Asset Management & Investment Funds Update

June 2022

ESAs Issue Key SFDR Level 2 Clarifications

On 2 June 2022, the European Supervisory Authorities (**ESAs**) published a supervisory statement clarifying SFDR disclosure rules set out in the ESA regulatory technical standards (**RTS**), which were recently adopted by the Commission as SFDR delegated measures (**SFDR Level 2**) (the **June 2022 Supervisory Statement**).

Although the June 2022 Supervisory Statement references the ESA RTS (adopted in February and October 2021), the clarifications are nonetheless relevant as no material amendments were made to the RTS as part of their adoption by the Commission as SFDR Level 2 measures. It also appears unlikely that the Commission-adopted SFDR Level 2 measures will be amended during the EU legislative process to finalise those measures ahead of the scheduled effective date of 1 January 2023 and, as such, UCITS managers and AIFMs (**fund managers**) should take account of the contents of the June 2022 Supervisory Statement as part of their compliance preparations for the next SFDR compliance deadline on 1 January 2023.

A summary of the key clarifications in the June 2022 Supervisory Statement are set out below.

1. Product-level sustainability indicators are not principal adverse impact indicators

SFDR requires funds in scope of Articles 8 or 9 to make website and financial report disclosures of the sustainability indicators used to measure the success of the fund in implementing its environmental and/or social characteristics (Article 8) or in achieving an overall sustainability-related impact (Article 9). In the June 2022 Supervisory Statement, the ESAs clarify that the term 'sustainability indicators' is not a reference to the principal adverse impact (**PAI**) indicators (in Tables 1-3, Annex 1, SFDR Level 2) however, the ESAs note the possibility of using the PAI indicators when making the above-mentioned disclosures. For example, fund managers may show improvements in fund investments over time as against those indicators in order to evidence success in implementing a fund's environmental/social characteristics or achieving a sustainability-related impact.

As such, the ESAs clarify that the PAI indicators appended to SFDR Level 2 have three possible product-level uses under SFDR:

(i) **demonstrating investments' compliance with the 'do no significant harm' (DNSH) principle as part of the classification of sustainable investments** – the ESAs clarify that use of the PAI indicators in Table 1, Annex 1 of SFDR Level 2 is mandatory and relevant indicators from Tables 2 and 3, Annex 1 should also be used within disclosures required in both the pre-contractual and financial report templates annexed to SFDR Level 2.

Notably however, SFDR Level 2 does not specify how exactly the PAI indicators should be used for this purpose. As a result, it is for fund managers to establish and set significant harm thresholds for individual impact indicators, against which sustainable investments can be assessed for DNSH compliance. The June 2022 Supervisory Statement notes the Taxonomy technical screening criteria may, where feasible, be worth considering in the context of setting such internal significant harm thresholds.

In addition, SFDR Level 2 disclosure templates do not mandate one form of DNSH disclosure and instead require disclosure of how the PAI indicators will/have been taken into account when assessing sustainable investments' DNSH compliance. The June 2022 Supervisory Statement notes, however, that best practice could be to extract the Table 1 indicators and any relevant indicators from Tables 2 and 3 and disclose the impacts against the indicators "proving through appropriate values [referencing the Taxonomy technical screening criteria] that the sustainable investments do not significantly harm any environmental or social objectives". The June 2022 Supervisory Statement also confirms the position under SFDR Level 2 that all sustainable investments, including Taxonomy-aligned investments, must be assessed for DNSH compliance using the SFDR approach (i.e., by taking account of the PAI indicators) with the result that Taxonomy-aligned investments must be assessed for DNSH compliance using both the SFDR approach and that set out in the Taxonomy Regulation.

(ii) **product-level consideration of PAIs under Article 7 SFDR** – the ESAs clarify that there is no requirement to use the PAI indicators when disclosing product-level consideration of PAIs under Article 7 SFDR. However, as set out in the May 2022 ESMA Supervisory Briefing on sustainability-related disclosures, there is a supervisory expectation that Table 1 indicators are used in this regard

(iii) **measuring the achievement of environmental/social characteristics and a sustainability related impact** – as discussed above. The ESAs clarify that there is no requirement for advance consideration of PAI indicators at either entity-level (under Article 4 SFDR) or product-level (under Article 7 SFDR) in order to use the PAI indicators for this purpose.

2. PAI calculation methodologies applicable to entity-level PAI consideration

The template PAI statement at Annex 1, SFDR Level 2, includes calculation methodologies for the disclosure of investments' PAIs on sustainability factors. As set out above, the PAI indicators and the calculation methodologies are only required to be used, at product-level, for the classification of sustainable investments and, at entity-level, for PAI consideration under Article 4 SFDR.

In the June 2022 Supervisory Statement, the ESAs provide various clarifications for the calculation of the PAI indicators using the methodologies set out in Annex 1, SFDR Level 2 (as summarised below). The ESAs also provide a sample calculation of the GHG emission indicator which confirms the ESAs view that this should be carried out on each of the required calculation dates (or those on which the fund holds the relevant investment) using a weighted average calculation by reference to the fund's share of ownership of the investee company.

Mandatory indicators in Table 1

- investee company energy consumption intensity per high impact climate sector (Table 1, indicator 6) – calculation is restricted to the energy consumption of the entities for the high impact climate sectors only (not general entity-level energy consumption intensity

- investee company emissions to water (Table 1, indicator 8) – should be expressed as a weighted average of the specified priority substances

- exposure to energy-inefficient real estate assets (Table 1, indicator 18)– asset types used in the calculation methodology are to ensure alignment with Taxonomy technical screening criteria

Optional indicators in Tables 2 & 3

- investee company water usage and recycling (Table 2, indicator 6) – should be considered as weighted average amount of water consumed by investee company per million EUR of investee company revenue

- real estate GHG emissions (Table 2, indicator 18) – calculation should use share of ownership of real estate asset per above GHG emissions calculation formula

- number of identified cases of severe human rights issues and incidents (Tale 3, indicator 14) – is intended to capture exposure to investee companies connected to cases and incidents of severe human rights issues e.g., rights, freedoms and principles in the Charter of Fundamental Rights of the European Union and the European Convention for the Protection of Human Rights and Fundamental Freedoms and its protocols

- non-cooperative tax jurisdictions (Table 3, indicator 22) – should be understood as a reference to the EU list of non-cooperative jurisdictions maintained by EU Council

Multi-asset investment in real estate and investee companies

- disclosure of PAIs of multi-asset products should be by reference to the aggregation of impacts caused by exposures to different types of asset classes in the relevant indicators in Table 1, Annex 1

Direct and indirect investments to be included in PAI calculation

The ESAs clarify that the consideration of PAIs at entity-level should incorporate an assessment of all investments, both direct and indirect (e.g., via other funds, funds of funds and derivatives) investments in assets such as equity, corporate bonds, sovereign debt, private equity, supranational entities, infrastructure and real estate. In the case of indirect investments via another fund, a holding company or an SPV, fund managers should look through those investee companies and calculate the adverse impact of the individual underlying investments. To the extent information is not available on the investee companies' investments, PAI disclosures should include details of the best efforts used to obtain the information directly from the investee company, through additional research, from third party data providers, external experts or by making reasonable assumptions. When assessing the adverse impact of an investment which exclusively finances a project or type of project, e.g., a bond, the assessment can be limited to the impact of the project or type of project funded by the instrument.

3. Disclosed commitment to invest in Taxonomy-aligned investments should be maintained and must be binding

As has already been clarified by both the ESAs and the Commission, any pre-contractual disclosure of a minimum investment in Taxonomy-aligned investments constitutes a binding commitment to so invest and the penalties for failing to respect such commitments are those set out in relevant sectoral rules. Notably, the May 2022 ESMA Supervisory Briefing details an expectation for NCAs to take regulatory action to combat greenwashing where financial report disclosures of actual Taxonomy-alignment commitments do not match or fulfil pre-contractual commitments.

Furthermore, any pre-contractual commitment to invest in Taxonomy-aligned investments should be maintained over time and where changes to the fund require an update of that commitment e.g., as a result of a variation in the mixture of environmental and social objectives of investments or a change to the KPI (turnover/capex/opex) used to measure alignment levels, the fund prospectus should be updated in line with sectoral fund rules. Where there is a change to the Taxonomy-alignment KPI, the financial report disclosure of historical comparisons (which are required to include all three KPI) could be accompanied by a statement that the KPI in the pre-contractual disclosure changed along with the reasons for the change.

In the case of fund of funds (and similar products), the Taxonomy-alignment of the fund may be based on the market value of the proportion of Taxonomy-aligned investments of the underlying fund referencing the same KPI as that used by the underlying fund. However, where the underlying fund does not disclose any Taxonomy-alignment the fund may look-through to the investments of the underlying fund for the purposes of calculating the Taxonomy-alignment of its portfolio.

4. Product-level financial report disclosures

Financial report disclosures of the top holdings of a fund in scope of Articles 8 or 9 should include the country in which the investment is made, or where the investee company is headquartered, or the underlying fund is domiciled. No look-through of an underlying fund to the country of domicile of underlying investments is necessary to complete the relevant sections of the financial report disclosure templates appended to SFDR Level 2.

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