



## Asset Management & Investment Funds Update

June 2022

### Commission Issues New SFDR Q&A

On 25 May 2022, ESMA published responses received from the Commission to the SFDR questions raised by the European Supervisory Authorities (**ESA**) on 16 May last. This is the second SFDR Q&A to be issued by the Commission, the first of which issued in September 2021 (see [here](#) for further details).

The latest Commission SFDR Q&A is detailed and very likely to impact, not only fund management companies' compliance preparations ahead of the January 2023 expected effective date of the (as-yet-to-be finalised) SFDR delegated measures (**SFDR Level 2**), but potentially also the current approach to compliance with SFDR and the Taxonomy disclosure rules in effect, respectively, since March 2021 and January this year.

The following are key SFDR and Taxonomy clarifications in the latest SFDR Q&A of relevance to fund management companies (**FMCs**):

#### 1. Product-level Consideration of Principal Adverse Impacts Absent Entity-Level Consideration

FMCs opting not to consider entity-level principal adverse impacts (**PAIs**) of investment decisions on sustainability factors can still consider product-level PAIs as part of the investment strategy of an underlying fund. If this option is chosen, the FMC must make a negative entity-level PAI disclosure on its website (per Article 4(1)(b) SFDR) and in the pre-contractual documents of those funds for which PAIs are not considered at product-level (per Article 7(2) SFDR). The FMC must also, in respect of the relevant fund(s), comply with Article 8 or 9 pre-contractual and periodic report disclosure rules as triggered by its decision to consider product-level PAIs. For FMCs opting out of entity-level PAI consideration, this is a most welcome clarification particularly considering the rapidly approaching August 2022 effective date of MiFID sustainability preference rules, under which the consideration by a fund of the PAIs of its investments facilitates its recommendation to clients with sustainability preferences.

#### 2. Application of SFDR Taxonomy-related Disclosure Rules

##### *Article 8 funds with no sustainable investments in scope of Taxonomy disclosures*

The Commission clarifies that funds in scope of SFDR Article 8 which promote environmental characteristics are in scope of the Taxonomy disclosure rules, including those funds which do not invest in sustainable investments. There is no doubt, but this is somewhat counterintuitive given the key Taxonomy disclosure is the level of any in-scope fund's investment in Taxonomy-aligned investments which are a sub-set of the wider category of sustainable investments and so a fund without sustainable investments is unlikely to hold Taxonomy-aligned investments. The Commission's view, however, is that the disclosures are necessary from

this wider category of funds in scope of Article 8 to 'incentivise behavioural change in the whole value chain, including delivery of sound information on sustainability performance on underlying investments'. As a result of this clarification, all funds in scope of Article 8 promoting environmental characteristics with no sustainable investments are, in the Commission's view, obliged to make a negative disclosure, not only in respect of sustainable investments as was foreseen, but also in relation to Taxonomy-aligned investments.

#### *Disclosure of no Taxonomy-aligned investments required to 'indicate zero'*

The Commission also confirms that any negative Taxonomy-aligned investment disclosure in the fund's offering document and periodic report must 'indicate zero'. This conflicts with the largely helpful approach recently adopted by the Central Bank to Taxonomy disclosures in the period until SFDR Level 2 takes effect next January and as such it may be expected that there will be a change in that regard. Formal confirmation from the Central Bank of any such change has however, yet to be published.

#### *Limitations on narrative explanations of 'zero' Taxonomy-aligned investments*

In terms of narrative explanations accompanying the disclosure of zero Taxonomy-aligned investments, including on the lack of reliable data, the Commission notes that 'such narratives risk contradicting the purpose' of the Taxonomy disclosures and such 'clarifications should neither leave room for ambiguity about the alignment of the investments of the [fund] with [the Taxonomy], nor should they include negative justifications, such as explaining a lack of the alignment by a lack of data.' Given the widely acknowledged data issue, this is likely to impact compliance plans for a range of FMCs.

#### *Use of estimated data to calculate Taxonomy-alignment levels*

The Commission Q&A also addresses the use of estimated data but goes no further than the current provision for its use under recital 21 of the Taxonomy i.e., when assessing activities of entities not subject to Taxonomy disclosures and only then under the conditions so specified.

#### *Ex-post disclosure of Taxonomy alignment absent a pre-contractual commitment*

On the question of whether a fund may/must make disclosure in its periodic reports of any investment assessed in the period as being Taxonomy-aligned in circumstances where no pre-contractual commitment to so invest has been disclosed, the Commission's view is that such disclosures are required pursuant to Taxonomy disclosure rules. This is likely a welcome clarification for FMCs, particularly given the current difficulties in assessing investments' Taxonomy-alignment and making pre-contractual commitments to such investments. However, it is notable that the Commission also considers that pre-contractual documents should be updated (subject to relevant sectoral rules) to reflect any change over time to a fund's investments resulting in investment in Taxonomy-aligned investments.

### 3. Requirement to Follow Good Governance Practices ('good governance' rule)

#### *Article 8*

The Commission confirms that the requirement for funds in scope of Article 8 to invest in companies with good governance practices is applicable to all such funds' investment in companies. There has been some industry debate as to whether this requirement was limited, for example only to investments aligned with the ESG characteristics of the fund. The Commission confirms this is not the case and that funds in scope of Article 8 which invest in companies that do not follow good governance practices are in 'breach of Article 8'. The logical view that the 'good governance' rule is not applicable to non-corporate investments is also confirmed by the Commission.

#### *Article 9*

For an investment in a company to be eligible under the SFDR definition of sustainable investments, the investee company must follow good governance practices. As the assets of funds in scope of Article 9 'must qualify as sustainable investments', all Article 9 funds are subject to the 'good governance' rule. For the avoidance of doubt, funds in scope of Article 8 which opt to hold sustainable investments are similarly subject to the 'good governance' rule in respect of those investments, in addition to the specific application of the rule under Article 8 (as discussed above).

### 4. SFDR's Application to Existing Funds

Funds in existence on 10 March 2021 (the first effective date of SFDR) which continue to be made available to investors after that date are in scope (without transition) of all SFDR disclosure rules. Funds no longer available to investors as of 10 March 2021, are in scope of the periodic report and website disclosure rules under the relevant provisions of SFDR. While not specifically referenced, the intimation appears to be that those funds no longer available for investment as of 10 March 2021 are not subject to the SFDR pre-contractual disclosure rules in place for funds in scope of Articles 8 or 9.

### Next Steps

FMCs should take account of the clarifications set out in the Commission's Q&A which may impact both the current approach to compliance with SFDR and the Taxonomy as well as compliance plans for the next SFDR deadline of January 2023 (SFDR Level 2 expected effective date).

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