simmons+simmons

SFDR – Key points and implications of the Commission's Q&As

On 26 July 2021, the European Commission published its long awaited replies to the questions raised in the European Supervisory Authorities' letter of 7 January 2021.

In the course of their work developing draft regulatory technical standards (RTS) under SFDR, the European Supervisory Authorities (ESAs) came up against several important areas of uncertainty in how to interpret the rules under the **SFDR**.

In January 2021, **they wrote to the European Commission**, identifying five priority questions on which they sought 'urgent clarification'. These were:

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

The Commission has now responded with a set of Q&As – **here** – which provide the following pointers on interpretation of the SFDR requirements. The note below takes you through the issues identified by the ESAs, the Commission's clarification and, where relevant, our comments on the impact of these responses for asset managers. The Commission's document does not in each case follow the ordering of the ESAs' questions, and in some cases not directly answer questions, and so we have attempted to summarise and re-order the answers to more logically follow the original structure.

It's worth noting that this Q&A does not deal with the **delay to the implementation date** of the SFDR RTS and contains no information on any potential revisions to the Draft RTS.

A. Application of SFDR to registered AIFMs and to non-EU AIFMs

What's the issue?

SFDR applies to 'financial market participants' (FMPs), a term that includes 'alternative investment fund managers' (AIFMs).

The SFDR definition of an 'AIFM' refers back to Article 4(1)(b) of the **AIFMD**, i.e., any 'legal persons whose regular business is managing one or more AIFs'.

This means that, in theory at least, SFDR is intended to apply to **all** AIFMs, whether above or below the threshold in Article 3(2) of the AIFMD and whether established in the EU or outside it.

Note: *the Commission's answers to questions 1 and 2 below appear to have been published in a slightly muddled order. Our summary below assumes a read-across of how the answers should logically correspond to the questions.*

What did the ESAs ask and what was the answer?

Q1. Does SFDR apply to registered (or sub-threshold) AIFMs referred to in Article 3(2) of the AIFMD?

Summary of the Commission's answer:

Yes, SFDR applies to registered sub-threshold AIFMs, both for entity-level and product-level disclosures. Where a sub-threshold AIFM is not directly subject to AIFMD disclosure requirements, it should include the SFDR disclosures in analogous documents.

S&S comments:

This is an uncontroversial interpretation. In the absence of harmonised EU rules applying to a sub-threshold AIFM, such firms must instead include the disclosures in documents required under applicable national law. Any sub-threshold AIFM which has taken a contrary view will need to ensure prompt compliance with SFDR.

Q2. Does SFDR apply to non-EU AIFMs, for example when they market a sustainable EU Alternative Investment Fund under a National Private Placement Regime (NPPR)?

Summary of the Commission's answer:

Yes, SFDR applies to non-EU AIFMs, as they are included in the definition of "AIFM" in Article 4(1)(b) of AIFMD. The trigger point for the application of SFDR to a non-EU AIFM is entering the market of a given EU member state by means of the NPPR. If a non-EU AIFM uses the NPPR, it must ensure compliance with SFDR, including the financial product related provisions.

S&S comments:

This answer is in line with the approach adopted by most of the market ahead of **10 March 2021**, to assume that SFDR applies to non-EU AIFMs which market alternative funds into the EU. It is helpful and in line with the standard interpretation (including the long-held view of Simmons & Simmons) that the trigger point for the application of SFDR to non-EU AIFMs is marketing under NPPRs.

If a non-EU fund manager has taken a contrary view, it will need to ensure prompt compliance with SFDR for those funds which are currently marketed in the EU under AIFMD NPPRs.

The Commission does not specify that marketing in response to a reverse enquiry would trigger the application of SFDR to a non-EU AIFM. We therefore suggest that firms assume that responding to a reverse enquiry does not trigger SFDR. This is consistent with the approach taken to-date by many in the industry (including Simmons & Simmons).

One point which firms may wish to consider further is how SFDR applies to a non-EU AIFM, once it has marketed a fund under the NPPRs. The prevailing industry view (which accords with our own view) has been that SFDR applies only to the manager in respect of the relevant fund(s) which are actively marketed into the EU under NPPRs (and not to other funds which are not marketed).
The Commission Q&A simply states that AIFM must "ensure compliance with [SFDR], including the financial product related provisions." We don't think this undermines the view that SFDR applies only to those products which are marketed under NPPRs, but it might mean that the manager is directly in-scope (at least in respect of those funds). We had advised that the manager would effectively be indirectly in-scope, but this Q&A may mean that the manager is in-scope as a regulatory matter. This would for example require a manager to publish its sustainability risk policy, and to make a comply or explain decision on the PAI regime. For non-EU managers with more than 500 employees, further consideration will be required around mandatory compliance with the PAI regime.

B. Application of the 500-employee threshold for principal adverse impact reporting at entity level to parent undertakings of a large group

What's the issue?

Under Article 4(4) of SFDR, from 30 June 2021, FMPs which are

> 'parent undertakings of a large group as referred to in Article 3(7) of [the EU Accounting Directive] exceeding on the balance sheet date of the group, on a consolidated basis, the criterion of the average number of 500 employees during the financial year'

must publish and maintain on their websites a statement on their due diligence policies with regard to the PAIs of investment decisions on sustainability factors.

What did the ESAs ask and what was the answer?

Q1. 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?

Summary of the Commission's answer:

The Article 4(3) test relates to an FMP.
The Article 4(4) test relates to the "large group" as defined, in its entirety, regardless of where the entities are domiciled. Article 4(4) applies to FMPs that are parent undertakings of those large groups.

S&S comments:

The Commission's answers preserve the legal definitions as they currently stand. There is no purposive expansion or wider reading of the text of the legislation. In particular, there is no requirement under Article 4(4) to look "up the chain" at parent undertakings of an EU FMP.
This will be welcomed by many in the industry, who had feared the potential for a more expansive purposive reading. As such, firms which have followed a technical legal reading of the large group definition have adopted a compliant approach.

We are aware that other market participants are reading this question differently but we don't see anything in the Commission's response requiring an EU FMP to look at its parent undertaking when counting number of employees.

Q2. 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?

Summary of the Commission's answer:

The disclosure relates to the relevant FMP only, and not the activities of the group. The criterion of a group is relevant only for the headcount trigger.

S&S comments:

It is helpful to confirm that the disclosures apply only to the relevant FMP.

C. Application of Article 9 SFDR

What's the issue?

Article 9(1) and (2) of SFDR apply where a financial product's objective is 'sustainable investment'.

Where the product's objective is a reduction in carbon emissions, Article 9(3) further requires that the information to be disclosed (under Article 6(1) and (3) of SFDR) must include

> "the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement".

However, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with the EU Benchmarks Regulation is available, the information referred to in Article 6 must include a detailed explanation as to

> "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".

What did the ESAs ask and what was the answer?

Q1. Must a product to which Article 9(1), (2) or (3) of SFDR applies only invest in sustainable investments as defined in Article 2(17) of SFDR?

If not, is a minimum share of sustainable investments required (or would there be a maximum limit to the share of "other" investments)?

Summary of the Commission's answer:

An Article 9 product may invest in a wide range of assets, provided that they qualify as sustainable investments under Article 2(17) of SFDR. Alongside those investments, an Article 9 product may invest in other investments for certain specific purposes such as hedging or liquidity (and provided that they meet minimum safeguards).

The product documentation for an Article 9 product must explain how the "mix" of investments complies with the sustainable investment objective of the financial product.

S&S comments:

The Commission has effectively confirmed that an Article 9 product must invest only in (i) sustainable investments, or (ii) permitted "remainder" investments, such as investments for hedging or liquidity purposes.
This is the view adopted by many in the industry and is consistent with the approach implicit in the Draft RTS.
Any firm which has taken a contrary view, and allows non-sustainable / non-"remainder" investments in the portfolio of an Article 9 product, will need to revisit that classification.

Q2. 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?

Summary of the Commission's answer:

Article 9(3) envisages two scenarios:

1. where an EU CTB or EU PAB 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;
2. where an EU CTB or EU PAB exists, a financial product must be tracking these.

S&S comments:

In our view, the Commission's answer here is unclear. Our current understanding is that the Commission is saying that if an EU CTB or EU PAB exists, that an Article 9(3) financial product must track that relevant index, to achieve its sustainable investment objective of a reduction in carbon emissions.

If this is the Commission's intended message then it would mean that a product which is not a passive tracker, but for which an EU CTB or EU PAB exists, could not sit within Article 9(3) of SFDR. From a policy perspective this would seem a surprising outcome as it would rule out actively managed funds with an objective of a reduction in carbon emissions. We wonder whether the requirement to use an EU CTB or EU PAB if one is available is only intended to apply to passive funds. Overall, we consider that this answer requires further clarification by applicable regulators.

Q3. 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?

Summary of the Commission's answer:

The implementation of minimum standards by benchmark administrators for the construction of EU CTBs and EU PABs must ensure compliance with Article 2(17) of SFDR.

S&S comments:

Again, in our view, the Commission's answer here is unclear. The Commission asserts that the requirements of the reading together the Benchmark Regulation must be read in conjunction with the SFDR and in particular definition of "sustainable investment" and so we assume the Commission means that a benchmark which contains components that are not sustainable investments will not be sufficient.

Overall, we consider that this answer requires further clarification by applicable regulators.

D. Meaning of "promotion" in the context of products promoting environmental or social characteristics

What's the issue?

Article 8 of SFDR seeks to enhance pre-contractual disclosure for products "promoting environmental or social characteristics".

It applies where a financial product promotes, among other things

> "environmental or social characteristics, or a combination of those characteristics".

In the view of the ESAs, clarification would be helpful as to "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".

What did the ESAs ask and what was the answer?

Q1. 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?

Summary of the Commission's answer:

Note: in summarising the Commission's answer, we have first included the general description of what "promotion" means, followed by the specific answer for product names. The general description is also relevant for Q4 and Q5 below

GENERAL:

The term 'promotion' encompasses claims, information, reports, disclosures, or other "impressions" that the investments pursued by the given financial product consider environmental or social characteristics in terms of investment policies, goals, targets or objectives.

Such impressions may be contained in any of the following documents:

- pre-contractual documents
- periodic documents
- marketing communications
- advertisements
- product categorisation
- other descriptions of investment strategies or asset allocation
- information on the adherence to sustainability-related financial product standards and labels
- use of product names or designations
- memoranda or issuing documents
- factsheets
- specifications about conditions for automatic enrolment
- compliance with sectoral exclusions or statutory requirements

This applies regardless of the form used, such as on paper, durable media, by means of websites, or electronic data room.

SPECIFIC QUESTION ON PRODUCT NAMES:

In answer to the specific question, this therefore includes the use of product names and designations.

S&S comments:

A key area of uncertainty with SFDR has been the definition of Article 8 products. The Simmons & Simmons view has consistently been that an Article 8 product is one which (i) identifies one or more environmental or social characteristics as being promoted by the product, (ii) gives effect to those characteristics via binding investment criteria, and (iii) complies with the good governance requirement.

The Commission's view in the Q&A is consistent with this interpretation. In particular, it is helpful to understand that "promote" is not about actively marketing an ESG product; instead, it is about giving the impression to investors that the product considers environmental or social characteristics in its investment policies, goals, targets or objectives.

It is noteworthy in this Q1 that the Commission confirms that product names can be sufficient to form the basis for an Article 8 product. (See also Q4 and Q5 below for related issues).

We anticipate that the broad interpretation expressed here by the Commission may cause concern in the industry. This is because we have detected a trend of market participants increasingly seeing Article 8 status as a label or badge to be attained by a fund. That view of Article 8 as a label might be undermined by the breadth of "promotion" which causes a product to fall within Article 8. One might query then whether simply calling a fund a "Sustainable Investments" fund should be sufficient to be Article 8.

This, though, reveals that Article 8 is actually more about ***disclosure***, rather than being a label. If a fund can "slip through the net" with a very low bar to having Article 8 status, then it still has to comply with the detailed disclosure requirements under the RTS, in respect of Article 8 status. Compliance with those disclosure requirements is not a trivial undertaking and will effectively require all Article 8 products to comply with baseline requirements (e.g. setting and monitoring sustainability metrics). In practice, the disclosure required from "lower" Article 8 products will reveal their status relative to "upper" Article 8 products.

But, it's important to emphasise that the Commission's approach here is not aligned with the industry consensus that Article 8 is a badge or label to which products might aspire.

Q2. 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) of 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 FMPs that disclose mandatory information according to Article 6(1) or Article 7(1) of SFDR ensure that this is not automatically considered as "promoting environmental or social characteristics".

Summary of the Commission's answer:

Article 8 financial products may comply with the PAI regime.

The integration of sustainability risks is not sufficient for Article 8 to apply to a product.

S&S comments:

It is very helpful to confirm that Article 8 products may (but implicitly need not) comply with the PAI regime.

It is also helpful to confirm that compliance with the requirements on integration of sustainability risk does not make a product fall within Article 8.

The Commission also does not state that compliance with the PAI regime automatically causes a product to fall within Article 8. As such, we read the Commission as effectively saying that an "Article 6 / Other" product can comply with the PAI regime, as long as the product documentation does not expressly link such compliance to the promotion of specific E/S characteristics.

Q3. 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?

Summary of the Commission's answer:

Article 8 of SFDR is neutral as to the design of financial products. Article 8 does not prescribe the composition of investments or minimum investment thresholds. Article 8 does not determine eligible investing styles, investment tools, strategies or methodologies to be employed.

Article 8 products may continue applying various current market practises, tools and strategies and a combination thereof such as screening, exclusion strategies, best-in-class/universe, thematic investing, certain redistribution of profits or fees.

S&S comments:

It is helpful to confirm that there is no minimum investment threshold for an Article 8 product. This has been widely debated in the industry.

It is also helpful to confirm that a wide range of investment tools and strategies are compatible with an Article 8 product status.

Q4. 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"?

Summary of the Commission's answer:

See also the response to Q1 above.

A sectoral exclusion can be the basis for an Article 8 product, provided that the product documentation specifies (via claims, information, reports, disclosures, or other "impressions") that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives

S&S comments:

It had been widely assumed in the industry that sectoral exclusions are a sufficient basis to fall within Article 8, provided that they are promoted as relating to specific environmental or social characteristics.

As a result of the Commission's view on needing to give "impressions", it would in our view therefore be the case that complying with sectoral exclusions, but not expressly promoting that as being linked to environmental or social characteristics, does not make a product fall within Article 8.

As such, we read the Commission as effectively saying that an "Article 6 / Other" product can have sectoral exclusions, as long as the product documentation does not expressly link those exclusions to the promotion of specific E / S characteristics.

Q5. In addition, would complying with a national legal obligation, which applies to the FMP, such as a ban on investment in cluster munitions, also bring the product into the scope of Article 8?

Summary of the Commission's answer:

See also the response to Q1 above

Compliance with statutory requirements can be the basis for an Article 8 product, provided that the product documentation specifies (via claims, information, reports, disclosures, or other "impressions") that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives

S&S comments:

This is a somewhat unexpected answer, as many in the industry had assumed that compliance with mandatorily binding legal requirements (e.g. a ban on investing in cluster munitions) would not be sufficient to cause a product to fall within Article 8.

In our view, though, the same considerations would apply here as under Q1 and Q4. In other words, following such a legal requirement (e.g. a ban on investing in cluster munitions) would not cause a product to fall within Article 8, unless the product also express links that restriction to the promotion of specific E / S criteria.

E. Application of SFDR product rules to MIFID portfolios and other tailored products

What's the issue?

SFDR applies to an FMP which is an investment firm 'which provides portfolio management' (Article 2(1)(b)).

In also applies to 'financial advisers', including an investment firm 'which provides investment advice' (Article 2(11)(d)).

In each case, 'investment firm' has the meaning given to it under Article 4(1) of MiFID II.

What did the ESAs ask and what was the answer?

Q1. 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?

Summary of the Commission's answer:

SFDR makes no distinction as to whether products are tailored or not.

S&S comments:

As expected by many in the industry, this confirms that SFDR product-level obligations generally apply at the level of each individual IMA or mandate.

Q2. 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?

Summary of the Commission's answer:

SFDR website disclosures must ensure compliance with data protection and with client confidentiality.

Where an FMP is required to make website disclosures in respect of portfolio management services, it could do so at the level of standardised product solutions.

S&S comments:

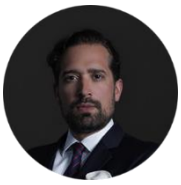
It is very helpful, and will likely be welcomed by the industry, that website disclosures for portfolio management services must comply both with data protection and client confidentiality. This should give managers comfort not to make public website disclosures if it would breach client confidentiality to do so. Managers may wish to consider making a generic disclosure instead for the public website disclosure. There remains an open question as to whether regulators would expect the equivalent bespoke disclosures to be made privately to clients..

Simmons & Simmons key contacts

Lucian Firth
Partner
T +44 20 7825 4155
E lucian.firth@simmons-simmons.com

Craig Bisson
Partner
T +44 20 7825 4691
E craig.bisson@simmons-simmons.com

Sarah Crabb
Partner
T +44 20 7825 3597
E sarah.crabb@simmons-simmons.com



Daniel Lühmann
Managing Associate
T +49 69 907454 25
E daniel.luehmann@simmons-simmons.com

Patricia Schneider
Associate, Rechtsanwältin
T +44 20 7825 4310
E patricia.schneider@simmons-simmons.com

Niamh Ryan
Partner
T +353 1266 2115
E niamh.ryan@simmons-simmons.com

Neil Simmonds
Partner
T +44 20 7825 3151
E neil.simmonds@simmons-simmons.com

Catherine Weeks
Partner
T +44 20 7825 3940
E catherine.weeks@simmons-simmons.com

Ursula Goniszewska
Supervising Associate
T +44 20 7825 3108
E ursula.goniszewska@simmons-simmons.com

Grace Chong
Of Counsel
T +65 6831 5 626
E grace.chong@simmons-simmons.com

Nick Colston
Partner
T +44 20 7825 4147
E nicholas.colston@simmons-simmons.com

Dr Harald Glander
Partner
T +49 69 907454 44
E harald.glander@simmons-simmons.com

Louise Tudor Edwards
Managing Associate
T +44 20 7825 4539
E louise.tudor-edwards@simmons-simmons.com

Iris Dingemans
Partner
T +31 20 722 2335
E iris.dingemans@simmons-simmons.com

Matthew Pitman
Partner
T +44 20 7825 4629
E matthew.pitman@simmons-simmons.com

Devarshi Saksena
Partner
T +44 20 7825 3255
E devarshi.saksena@simmons-simmons.com

Augustin de Longeaux
Partner
T +352 26 21 16 34
E augustin.delongeaux@simmons-simmons.com

David Williams
Partner
T +44 20 7825 4150
E david.williams@simmons-simmons.com

James Wallace
Managing Associate
T +44 20 7825 4249
E james.wallace@simmons-simmons.com

Katherine Tracey
Managing Associate
T +44 20 7825 4820
E katherine.tracey@simmons-simmons.com

simmons+simmons

51258810

For additional information on our firm, please visit our website at **simmons-simmons.com.**

© Simmons & Simmons LLP and its licensors. All rights asserted and reserved. This document is for general guidance only. It does not contain definitive advice.

Simmons & Simmons LLP is a limited liability partnership registered in England & Wales with number OC352713 and with its registered office at CityPoint, One Ropemaker Street, London EC2Y 9SS, United Kingdom. It is authorised and regulated by the Solicitors Regulation Authority and its SRA ID number is 533587. The word "partner" refers to a member of Simmons & Simmons LLP or one of its affiliates, or an employee or consultant with equivalent standing and qualifications. A list of members and other partners together with their professional qualifications is available for inspection at the above address.