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FINANCIAL REGULATION 15 JAN 2021

ESAs request clarification under Sustainable Finance Disclosure Regulation as a matters of matter of urgency;

The European Supervisory Authorities (EBA, ESMA, EIOPA) have written a letter to the European Commission highlighting several important areas of uncertainty in the interpretation of the Sustainable Finance Disclosure Regulation ("SFDR"). The ESAs note that these uncertainties have been highlighted by stakeholders as part of the recent consultation process. The letter notes that while many uncertainties may be clarified in due course the ESAs have identified certain priority questions that would benefit from 'urgent clarification' in advance of the SFDR applying from 10 March 2021. The areas of uncertainty of priority are:

- the application of the SFDR to non-EU AIFMs and registered AIFMs;
- the application of the 500 employee threshold for principal adverse impact reporting on parent undertakings of a large group;
- the meaning of 'promotion' in the context of (article 8) products promoting environmental or social characteristics;
- the application of article 9 SFDR; and
- the application of SFDR product rules to portfolios and dedicated funds

In practice, this list covers many of the key aspects of SFDR. These are questions that we have been speaking about with clients over the last few months and we share industry's frustration that so many uncertainties remain outstanding so close to the application date of the SFDR. This is particularly worrisome in light of the European Commission's view that firms should comply with SFDR obligations on a best efforts basis, despite the delay to the level 2 measures. The ESAs letter is comforting but does mean that many firms, and in particular non-EU AIFMs

will be on tenterhooks waiting for a response that will need urgent action if the 10 March 2021 deadline is to be achieved. Calls for a no action letter to be issued by the Commission must surely be mounting?

Annex

Below sets out a fuller summary of the questions the ESAs have asked the Commission to clarify.

1. The application of the SFDR to non-EU AIFMs and registered AIFMs;

- Does SFDR apply to registered (sub-threshold) AIFMs?
- Does SFDR apply to non-EU AIFMs referred to in Article 3(2)

Ashurst comment: To date it has generally been viewed that non-EU AIFMs would need to comply with SFDR as a result of the reference to article 4(1)(b) AIFMD which itself captures non-EU AIFMs. This question, however, raises the possibility that these entities could be de-scoped.

For non-EU AIFMs the question will be do you hold off preparing for SFDR or prepare but be ready to down tools if you are no longer subject to SFDR.

2. Application of the 500 employee threshold for principal adverse impact reporting on parent undertakings of a large group;

- Must the calculation of the 500-employee threshold to the parent undertaking of a large group be applied to both EU and non-EU entities of the group without distinction as to the place of establishment of the group and/or subsidiary?
- Does the due diligence statement include impacts of the parent undertaking only or must it include the impacts of the group at a consolidated level?

Ashurst comment: *This is important particularly for the obligations under article 4. If you have a parent undertaking over the 500 threshold test, you can not make a negative principal adverse impact statement from June this year. Understanding whether you are subject to this rule is therefore critical to your operational planning.*

3. The meaning of 'promotion' in the context of (article 8) products promoting environmental or social characteristics;

- The ESAs note that in general, clarification on the level of ambition of the characteristics through the provision of examples of different scenarios that are within, and outside, the scope of Article 8 SFDR would assist the orderly application of SFDR.

- More specifically, the following questions arise:
  - Can the name of a product, which may include words like "sustainable", "sustainability", or "ESG" be considered to qualify a product to be promoting an environmental or social characteristic or to be having sustainable investment as its objective?
  - While a financial product to which Article 8 applies does not need to explicitly promote itself as targeting sustainable investments (within the meaning of Article 2(17) SFDR), would a reference to taking into account a sustainability factor or sustainability risk in the investment decision be sufficient for Article 8 to apply? If the answer is yes, how can financial market participants that disclose mandatory information according to Article 6(1) or Article 7(1) SFDR ensure that this is not automatically considered as "promoting environmental or social characteristics".
  - Must a product to which Article 8 applies invest a minimum share of its investments to attain its designated environmental or social characteristic in order to be considered to be promoting environmental or social characteristics?
  - In the absence of active advertising of an environmental or social characteristic of the product, would an intrinsic characteristic of the product, such as a sectoral exclusion (e.g. tobacco) which is not advertised, also qualify as "promotion"?
  - In addition, would complying with a national legal obligation, which applies to the financial market participant, such as a ban on investment in cluster munitions, also bring the product into the scope of Article 8?

Ashurst comment: *The key question for many manufacturers is whether a product is an article 8 product or not. If you have an article 8 product under SFDR, additional obligations apply in relation to the disclosures to be made. Previously the ESAs have indicated that the article 8 threshold was particularly low and could even be satisfied by virtue of exclusions applied to the investment portfolio. These questions show that the ESAs now understand the need for much further clarification in this area.*

4. The application of article 9 SFDR; and

- Must a product to which Article 9(1), (2) or (3) SFDR applies only invest in sustainable investments as defined in Article 2(17) SFDR? If not, is a minimum share of sustainable investments required (or would there be a maximum limit to the share of "other" investments)?
- Where an EU Climate Transition Benchmark (EU CTB) or EU Paris-aligned Benchmark (EU PAB) exists, is it necessary for a product to track an EU PAB or an EU CTB on a passive basis for Article 9(3) SFDR to apply to it?
- If the questions above are answered in the affirmative and if the minimum standards of an EU PAB or an EU CTB do not require the index components to be sustainable investments, can the product fall within the scope of Article 9(3) SFDR?

Ashurst comment: Again, further clarification is certainly needed on what will or will not constitute an article 9 product. The ESAs acknowledge that it is not clear what the requirements are for a product to fall into this classification.

5. The application of SFDR product rules to portfolios and dedicated funds.

- For portfolios, or other types of tailored financial products managed in accordance with mandates given by clients on a discretionary client-by-client basis, do the disclosure requirements in SFDR apply at the level of the portfolio only or can they apply at the level of standardised portfolio solutions?
- If the disclosure requirements of SFDR apply at the portfolio level, how is it possible to maintain confidentiality obligations to the client in view of the disclosures required, especially the website disclosures required by Article 10 SFDR?

Ashurst comment: *Portfolio management brings products in scope of SFDR which may not otherwise have been caught. It is difficult for entities to operationalise the SFDR disclosure products in different types of portfolio management scenarios. This clarification will be welcomed by industry.*

Key Contacts

We bring together lawyers of the highest calibre with the technical knowledge, industry experience and regional know-how to provide the incisive advice our clients need.

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