

European Commission Responds to ESAs Questions on SFDR Priority Issues

August 2021

On 26 July 2021, the European Commission (“**Commission**”) published a **Q&A** seeking to clarify the application and implementation of the Sustainable Finance Disclosure Regulation (“**SFDR**”). The Q&A is the long-awaited response to the European Supervisory Authorities’ (“**ESAs**”) letter dated 7 January 2021 on priority issues for clarification under the SFDR.

The ESAs’ questions addressed the following matters:

- the application of SFDR rules to registered and non-EU alternative investment fund managers (“**AIFMs**”);
- the application of the large group (500 employees) threshold in respect of mandatory principal adverse impact reporting;
- rules applicable to products falling under Article 9 (Dark Green Funds);
- rules applicable to products falling under Article 8 (Light Green Funds), including scoping and the meaning of ‘promotion’ of environmental or social characteristics; and
- the application of SFDR rules to MiFID portfolios.

The publication of the Commission’s Q&A has raised a number of issues for financial market participants, including fund managers, seeking to comply with the SFDR. In light of these issues, the Irish Funds industry association contributed to an EFAMA letter dated 20 August 2021 seeking clarification from the Commission on certain aspects of the Q&A, as well as on the impact of a deferral in the application of the SFDR RTS to 1 July 2022.¹

The matters addressed in the Commission’s Q&A are outlined below.

¹ The application of the SFDR RTS has been further delayed to 1 January 2023.

Registered AIFMs and Non-EU

The SFDR applies to AIFMs as defined in the Alternative Investment Fund Managers Directive (“**AIFMD**”). The Q&A clarifies that the SFDR applies to registered AIFMs (that is, sub-threshold AIFMs not authorised under the AIFMD) as well as non-EU AIFMs carrying out activities in the EU under a national private placement regime (“**NPPR**”). The Q&A expressly states that the “*entity and financial product related requirements*” of the SFDR apply to registered AIFMs, whereas it states that, where a non-EU AIFM markets in the EU using NPPR, that AIFM must ensure “*compliance with [the SFDR], including the financial product related provisions*”.

The EFAMA letter to the Commission has queried the reference to “*including the financial product provisions*” in relation to non-EU AIFMs, as this implies that non-EU AIFMs marketing in the EU are subject not only to the product-level SFDR disclosure rules for products marketed in the EU, but to all entity and product-level SFDR rules.

Principal Adverse Impact Reporting for Parent Entities of Large Groups

Entities within the scope of the SFDR which have less than 500 employees may choose not to consider principal adverse impacts (“**PAI**”) on sustainability factors and to explain why PAI are not considered. Since June 2021, entities with more than 500 employees and in-scope parent entities of groups with more than 500 employees are required to consider PAI and to publish a PAI statement.

The Commission has clarified that the calculation of the 500 employee threshold by an in-scope parent entity must count employees both of the parent entity and each subsidiary entity, regardless of whether the subsidiaries are established in the EU. A parent entity of a group exceeding the 500 employee threshold must only disclose in respect of itself and not the group as a whole.

Article 8 SFDR Funds

Despite the fact that funds were required to be classified as Article 6, 8 or 9 by the first SFDR compliance deadline of 10 March 2021, significant uncertainty remains in relation to determining when a fund will fall into the Article 8 classification.

The ESAs sought a number of clarifications from the Commission in relation to determining the scope of Article 8 SFDR. Unfortunately, uncertainties still remain following the publication of the Q&A.

Definition of “Promotion”

According to the Commission, a fund will be deemed to be “promoting” environmental or social characteristics where it claims that investments pursued by the fund consider environmental or social characteristics and the fund discloses that claim to investors. The definition of “promotion” contained in the Q&A is very broad and we have set out the elements of the definition in the table below.

Claims that investments pursued by the fund consider environmental or social characteristics:

May be direct or indirect

May be made by way of:

- information;
- reporting;
- disclosures; or
- giving an impression

May be part of:

- investment policies;
- goals;
- targets;
- objectives; or
- a general ambition.

May be set out in:

- pre-contractual or periodic documents;
- marketing communications;
- advertisements;
- product categorisation;
- description of investment strategies or asset allocation;
- information on adherence to sustainability-related financial product standards and labels;
- use of product names and designations;

(This is stated to be a non-exhaustive list.)

May take any form such as paper, durable media, websites or electronic data rooms.

Although the Commission did not directly answer this question in the Q&A, based on the broad definition of promotion, which includes giving an impression that investments have a general ambition to consider environmental or social characteristics through the use of product names, the use of words like “sustainable”, “sustainability” or “ESG” in the name of a fund is likely to bring the fund within the scope of Article 8.

The Q&A clarifies that integration per se of sustainability risks is not sufficient for Article 8 to apply. The Commission also states that Article 8 is neutral in terms of the design of financial products. It does not prescribe certain elements such as composition of investments or minimum investment thresholds or eligible investment targets, nor does it determine eligible investment styles, investment tools, strategies or methodologies to be employed.² The Commission restates the requirement set out in the SFDR RTS published in February 2021 that Article funds must only disclose on those elements of their environmental or social characteristics which are binding during the whole holding period.

Article 9 SFDR Funds

To be classified as an Article 9 SFDR fund, the fund’s underlying assets must qualify as sustainable investments under the SFDR (including Taxonomy-aligned sustainable investments). The Commission states that, where an Article 9 product also holds investments for specific purposes such as hedging or liquidity in order to comply with prudential, product-related rules, such investments must meet minimum environmental or social safeguards ie, they must be in line with the sustainable investment objective.

Objective of a “reduction in carbon emissions”

The Commission has stated that, where an EU Climate Transition Benchmark or EU Paris-aligned Benchmark does not exist, the pre-contractual information must include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement. Where an EU Climate Transition Benchmark or EU Paris-aligned Benchmark exists, the fund must be “tracking” these.

EFAMA has sought further clarification from the Commission, asking whether the SFDR requires funds with a carbon emission reduction objective to align with the Paris Agreement objectives and, if such alignment is sought, whether the fund is required to replicate an EU Climate Benchmark, where available.

² In the mandatory disclosure template set out in Annex II to the ESAs’ [Final Report](#) on draft Regulatory Technical Standards 22 October 2021, Article 8 products are required to disclose a minimum proportion percentage of sustainable investments. This may be a precursor to prescribing minimum standards for Article 8 funds.

Following the submission of its August letter to the Commission, EFAMA has attended a number of meetings with the Commission and has also engaged with the ESAs to try to address the uncertainties that remain in relation to the application of the SFDR. The ESAs have indicated that they may issue a Q&A document to provide further clarifications and to assist fund managers in meeting the implementation challenges under the SFDR. They may also submit further queries to the Commission for clarification.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

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