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SFDR – Commission's opinions on key SFDR questions finally published

April 2023

On 14 April 2023, the European Commission published a series of answers on the interpretation of the SFDR. The eight questions being answered are those which the European Supervisory Authorities (ESAs) submitted to the Commission on 9 September 2022. (See our summary of those questions here.)

This note summarises the answers, and sets out our high-level reaction.

1. What's the background?

The ESAs' questions of September 2022 represented the biggest remaining significant "known unknowns" – where key SFDR interpretative questions had not yet been formally answered by EU regulators. In particular, they included key questions on the definition of "sustainable investments", and what it means in practice to "consider" principal adverse impacts (PAI) at product-level.

We now, some seven months later, have the Commission's opinions.

For the most part, the Commission's answers are generally broad and neutral, rather than prescriptively identifying a narrow definition or answer (although there are one or two exceptions). Generally speaking, the Commission emphasises that SFDR is a disclosure-based regime, and emphasises that the onus is generally on firms to disclose what they do, and for what they do to be consistent with the core requirements of SFDR.

What does Simmons think?

We expect that the asset management industry will strongly welcome the Commission's opinions. The Commission's approach of allowing firms the flexibility to disclose what they do (rather than being prescriptive about how to approach these topics) will be a relief.

Key highlights:

- **Sustainable investments:** firms retain subjective discretion to apply their own assessment methods and qualifications for what is a sustainable investment. The Commission has not taken a narrow or prescriptive approach. In particular, the Commission does not set a minimum quantitative threshold for when a company sufficiently contributes to an E/S objective, does not require firms to adopt a Taxonomy-style "value weighted" approach to determine how much of the value of an investment counts as a sustainable investment, and allows both direct and indirect contributions to count towards the definition of a sustainable investment.
- **"Consideration" of PAI:** The Commission confirms (as we expected) that "consideration" of PAI involves both obtaining/publishing data on adverse impacts, and also implementing processes around how you mitigate that harm. This is the logically correct outcome, but any firm which has taken a more bullish view may need to reassess its approach.
- **Reduction in carbon emissions:** The Commission rows-back on some of its previous unhelpful / unclear guidance. Helpfully, it is now clear that an article 9(3) product can have an active or a passive strategy, and that article 8 products can also pursue a reduction in carbon emissions as a promoted characteristic.
- **Periodic reports for portfolio management services:** The Commission has acknowledged the error in the cross-references to MiFID, and confirmed (in line with industry views) that only annual reports are required, not quarterly.

2. What do the Q&As cover?

In order of likely importance for the financial services industry, the questions cover:

- The definition of "sustainable investments"
- What it means to "consider" principal adverse impacts
- The definition of article 9(3) products which have an objective of the reduction in carbon emissions
- The timing of periodic reports for portfolio management services
- The 500 employee test for mandatory PAI compliance

In our summary below, we have summarised and re-ordered the ESAs' questions.

3. Sustainable investments - Article 2(17)

Q1. How does the definition of "sustainable investment" in Article 2(17) SFDR apply to investments in funding instruments that do not specify the use of proceeds, such as the general equity or debt of an investee company?

Q2. How should "investment in an economic activity that contributes to an environmental objective" or "investment in an economic activity that contributes to a social objective" in Article 2(17) SFDR be interpreted?

What did the Commission say?

- **No prescriptive methodology to determine "contribution"**

  The Commission emphasises that SFDR does not prescribe any specific approach to determine the contribution of an investment to environmental or social objectives. Instead, firms must disclose the methodology they have applied to carry out their assessment of sustainable investments, including how they determine the contribution to environmental or social objectives.

  The Commission also explains that SFDR does not limit sustainable investments to funding instruments which specify the use of proceeds. As such, the general equity or debt of investee companies could qualify as "sustainable investments", as could index positions which track a Paris-aligned Benchmark (PAB) or Climate Transition Benchmark (CTB).

  Consequently, the Commission concludes that a company itself can be a sustainable investment (without needing to limit this to the level of specific economic activities). [**Simmons comment**: although not expressly specified, this also implicitly serves as a rejection of the Taxonomy-style "value-weighting" approach, as allowing the company as a whole to be treated as a sustainable investment and endorses the "True/False" approach.]

- **No prescriptive minimum requirements to determine "contribution"**

  The Commission emphasises that SFDR does not set out minimum requirements that qualify concepts such as "contribution". Instead, firms must carry out their own assessment for each investment, and disclose their underlying assumptions.

  However, the Commission notes that this policy approach places increased responsibility on firms. The Commission cautions that firms should "*exercise caution*" when measuring the parameters of a sustainable investment. But, the Commission does not specify any prescriptive minimum qualitative or quantitative thresholds in making those measurements or assessments.

- **Transition plans alone likely not sufficient to be a sustainable investment:**

  One exception to the approach of broad flexibility is that the Commission states that an investee company which has a transition plan aimed at mitigating harm to environmental (or social) objectives may not in itself be sufficient to qualify as a sustainable investment.

What does Simmons think?

The asset management industry will likely be extremely relieved at the Commission's approach.

It is significant good news that firms retain subjective discretion to apply their own assessment methods and qualifications for what is a sustainable investment. Firms will be pleased that the Commission has not taken a narrow or prescriptive approach. For the vast majority of firms, this means that there should not be any need to revise their existing approaches to qualifying sustainable investments.

(Although firms which classify transition plans alone as the basis for qualifying an investee company as a sustainable investment will need to revisit that).

The positive outcomes here also include that:

- The Commission does not set a minimum quantitative threshold (e.g. based on percentage revenue, turnover, etc) for when a company sufficiently contributes to an E/S objective.
- The Commission does not require firms to adopt a Taxonomy-style "value weighted" approach to determine how much of the value of an investment counts as a sustainable investment. Instead, the Commission effectively endorses the "True/False" methodology. This allows the entire value of an investment to be treated as a sustainable investment, rather than having to narrow it to specific economic activities of an investee company.
- Probably the most generous of the Commission's interpretations is allowing both direct and indirect contributions to count towards the definition of a sustainable investment. This is a more open approach than we had expected, although we note the Commission's warning that this approach places responsibility on firms, which should "exercise caution". Firms should therefore be alive to greenwashing risk, if they adopt too aggressive an approach.

4. Principal Adverse Impacts (PAI)

Q6 Where Article 7(1)(a) of SFDR applies, a financial market participant (FMP) must disclose whether, (and, if so, how) a financial product "considers" PAI on sustainability factors.

What does "consider" mean in this context?

Does "consideration" of PAI:

- mean that the product only discloses the relevant PAI of the investments (e.g., total greenhouse gas emissions) or
- require the FMP to have taken action to address the PAI of the product's investments (such as engagement with investee companies) – and if so, are there any minimum criteria for such actions?

What did the Commission say?

In reliance on SFDR recital (18), the Commission states that consideration of PAI requires disclosure of both:

- a description of the adverse impacts, and
- the procedures put in place to mitigate those impacts. SFDR is not prescriptive as to what action must be taken, and so (implicitly) firms can subjectively define this for themselves.

What does Simmons think?

We have consistently advised that "consideration" of PAI must mean more than simply gathering and reporting on data. It is strongly implicit from SFDR consultation materials and the final RTS that "consideration" of PAI means taking action to mitigate any identified adverse harm.

The Commission's answer now aligns with our expectation, as the Commission is confirming that consideration of PAI means both considering the data on adverse impact, and also putting in place procedures to mitigate those identified adverse impacts. In other words, firms must have procedures to take action to mitigate the adverse harm.

Although this has been the Simmons & Simmons view, we are aware that others in the market have until now taken a narrower view, and concluded that merely obtaining/publishing data would be sufficient. Firms which have adopted that approach for product-level PAI may need to revisit their procedures, and plan to take action where adverse harm is identified.

We do note, though, that the Commission has not been prescriptive as to what action must be taken, and so it appears to us that firms can subjectively define this for themselves. Such action could potentially include voting, stewardship, engagement with management and up to reduction or divestment of positions.

5. Article 9(3) products

Q3. In light of the Commission's response in July 2021, is it correct that a financial product with an Article 9(3) objective of reduction in carbon emissions can be a product with either a passive or an active investment strategy?

If a financial product with an active investment strategy can, indeed, have "reduction in carbon emissions" as its objective under Article 9(3), what (if any) specific requirements does it need to meet when designating an index as a reference benchmark?

Q4 Can a financial product "promote" carbon emissions reduction as an "environmental characteristic", rather than having it as an "objective"?

Put another way, can a financial product disclose carbon emissions reduction as an environmental characteristic under Article 8 SFDR or must a financial product which targets carbon emissions reduction always be considered to be having "carbon emissions reduction" as an "objective" and so be required to disclose the information required under Article 9(3)?

(And, in the above example, if the financial product can be seen as an Article 8 product, what criteria differentiate it from an Article 9 product?)

Q5 Can a financial product with a **passive** investment strategy which designates either a Paris Aligned Benchmark (PAB) or - from 1 January 2023 - a Climate Transition Benchmark (CTB) as a reference benchmark automatically be deemed to fulfil the conditions of Article 9(3)?

Can a financial product with an **active** investment strategy focused on carbon emissions reduction satisfy Article 9(3) where it applies the same portfolio composition etc requirements

as a PAB and a CTB under the Benchmarks Regulation framework (and, in particular, Delegated Regulation 2020/1818)?

What did the Commission say?

Article 9(3) is neutral in terms of product design. Article 9(3) products can therefore use either an active or a passive investment strategy. In particular, there is no requirement for an Article 9(3) product to track a PAB or CTB. (But, if an article 9(3) product does not track a PAB or CTB, then SFDR requires a detailed explanation of how the objective of ensuring a reduction in carbon emissions in ensured in view of achieving the long-term objectives of the Paris Agreement).

Where an article 9(3) product does passively track a PAB or CTB, it can automatically be deemed to have sustainable investments as its objective (for the purposes of Article 2(17) of SFDR).

In addition, the Commission confirms that Article 8 products can validly promote the environmental characteristic of a reduction in carbon emissions. In other words, the goal of a reduction in carbon emissions is not limited to article 9 products.

What does Simmons think?

Article 9(3) had caused significant uncertainty for the industry. The Commission's prior answers on this issue were not well received or well understood (to put it mildly) and so clarity was much needed. In keeping with the trend in the Q&As, the Commission's opinion here is clear and helpful.

In particular, the industry will welcome the clarifications that:

- An article 8 product may validly pursue a reduction of carbon emissions as a promoted characteristic, without being subject to Article 9(3).
- An article 9(3) product may be either actively managed or passively managed.
- An article 9(3) product which passively tracks a PAB or CTB is automatically deemed to be making sustainable investments.

6. Periodic disclosure frequency for portfolio management services

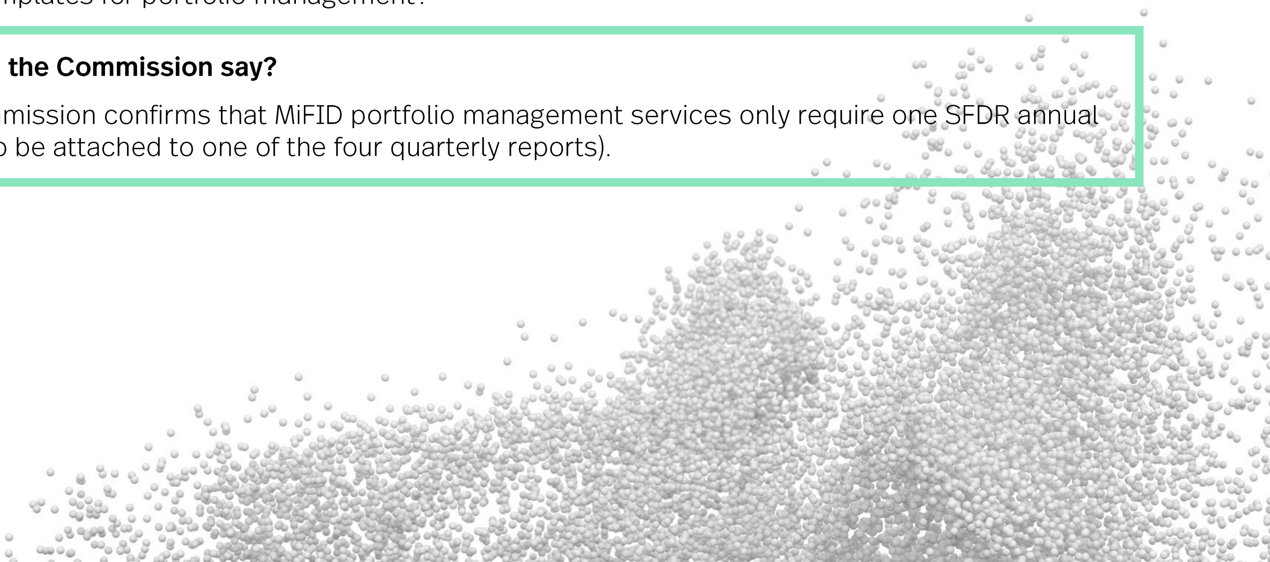
Q8 Both Article 11 (2)(i) of SFDR (with reference to Article 25(6) of MiFID) and Article 60 of IFR Level 2 set out details of the frequency of periodic reporting requirements in respect of portfolio management services. The latter states that the frequency should be quarterly, unless an exception applies.

On the other hand, recital 21 of SFDR refers to periodic reports being annual.

Should an in scope FMP, then, provide quarterly periodic reports based on the SFDR templates, or can it use one of the quarterly reports to present a yearly report based on the SFDR templates for portfolio management?

What did the Commission say?

The Commission confirms that MiFID portfolio management services only require one SFDR annual report (to be attached to one of the four quarterly reports).



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What does Simmons think?

In the absence of formal guidance, many firms had concluded that the cross-reference to MiFID quarterly reporting must have been a drafting error, given that SFDR otherwise pre-supposes annual periodic reports.

The asset management industry will welcome the sensible clarification that portfolio management services under SFDR are only required to provide the Annex IV or V periodic disclosure template annually (even if the service is subject to a quarterly portfolio reporting requirement).

7. 500 employee threshold under PAI

Q7 Article 4(3) and 4(4) refer to an FMP with an "average number of 500 employees". Does this figure include workers who are assigned to the FMP, even if employed by a third party that invoices their services back to the FMP?

What did the Commission say?

The Commission does not directly answer the question on the definition of "employees", leaving this as a matter of national law.

What does Simmons think?

In the absence of a formal definition of employees, we continue to believe it would be prudent to include secondees, contractors, and group employees.

For more information on the SFDR, please see our online resource **here**.

To see our previous client notes on ESG- related topics, please see our online resource **here**.

If you require any further information on any of the issues referred to above, please contact one of the Simmons & Simmons team listed on the next page.

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