

# Asset Management & Investment Funds Update

October 2022



## ESAs Request Further SFDR Clarifications

On 9 September 2022, the ESAs published a further series of questions issued to the Commission on the interpretation of SFDR, responses to which may provide clarification, whether welcome or otherwise, of several of the key outstanding SFDR issues ahead of the 1 January 2023 Level 2 compliance deadline. This is the third such request from the ESAs and both previous requests resulted in highly impactful and detailed SFDR Q&As from the Commission. A summary of the ESAs questions most relevant to fund management companies is set out below.

### The definition of Sustainable Investments (SIs)

The ESAs have asked the Commission how to calculate an investment's contribution to environmental or social (E/S) objectives in accordance with the first limb of the SI definition and whether investments should be weighted by reference to the proportion of sustainable activities of the investee company when classifying SIs. The ESAs' question includes the example of a €100k investment in a company which satisfies limbs two ('do no significant harm' principle) and three (the good governance rule) of the SFDR definition of SIs and which reports 20% of its activities as contributing to E/S objectives, with the question being whether the whole investment can be classified as a SI or only the 20% referencing the sustainable activities of the investee company.

Notably, the ESAs second question on the SI definition relates to how an investee company's activity(ies) may be considered to contribute to E/S objectives and whether some, or all of the following must be met to satisfy the contribution test under the SI definition:

- the relevant E/S activity of the investee company itself contributes to E/S objective(s),
- the activity is, relatively speaking, carried out in a sustainable manner,
- the activity is covered by a climate change action plan adopted by the investee company,
- the investee company has adopted an E/S harm reduction strategy,
- the investee company has a transition plan to avoid significantly harming E/S objectives

A long-standing industry issue for those seeking to classify SIs has been whether the classification should be at the level of the investee company or at the level of its underlying activities and, if at the level of the company, to what extent do the company's activities need to contribute to E/S objectives before an investment in the company as a whole can be classified as sustainable. To date, no legal or regulatory guidance has been

published for investors in SIs and while clarification of the high-level, principles-based SI definition would undoubtedly be welcome, the timing of any such clarification so close to the Level 2 compliance deadline has the potential to be extremely challenging for funds already implementing SI methodologies.

### Carbon emission reduction objectives

In July 2021 the Commission issued its first SFDR Q&A and clarified that SFDR Article 9(3) funds are subject to the dual obligation of only investing in SIs (Article 9(1)) and tracking an EU Climate Benchmark, where available (Article 9(3)). Perhaps in response to the practical and interpretative questions arising from the Commission's clarification, the ESAs have asked whether funds with a carbon emission reduction objective that track an EU Climate Benchmark (either passively or actively by applying the minimum standards for such benchmarks) can be automatically deemed to satisfy the requirements under Articles 9(1) and 9(3).

The ESAs have also requested clarification

- that Article 9(3) funds can have either a passive or active investment strategy and, if so, whether funds with an active strategy that designate a benchmark are subject to any specific requirements, and
- whether funds with carbon emission reduction targets are always in scope of Article 9(3) or if funds can have this target as an environmental characteristic and be in scope of Article 8.

### PAI consideration

The ESAs have requested clarification of the term 'consider' in the context of product-level consideration of PAIs under Article 7 SFDR and whether this term refers to the identification and disclosure of PAIs or does it also require mitigating action(s) be taken to address those PAIs identified? And, if mitigating action is required, whether there are any minimum criteria for such actions.

### Next steps

A response from the Commission to the ESAs request for clarifications is currently awaited. However, funds which may be impacted by the Commission's should be aware of the issues raised by the ESAs and, if at all feasible, seek to prepare for further SFDR clarifications, which may issue close to the 1 January 2023 Level 2 compliance deadline.

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