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// ASSET MANAGEMENT & INVESTMENT FUNDS

Asset Management & Investment Funds Update

June 2022

Key Dates & Deadlines: Q2 / Q3 2022

DATE	SOURCE	SUMMARY	ACTION/IMPACT
25 May		Revised Irish UCITS Regulations published to facilitate preparation of a PRIIPs KID in satisfaction of UCITS KIID rules with effect from the application of PRIIPs rules to UCITS from 1 January 2023. Under new Regulation 102A (effective 1 January 2023) the preparation of a PRIIPs KID satisfies UCITS KIID rules and the Central Bank will not require the production of a UCITS KIID where a PRIIPs KID has been prepared.	Advance preparations for compliance with the PRIIPs deadline for UCITS of 1 January 2023, at which point UCITS must produce: • a PRIIPs KID for EEA retail investors • either a PRIIPs KID or UCITS KIID for professional investors • a UCITS KIID for any UK investors See here for further details.
30 June (30 September and 31 December)		Second calculation date for entity-level assessment of principal adverse impacts (**PAIs**) of investment decisions under SFDR Article 4(1)(a), (3) or (4) and draft SFDR Level 2, Chapter II.	Implement processes and procedures for the collection of data necessary to calculate PAIs on each of the calculation dates during the first PAI reference period of January – December 2022 ahead of the publication of the first PAI statement by 30 June 2023. See here for further details.

Q3 (exact date to be confirmed)		Deadline for filing PPSNs for beneficial owners of ICAVs, ILPs, CCFs and unit trusts with the Central Bank as Registrar for the relevant beneficial ownership register.	Relevant fund vehicles to gather PPSNs for beneficial owners and for those without PPSNs, identify whether a Central Bank reference number is available and, if not, prepare to file declarations in accordance with specified regulatory process. See here for further details.
Q3 (exact date to be confirmed)		Revised ESMA MiFID Suitability Guidelines, updated to take account of sustainable preference rules, expected to be finalised.	In-scope fund managers to advance compliance preparations for MiFID sustainable preference rules effective 2 August 2022 (see below) absent final ESMA guidelines which are not expected to be published in advance of 2 August deadline. See here for further details.
6 July		Anticipated end of SFDR Level 2 legislative scrutiny period following which, if no objections are raised on the Commission's adopted text, SFDR Level 2 will enter into force and be applicable from the scheduled date of 1 January 2023.	Advance preparations for, as applicable, disclosure of entity-level PAIs and product-level green/social characteristics/objectives using the mandated disclosure templates appended to SFDR Level 2. See here for further details.
21 July		Scheduled completion date for Commission review of MMFR under the legislation.	Action required will depend on the draft proposals issued by the European Commission to potentially amend the MMFR. See here for further details.
31 July		New Central Bank 'Fund Profile V2' regulatory return required to be filed by existing funds (authorised on or before 29 April 2022) in respect of report date 30 April 2022 on ONR.	Following the introduction of a new version of the Fund Profile return, which delayed the December 2021 annual Fund Profile return filing, a once-off mid-year filing of this return by existing funds is required. For future returns, the return dates will revert to as of 31 December and due by 28/29 February beginning with the return for 31 December 2022. See here for further details.

1 August		Effective date of UCITS Directive and AIFMD provisions for the governance and management of sustainability risks and adverse sustainability impacts.	Advance compliance preparations including any necessary updates to investment due diligence, risk management, conflicts of interest and resourcing arrangements for the management of sustainability risk. See here for further details.
2 August		Effective date of MiFID organisational requirements and operating conditions for the integration of sustainability factors, risks and preferences including the amended MiFID client suitability assessment rules.	In-scope fund managers to advance compliance preparations for sustainability risk management rules and update client suitability assessment processes and procedures to reflect new sustainability preference rules. See here and here for further details.
8 August		Corporate Sustainability Reporting Directive (**CSRD**) sustainability reporting standards consultation closed for comment.	'Large' and/or listed funds and fund management companies to advance preparations for compliance with CSRD reporting standards expected to be in place from January 2024, for f/y 2023. See here for further details.
1 September		Last phase of applicants (covered entities with an aggregate average notional amount of non-centrally cleared derivatives greater than €8 billion) subject to the initial margin requirements under EMIR.	This marks the end of the phase-in for initial margin requirements under EMIR. In-scope funds must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million and a de-minimis minimum transfer amount not to exceed €500,000. See here for further details.

ESMA Issues Guidance for Combating Greenwashing

On 31 May 2022, ESMA published guidance for national competent authorities' (**NCAs**) supervision of SFDR compliance by UCITS managers and AIFMs (**Fund Managers**) (the **Guidance**).

The Guidance, which is non-binding and to be applied on a proportionate basis, sets out several key supervisory expectations, including in respect of those SFDR breaches for which regulatory interventions may be necessary to combat greenwashing.

SFDR Breaches & Greenwashing

The Guidance cites the following as examples of cases where regulatory action to combat greenwashing may be appropriate:

1. **Legally required SFDR disclosures have not been made** since the application of the new rules

2. **SFDR disclosures are viewed as severely misleading** in particular where NCAs consistency checks across pre-contractual, website, marketing documents and financial reports highlight a "significant discrepancy" between the fund's investments and its pre-contractual investment commitments

3. **Sustainability risks are not integrated** throughout the organisation following the entry effect from 1 August 2022 of UCITS and AIFMD requirements for the integration of such risks in portfolio and risk management processes and overall governance structures

4. **Financial report disclosures do not match or fulfil pre-contractual characteristics or objectives** as set out in the offering document, fund KIID and/or constitutional document

5. **Funds in scope of Article 9 disclose significant non-sustainable investment holdings** in financial report disclosures

Additional Supervisory Expectations

In addition to the above, ESMA expects NCAs' supervision of SFDR compliance by Fund Managers to include:

- **taking action to ensure portfolio holdings reflect the fund name, objective, strategy, characteristics** for example, if a fund claims to invest in sustainable investments NCAs may directly perform portfolio compliance analysis and engage with Fund Managers for explanations and/or documentation to validate claims and involve the fund depositary in the context of their control function as well as assess reporting of the Fund Manager, internal control functions and external auditors

- **challenging the use of ESG-related terms in fund names** for example, use of the term 'sustainable' or 'sustainability' in the name of the fund should be limited to funds disclosing under SFDR Article 9 or Article 8 where such funds invest in Taxonomy-aligned investments and/or SFDR-defined sustainable investments. Use of the term 'impact' or 'impact investing' or any other impact-related term should only be used in the names of funds investing to positively contribute to social or environmental objectives. ESG-related terms should not be used in the name of index tracking funds applying an exclusion policy that results in a limited number of exclusions or where the fund's holdings are not materially different from a similar non-ESG index

- **reviewing sustainability-related disclosures in fund marketing materials, on websites and in financial reports** for consistency and compliance with applicable SFDR disclosure rules and ensure disclosures do not include boilerplate language, cross-references other than those specifically permitted in the disclosure templates annexed to Level 2, and pre-contractual disclosures indicate under which SFDR article (i.e. Article 8 or 9) disclosures have been made without giving the impression of a 'label' to investors

- **ensuring fund depositaries review ESG investment restrictions** as part of their monitoring for compliance of instructions from the Fund Manager or investment manager and ensure relevant information and data are provided by the Fund Manager to the appointed depositary to enable depositaries perform their functions

- **verifying any product-level PAI consideration is by reference to Level 2 mandatory PAI indicators** in Table 1, Annex 1 of SFDR Level 2. ESMA also considers it reasonable for NCAs to expect funds in scope of Article 9 disclosures to consider PAIs under SFDR Article 7 as, while it is not mandatory to do so, such funds must only make sustainable investments and must therefore take account of PAIs as part of the assessment of investments' compliance with the DNSH principle under the SFDR definition of sustainable investments

- **as part of the ongoing supervision of SFDR compliance,** using "*any further available information (for example, media reports, complaints, whistle-blower notifications etc…) as well as adverse findings reported by internal control functions, external auditors or depositaries*" and carrying out ad-hoc thematic reviews of Fund Managers' compliance with SFDR

- **reviewing sustainability risk disclosures** in pre-contractual documents, sample check website disclosures using surveys or questionnaires relating to the integration of sustainability risks, and ensure Fund Managers implement, periodically review and effectively apply internal policies and procedures relating to investment due diligence, risk management, remuneration, recruitments and human resources (including regular sustainability risk training), organisational structure and decision making, internal reporting and record keeping, conflicts of interest, delegation monitoring, accounting and valuation, costs and fees, NCA reporting and internal control functions and regular controls by senior management.

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 appliable 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).

Central Bank Clarifies UCITS and AIF Authorisation Procedures

On 19 May 2022, the Central Bank published new website guidance aimed at clarifying and enhancing the transparency of its authorisation processes and procedures (the Guidance). This Guidance, some of which represents a change to existing Central Bank authorisation processes (in respect of non-EU third party approvals), forms part of a wider Central Bank project to review UCITS and QIAIF authorisation processes over the course of 2022.

Non-EU Investment Manager, Discretionary Adviser, AIFM Applications

The Guidance amends and extends the existing regulatory guidance for the approval of UCITS and AIF investment managers and investment advisers by setting out a new online process for the clearance of non-EU based investment managers. The new process involves the submission of applicant details (similar to that required under the existing process) via the Central Bank's ONR, and, as an additional measure, an attestation from the fund manager as to the due diligence it has carried out on the applicant including, at a minimum:

1. Confirmation of the regulatory status and background of the investment manager to ensure they are appropriately regulated and supervised and are not subject to legal proceedings.
2. Confirmation that a review of the financial information has been completed to ensure the investment manager has the required level of share capital and has no contingent liabilities.
3. Confirmation that a review of the resources, systems and procedures of the investment manager have been completed to ensure that they are sufficient to adequately carry out all the functions delegated to it; and
4. A confirmation that they are in a position to effectively monitor the investment manager's compliance with the relevant fund documentation and all regulatory and legislative requirements in this regard.

In addition, the list of jurisdictions with comparable regulatory regimes has been extended to include Abu Dhabi, Qatar, South Korea and the UK. The Guidance also applies the above clearance process for non-EU investment managers to both non-EU discretionary investment advisers and non-EU AIFMs.

Derogation requests

The Guidance clarifies the process for UCITS and QIAIFs to request a derogation from, as applicable, the Central Bank UCITS Regulations and the AIF Rulebook, including a non-exhaustive list of the information which must be submitted to the Central Bank as part of the request and, in the case of the QIAIF guidance, details of commonly granted derogation requests.

Next Steps

Fund management companies should take note of the new Guidance which is immediately effective and accessible here on the Central Bank's website.

Supervisory statements on UCITS' use of side-pockets

On 16 May 2022, the Central Bank issued a notice of intention to permit UCITS to side-pocket assets impacted by the Russian invasion of Ukraine, subject to several specific conditions:

- only assets which have become illiquid/untradeable as a result of the Russian invasion may be side pocketed
- the side-pocket may only be established by way of a clone fund (either a new UCITS or sub-fund of the existing UCITS) into which the liquid assets can be transferred and investors, who must approve the transfer, are issued with shares on a pro-rata basis to their holding in the original fund
- illiquid assets will remain in the original fund, which must be placed in wind-down mode at the same time as the creation of the clone fund and be wound down over time with annual progress reports to the Central Bank
- the Central Bank has established a streamlined 5-day process for the authorisation/approval of the clone fund which can be availed of by submitting the new fund application in the normal manner along with a Board confirmation that the clone fund is identical to the original fund, a markup of the two objectives and policies and a copy of the shareholder resolution approving the arrangement

Publication of the Central Bank notice of intention was preceded by a statement from ESMA (also dated 16 May 2022) setting out an acceptable side-pocket arrangement for UCITS broadly similar to the above.

Next steps

While facilitation of side-pocketing by UCITS is not unwelcome, the ESMA/Central Bank process is not nearly as efficient or economical as the share class side-pocket option available to AIFs. It remains to be seen whether it will be availed of other than perhaps by funds already considering closure as a means to address issues arising from the situation in Ukraine.

UCITS Costs and Fees CSA Findings

On 31 May 2022, ESMA published findings from the 2021 UCITS CSA on costs and fees (the **Findings**). The costs and fees CSA, which formed part of, and will feed into, the broader EU retail investment strategy, was conducted over the course of last year and involved co-ordinated supervisory action on UCITS managers' compliance with applicable cost-related UCITS rules, adherence to the terms of the ESMA briefing on the supervision of costs (see here for details) and the EPM guidance set out in the ESMA Guidelines on ETFs and other UCITS issues.

CSA Findings

The Findings highlight satisfactory levels of compliance by UCITS managers with the above-mentioned costs-related rules and guidance. Particular issues are, however, identified with respect to smaller managers either having less formalised pricing processes or no pricing process at all per the expectations set out in the 2020 ESMA briefing on the supervision of costs. The Findings also highlight a problematic over-reliance on portfolio managers in the context of pricing resulting from the exercise of significant influence/ceding of decision-making on the levels of costs and fees to delegate portfolio managers.

ESMA views/recommendations based on the Findings are summarised below:

- ***pricing process for all managers:*** all UCITS managers, regardless of the characteristics of the management company (including the size of AuM), must establish and periodically review a structured and formalised pricing process, in line with the characteristics of the fund(s) and the recommendations enshrined in the ESMA briefing on the supervision of costs

- ***no disapplication on proportionality grounds:*** the principle of proportionality may justify less sophisticated processes but should not result in a full disapplication of the requirement to have in place a structured and formalised pricing process in line with the ESMA briefing on the supervision of costs. ESMA considers the risk of undue costs may be higher in the case of smaller funds/UCITS managers

- ***independent analysis*** of fee structures should be carried out and over-reliance on the assessment made by the delegate portfolio manager should be avoided

- ***authorisation stage monitoring:*** regulatory control of UCITS cost/fee structure at authorisation stage should continue with enhanced scrutiny of costs and fees encouraged by ESMA

- ***annual review of costs:*** the level of costs should be periodically, and at least annually, reviewed and monitored in order to compare the estimated ongoing charges with the actual expenses incurred by the fund and, where possible, reduce the level of fees and ensure the viability and competitiveness of the fund over time against peer funds and in line with the best interests of investors

- ***value review:*** analysis regarding the sustainability of costs over time and/or the relative weight of fees on the investor's return based on the different market scenario is of paramount importance when setting the pricing structure of the fund

- ***intragroup/related-party transactions:*** intragroup/related-party transactions can result in higher costs and/or costs higher than average

- ***EPM in focus:***

- the absence of EPM policies and procedures constitutes a breach of regulatory obligations and NCAs should take stricter measures to rectify any such identified breaches
- disclosing a theoretical possibility of using EPM is not in line with the ESMA Guidelines on ETFs and other UCITS issues – boilerplate disclosures that do not clearly inform investors of specific arrangements and risks cannot ensure compliance with these Guidelines and NCAs should focus on stricter measures to ensure compliance
- fee-split arrangements, involving the deduction of securities lending agents' fees from EPM revenue generated, merit further investigations and analysis as it appears there is limited consideration of fair market rates when entering into such arrangements, in particular intra-group arrangements.

Next steps

- ***enforcement action:*** NCAs should consider not only enhanced supervision but also enforcement actions in the limited cases where a significant regulatory breach was identified during the CSA
- ***investor compensation:*** investors must be adequately compensated in all CSA cases where they were charged with undue costs/fees or there were calculation errors that resulted in a financial detriment for investors

ESA Issue PRIIPs Level 3 Guidance

On 10 May 2022, the ESA issued a joint supervisory statement on the PRIIPs KID setting out regulatory expectations for adequate, clear and accessible disclosures.

The ESA supervisory statement, which serves as Level 3 guidance under the PRIIPs regime, sets out expectations for the 'What is this product?' section of the KID, containing information on the type of the product, its objectives, the type of retail investor targeted, any insurance coverage and the term of the product, if known.

The ESA expectations, aimed at improving the quality of descriptions provided by those PRIIPS for which the regime has been in effect for several years (i.e., PRIIPs other than UCITS), address a range of poor disclosure practices including:

- the use of overly broad, general categories when specifying the type of product
- poor practices regarding the overall clarity of the language and layout of the text, including as a result of automation in creating such texts
- insufficient information regarding capital protection levels and potential losses for the investor
- imprecise description of early termination features
- lack of clarity concerning the nature and timing of the coupon payments
- limited information about the specific nature of the underlying assets to which investors are exposed
- inadequate description of any leverage factors and the risks related to them
- undifferentiated and abstract descriptions for the ‘intended retail investor’.

Next steps

While the poor practices are not targeted at UCITS, the expectations set out in the statement provide useful guidance for UCITS preparing for compliance with the PRIIPs regime from January next year.

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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