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ESAs Seek to Clarify Draft Regulatory Technical Standards under the SFDR

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Detailed regulatory technical standards ("**RTS**") under the Sustainable Finance Disclosure Regulation ("**SFDR**") are expected to apply from 1 January 2023. Following "*numerous requests for clarifications received from stakeholders and national competent authorities*", on 2 June 2022, the European Supervisory Authorities ("**ESAs**") published "Clarifications on the ESAs' draft RTS under SFDR".

The key areas addressed by the ESAs[2] include the following:

- disclosure of principal adverse impacts ("**PAI**") of investment decisions on sustainability factors, including:
  - uses of "sustainability indicators";
  - PAI calculation methodology;
  - look through approach and investment instrument scope for PAI disclosures;
  - disclosures for direct and indirect investments in pre-contractual and periodic disclosures;
  - further guidance on the PAI in Tables 1-3 of Annex I to the draft RTS;
- guidance related to pre-contractual and periodic product disclosures;
- guidance related to Taxonomy-related product disclosures;
- guidance related to "do no significant harm" ("**DNSH**") disclosures; and
- guidance related to disclosures for financial products with investment options.

We have set out below some of the key aspects of the guidance provided by the ESAs.

2. The ESAs refer in their clarifications to their final reports of February and October 2021, rather than the RTS and related Annexes adopted by the European Commission on 6 April 2022 and now being considered by the European Parliament and Council of the EU. However, this does not impact on the guidance provided by the ESAs.

Uses of Principal Adverse Impact Indicators

A fund manager may decide to consider PAI of investment decisions on sustainability factors under Article 4 SFDR, which requires such managers to provide a detailed PAI statement on their websites in the form specified in Annex I to the draft RTS. However, the PAI indicators set out in Annex I may be used in other contexts, as clarified by the ESAs.

The ESAs state that "*sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product*" referred to in the context of website disclosures and periodic disclosures in the SFDR can be differentiated from PAI. The ESAs therefore confirm the following:

- the use of PAI indicators is mandatory in applying the DNSH principle to demonstrate that an investment qualifies as a sustainable investment under Article 2(17) SFDR;
- using PAI indicators to apply the DNSH principle does not require a firm to comply with the PAI regime at entity level;
- the use of PAI indicators is not mandatory for product-level disclosure of PAI consideration under Article 7 SFDR;
- the use of PAI indicators is not mandatory when using sustainability indicators to measure the attainment of environmental or social characteristics (for Article 8 SFDR products) or sustainable investment objective (for Article 9 SFDR products), although PAI may be used as sustainability indicators; and
- the use of PAI as sustainability indicators to measure the attainment of environmental or social characteristics or the impact of sustainable investments does not require any prior PAI consideration at entity level (under Article 4 SFDR) or at product level (under Article 7 SFDR).

Look through approach and investment instruments in scope for PAI disclosures

The ESAs have confirmed that both direct and indirect exposures must be included for the calculation for PAI reporting purposes. Indirect exposure includes exposure through funds, fund of funds, derivatives, holding companies and SPVs. Fund managers need to look through to the individual underlying investments and consider the total adverse impacts arising from them. Where this information is not available, managers need to use best efforts to obtain this data, including directly from relevant companies, from their own research, from third party data providers or external experts or by making reasonable assumptions.

Disclosure of investment proportions

The pre-contractual and periodic disclosures of Article 8 and Article 9 SFDR funds should outline what share of the investments of the financial product is held directly and what share is held indirectly. The proportion of investments used to attain the environmental or social characteristics promoted by the fund or to attain the sustainable investment objective should be disclosed in addition to the purpose of the remaining proportion of investments. With regard to the remaining proportion of the investments, environmental or social safeguards should be considered. Such safeguards should be described so that end investors receive accurate information about the entirely of the investments made by the fund.

The ESAs confirm the view of the Commission stated in its SFDR Q&A of July 2021 that Article 9 SFDR funds should only make sustainable investments. Disclosures are still required on the amount and purpose of any remaining assets to demonstrate how those investments do not prevent the fund from attaining its sustainable investment objective.

Change in minimum commitment disclosures

Where a fund's minimum commitment disclosures change, the pre-contractual disclosures should be updated.

Periodic reporting timelines

Periodic reports published during 2022 need to comply with the requirements set out in Article 11 SFDR on a principles-based basis. Periodic reports published after 1 January 2023 will need to comply with the RTS.

Taxonomy-related disclosures

The commitments on the "minimum proportion" of Taxonomy-aligned investments are intended to be binding commitments and penalties for failing to respect such commitments are set out in the relevant sectoral legislation.

The pre-contractual disclosure of Taxonomy-alignment is designed to favour the measurement by turnover. However, where a more representative calculation of the Taxonomy-alignment can be provided using capital expenditure or operating expenditure, those should be used and that use should be justified. In periodic disclosures, all three measurements should be disclosed.

DNSH disclosures

As noted above, the ESAs have confirmed that there is no direct link between the requirement to take PAI into account in applying the DNSH principle to sustainable investments and the product level requirements relating to the consideration of PAI under Article 7 SFDR, which are separate disclosure requirements.

The draft RTS do not specify additional criteria for taking PAI into account in DNSH disclosures. Fund managers must themselves determine whether the PAI have been respected in applying the DNSH principle. When making that determination, fund managers may compare, where feasible, the impacts with similar metrics in the Climate Delegated Act and the Complementary Climate Delegated Act adopted under the Taxonomy Regulation. The ESAs state that best practice could be to disclose DNSH by extracting indicators Annex I and showing the impact of the sustainable investments against those indicators.

The ESAs confirm that there are two separate tests for DNSH under the SFDR and under the Taxonomy Regulation, and that Taxonomy-aligned investments must satisfy both of these tests.

Next Steps

The draft RTS adopted by the European Commission on 6 April 2022 are currently being considered by the European Parliament and the Council of the EU and are expected to be published in the Official Journal of the EU in Q3 2022. Fund managers will be required to update their pre-contractual disclosures to comply with the RTS in advance of the expected 1 January 2023 application date, and the Central Bank of Ireland ("**Central Bank**") has confirmed that it will provide for a fast-track procedure for these updates. We will continue to keep our clients informed of further developments relating to the RTS.

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 update.

Full details of the Asset Management and Investment Funds Department, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

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