Asset Management & Investment Funds Update

December 2022

ESA SFDR Q&A Published

On 17 November 2022, the ESAs published the first edition of a SFDR Q&A incorporating Level 3 guidance on various aspects of the SFDR regime including on the calculation and disclosure of principal adverse impacts (**PAIs**), Taxonomy alignment, financial products' (including multi-option products') disclosures, and guidance for financial advisers and execution-only market participants.

The ESA SFDR Q&A is accessible here and the following are notable points of clarification:

Minimum investment proportions:

- **Part V. Q&As 7, 8:** the minimum investment proportions included in pre-contractual disclosures (**PCDs**) for (1) environmentally/socially aligned (**E/S aligned**) investments; (2) sustainable investments (**SIs**); and (3) Taxonomy-aligned SIs, are binding minimum commitments to investors that 'should be met at all times'. PCDs should only include minimum commitments and not 'targets' or indeed, the actual level of such investments as at a particular date (once a reporting period has passed).

- **Part V. Q&A 8:** only funds with PCD commitments to invest in SIs may report on their SI investments in the relevant financial report disclosure template annexed to Level 2. This clarification follows guidance from the Commission, in its May 2022 SFDR Q&A, that Taxonomy-aligned SIs must be reported in the periodic disclosure templates annexed to Level 2 irrespective of any PCD commitments noting, however, that PCDs should be updated to reflect any change to the investments of the fund on an ongoing basis. The ESAs reference this Commission guidance in their Q&A but confirm that it does not apply to SIs which are non-Taxonomy aligned. As a result, the ESAs clarify that those Article 8 funds with no SI commitments can leave out the SI sections when completing the periodic disclosure template at Annex IV to Level 2.

Assessing good governance practices:

- **Part III. Q&A 3:** the use of reference metrics such as UN Global Compact, OECD or ILO principles can form part of the 'policy to assess' good governance practices but this is not prescribed under SFDR (it being a disclosures regime).

Deletion of N/A sections of the annex:

- **Part III Q&A 1:** inapplicable sections of the PCD templates can be deleted provided this is permitted by the red drafting notes in the PCD templates.

Sustainable investments:

- **Part III. Q&A 6:** managers' SI frameworks are only limited by the definition of SIs set out under SFDR Article 2(17) however, the ESAs confirm that different interpretations of Article 2(17) cannot be used for different funds.
- **Part V. Q&A 15:** to avoid double counting when reporting SIs with both environmental (E) and social (S) objectives, managers should only consider one single E or S objective.
- **Part V. Q&A 2:** when using PAI indicators to assess DNSH compliance (which the ESAs have previously clarified is mandatory), the metrics can be adjusted e.g., in the case of green bonds to reflect that project financing bonds only finance specific activities and not the entire issuer.

SFDR Article 9:

- **Part III. Q&A 2:** rules under the Benchmarks Regulation for Paris-aligned benchmarks and climate transition benchmarks are not strict enough to mean that those benchmarks will only include SIs.
- **Part III. Q&A 7:** a 'reduction in carbon emissions' objective as referenced in Article 9(3) includes e.g. an objective to reduce GHG emissions as Article 9(3) is intended to cover all greenhouse gases and carbon emissions.

Reference benchmarks:

- **Part III Q&A 8:** reference benchmarks designated to achieve the E/S characteristics or SI objectives of a fund will not be broad market indexes.

Sustainability risk:

- **Part III Q&A 4:** in response to whether a manager can simply opt out and disclose under Article 6 that sustainability risks are not being integrated and not taken into account, the ESAs confirm that 'even in the unlikely situation' that sustainability risks are assessed as not relevant to any particular fund, disclosures under Article 6 must still 'explain the reasons for not considering [sustainability] risks relevant'.

In addition to the above, the ESAs' SFDR Q&A document includes Q&As on:

- *PAI calculations* – most relevant to those managers considering entity-level PAIs as these Q&As include clarifications on indicator calculation methodologies, how to take account of short positions and in many instances cross-referencing the clarifications set out in the June 2022 ESA SFDR RTS statement (see here for further details);
- *PAI disclosures* – most relevant to those managers considering entity-level PAIs as these Q&As include clarifications on elements of the PAI statement template and the application of SFDR Article 4.
- *Taxonomy-aligned investment*– most relevant to funds with Taxonomy-aligned investments as these Q&As include clarifications of the relevant calculation methodology and Taxonomy reporting requirements.

Next steps

Fund managers should take account of the SFDR Level 3 guidance set out under the ESAs' Q&A.