of the 500-employee threshold to determine whether a firm is required to publish information on PAI, stating, in response to a question on including workers employed by a third party but made available to the financial market participant, that "the definition of who constitutes an employee is governed by national law".

THE EXEMPTION TO PRODUCING CONSOLIDATED REPORTS UNDER THE ACCOUNTING DIRECTIVE DOES NOT APPLY TO PAI REPORTING

The Commission confirmed that an exemption in the Accounting Directive relating to the requirement to publish consolidated reports does not apply to interpretation of the requirement for parent undertakings to publish PAI information under the SFDR.

Periodic Reporting under Article 11 of the SFDR

As a last point of clarification, the Commission confirmed that, also in the case of portfolio management services, firms need only to include the information required under the SFDR on an annual, as opposed to quarterly, basis.

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Please do not hesitate to contact us with any questions.

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