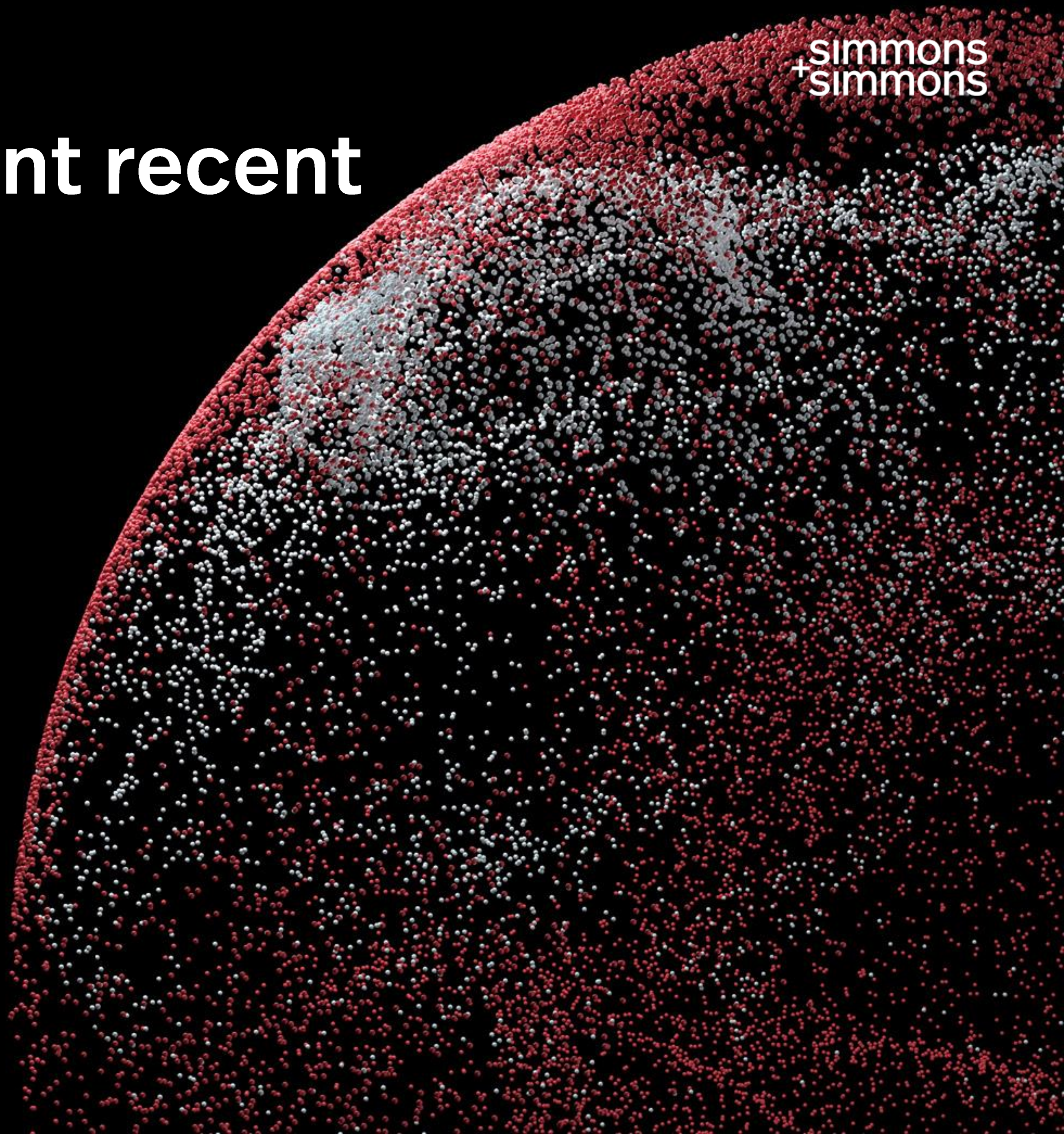
Taking stock of important recent SFDR developments



Nick Colston, Harald Glander, Lucian Firth
and Louise Tudor-Edwards

17 May 2023

What we're covering today

1 Commission Q&A on key interpretative questions

2 The ESAs' consultation paper on "SFDR 1.5"

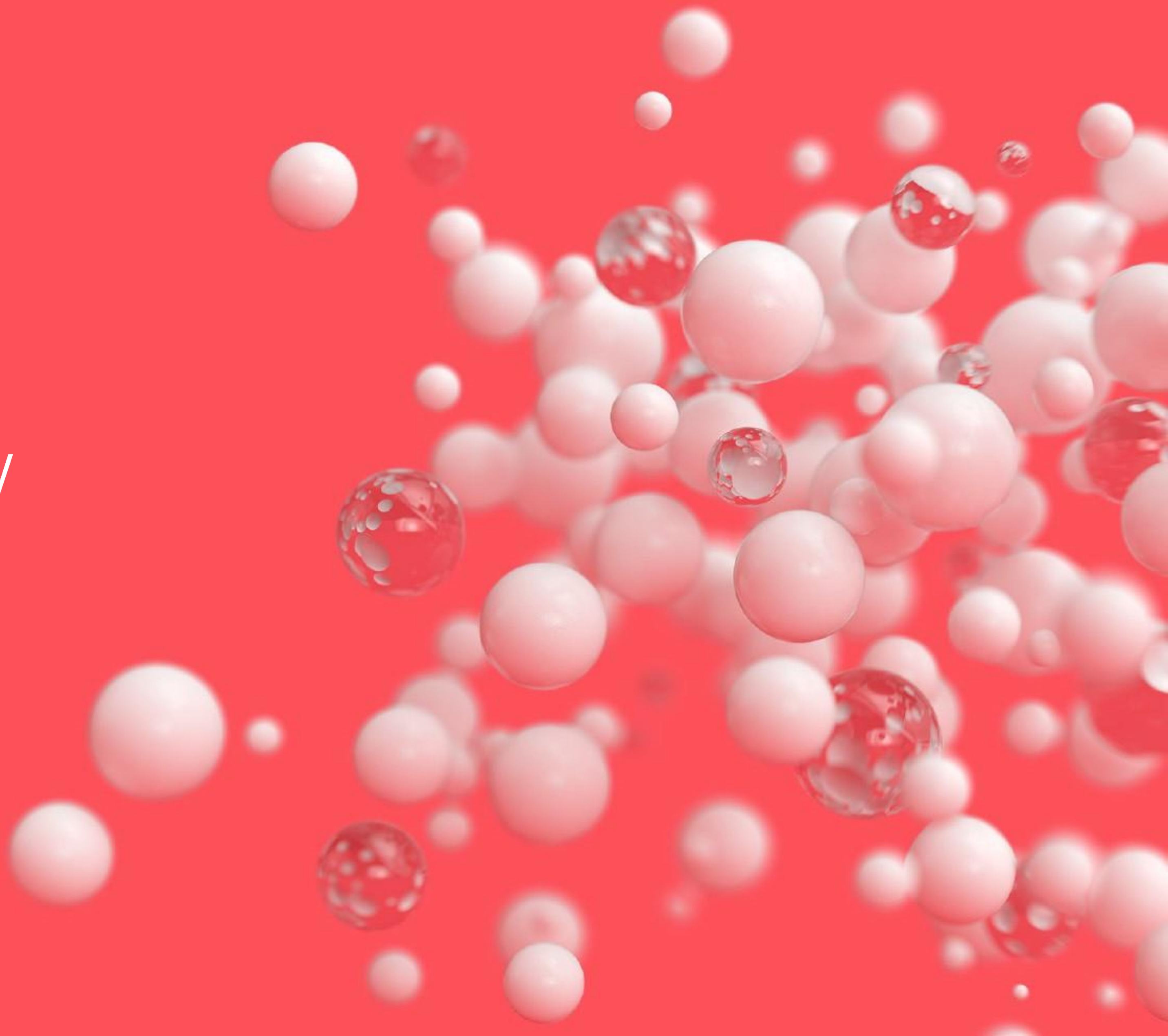
3 Other SFDR developments

and then Audience Q&A

simmons + simmons

Part 1

Commission Q&A on key interpretative questions (April 2023)



SFDR “known unknowns”

- ➢ ESAs key questions: September 2022
- ➢ Commission response: 14 April 2023

  - Definition of sustainable investments – “contribution” to environmental or social objective
  - How to consider PAI at product level
  - Clarity on article 9(3) products

NOTE: the Q&A is immediately effective

Getting our bearings…
Definition of sustainable investment

An investment in:

- an **economic activity** that **contributes to** an **environmental objective or**
- an **economic activity** that **contributes to** a **social objective**
- **provided that:**
  - a) such investments **do not significantly harm (DNSH)** any of those objectives and
  - a) the investee companies follow **good governance practices**, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

Focus of the Commission Q&A

What does "contribution" mean in practice?

Note – DNSH separately covered in detail by ESAs' "SFDR 1.5" consultation

"Contributes to" – type of contribution

<u>Wider view</u>: can look at the way in which an investment conducts its business (which may not be directly linked to E/S objective) or look at its harm reduction or transition plans

<u>Narrower view</u>: investment must intrinsically or directly contribute to an E/S objective

- ~~Transition plan / strategy aimed at DNSH but no active contribution to E/S objectives~~
- ~~Commitment / strategy to reduce E/S harm (eg SBTi methodology)~~
- Transition plan (eg aiming for climate neutrality based on ACT methodology)
- Economic activity carried on in a "sustainable manner" *(indirect)*
- Economic activity itself intrinsically contributes to E/S objective *(direct)*

Commission takes <u>broad</u> approach:

- SFDR <u>not</u> prescriptive on how to determine (e.g. no minimum quantum)
- Firms have subjective discretion to define (but must exercise caution)

“Contributes to” – assessment method

So what’s likely to be valid?

1. Set a minimum percentage of turnover attributable to E/S objective (e.g. 20% - but no minimum imposed by EC)
2. Proprietary assessment by the investment manager (subjective) – could include “best in class”
3. Use of external ESG ratings (disclose what are they based on?)
4. Use of alignment with UN SDGs as proxy for contribution to E/S objective

(...others available and valid too!)

"Contributes to" – how to report

Two contrasting approaches

True/False approach:

Assess whether investment meets SI definition. If yes, report 100% of value

Value-weighted approach:

Re-weight the value of investment based on proportion of activities which are sustainable

Commission: did <u>not</u> require firms to adopt a value-weighted approach (implicitly endorsing True/False approach)

Consideration of PAI at product level

Manager level

Consider external impact of PAIs on sustainability factors

Principal adverse impacts policy
Article 4 SFDR and RTS Annex 1
(or explain non-compliance)

Separate decision

Product level

Consider external impact of PAIs on sustainability factors

Principal adverse impacts policy
Article 7 SFDR, no RTS req'ts
(or explain non-compliance)

The problem:

- Unclear what it means to "consider" PAI at product level only (Article 7), when there are no technical standards
- Is it enough to disclose the relevant adverse impact of the investments....
- .... Or is it <u>also</u> necessary to take action to address the adverse impacts of the investments?

<u>COMMISSION'S ANSWER FOR PRODUCT-LEVEL PAI</u>

- **Not sufficient to disclose only the PAIs. Must <u>also</u> disclose procedures in place to mitigate adverse impacts**
- **BUT, not prescriptive as to what actions must be taken, so firms can subjectively define for themselves**

Article 9(3) products – clearing up the mess

Article 9(3)

- Products with a reduction in carbon emissions as the objective
- Either aligned with EU Climate Transition Benchmark (CTB) or EU Paris-Aligned Benchmark (PAB)
- Or if not, disclose how to attain reduction in carbon emissions in light of Paris Agreement

July 2021 Q&A

- Caused a lot of confusion in the industry
    - Seemed to say that only an article 9 fund could pursue a reduction in carbon emissions (excluding article 8)
    - Also seemed to say that article 9(3) funds must be passively managed
- *Answers were effectively wrong!*

April 2023 Q&A

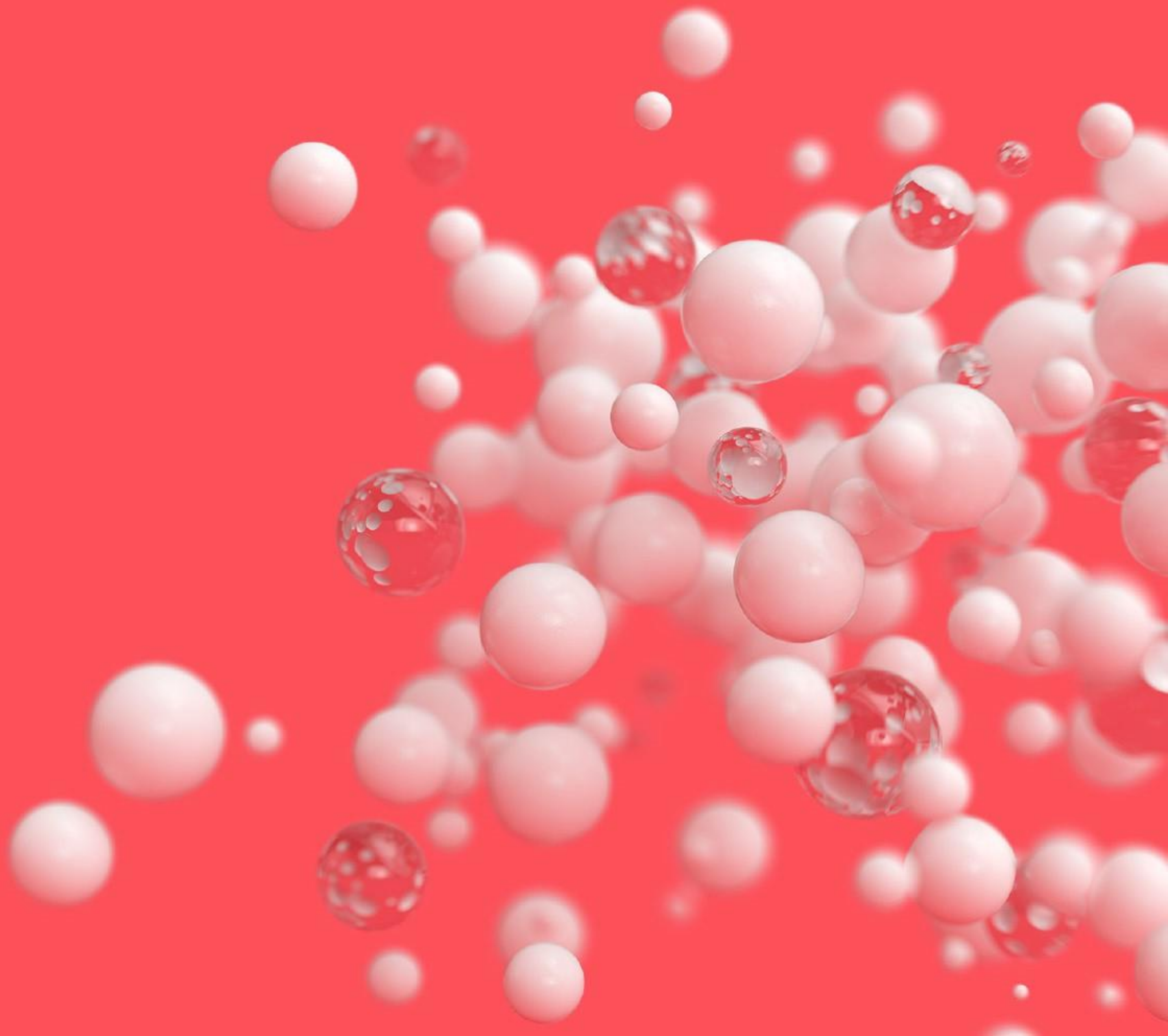
- Helpfully rows-back from the July 2021 confusion
- Now confirmed that article 9(3) funds can be active or passive
- Article 8 funds may validly promote a reduction in carbon emissions
- Most helpful: article 9(3) passively tracking a PAB or CTB is automatically deemed to be SI

What do we think?

- Q&A had potential to be very bad for the asset management industry (but it wasn't)
- Surprised by the broad / flexible view on definition of "sustainable investments"
  - Good for (most) firms
  - What if you'd already self-imposed a stricter standard?
  - Does this serve SFDR policy goals?
- Revised definition of "consider" PAI may give pause for thought
- Maybe Commission holding fire for "SFDR2"?

L_LIVE_EMEA1:104977903v2

Part 2
SFDR 1.5 – Consultation paper proposing major amendments to RTS (April 2023)



"SFDR 1.5" - overview

Response to April 2022 mandates from Commission

.... but scope goes significantly beyond

Mandate
- Expansion of PAI regime
- New disclosures: decarbonisation commitments

Scope creep...
- Enhanced DNSH disclosures
- Amendments to Article 8/9 disclosure templates
- "Technical" points – NB!

Who's caught?
- Any firm subject to entity-level PAI (Article 4)
- Any firm with Article 8 / 9 financial products

Consultation
- Consultation (not final rules)
- Still influence outcomes?
- Open until 4 July 2023

In force?
- Not officially confirmed but...
- *Rumour*: must comply with new rules from 2025
- No grandfathering proposed

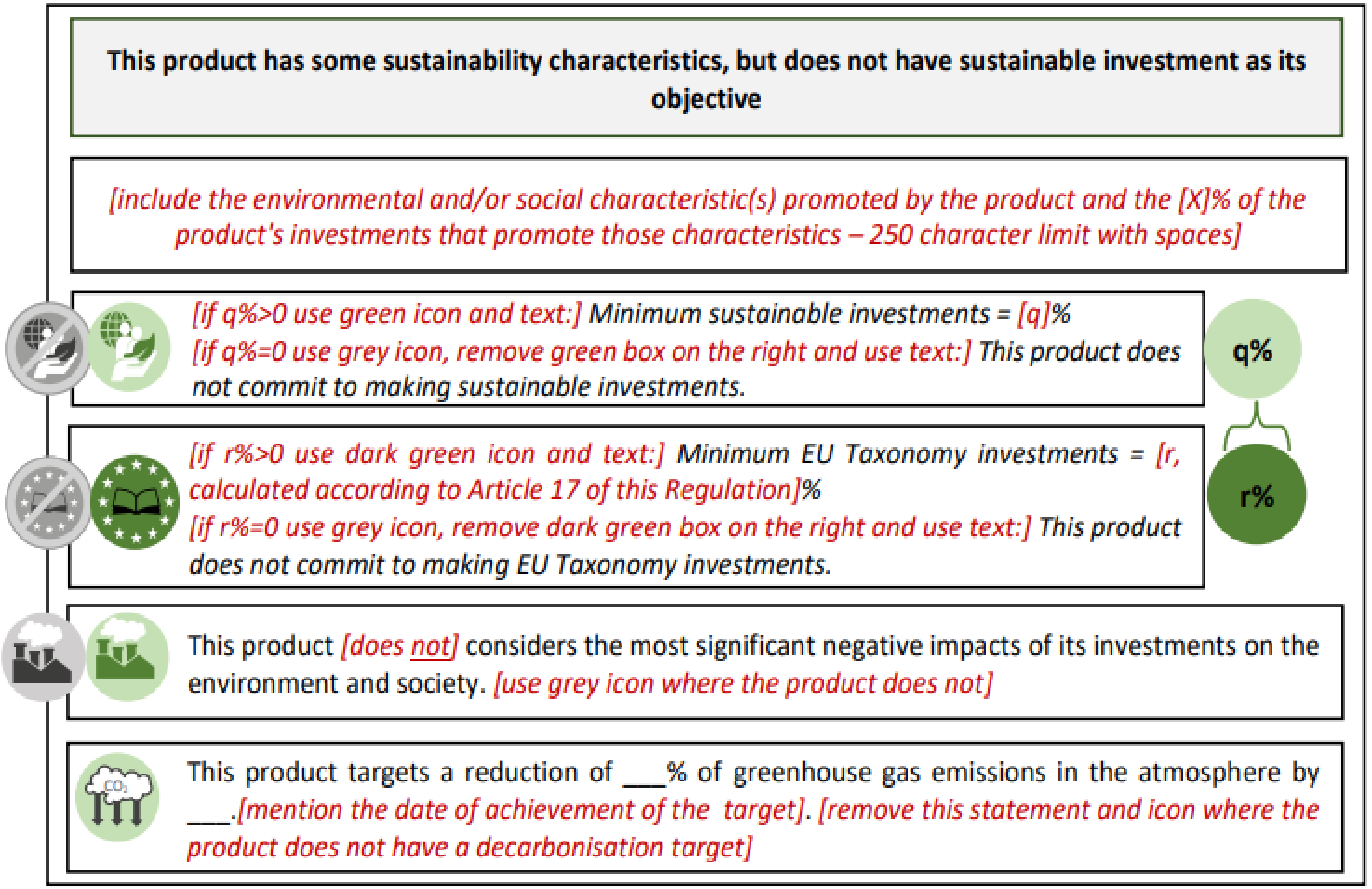
Decarbonisation disclosures – article 8/9

- New mandatory disclosures in pre-contractual, periodic and website disclosures
  - **Example: Does this product have a GHG emission reduction target? (Yes / No)**
  - If yes, additional narrative explanations and quantitative disclosures required

	[Baseline year]	*[Date of expected achievement of intermediate target]*	*[Add columns for other intermediate targets, where applicable]*	*[Date of expected achievement of the final target]*
GHG emission reduction targets (tCO_2-eq/€M)	*[GHG emissions in tCO_2-eq/€M, not including carbon removals and storage and credits]*			
GHG removals and storage (tCO_2-eq/€M) *[include row where relevant]*				
Carbon credits used by investee companies and/or purchased by the financial market participant (tCO_2-eq/€M) *[include row where relevant]*				

Revisions to article 8/9 templates

- New “dashboard” at the start of disclosure template (replaces current intro box)
- Other changes proposed: rewriting various questions
- <u>Note</u>: No grandfathering for existing funds and existing disclosures
- In practice… could be fourth re-write of fund docs in 5 years!



This product has some sustainability characteristics, but does not have sustainable investment as its objective

[include the environmental and/or social characteristic(s) promoted by the product and the [X]% of the product's investments that promote those characteristics – 250 character limit with spaces]

[if q%>0 use green icon and text:] *Minimum sustainable investments = [q]%*
[if q%=0 use grey icon, remove green box on the right and use text:] *This product does not commit to making sustainable investments.*

q%

[if r%>0 use dark green icon and text:] *Minimum EU Taxonomy investments = [r, calculated according to Article 17 of this Regulation]%*
[if r%=0 use grey icon, remove dark green box on the right and use text:] *This product does not commit to making EU Taxonomy investments.*

r%

This product *[does <u>not</u>]* considers the most significant negative impacts of its investments on the environment and society. *[use grey icon where the product does not]*

This product targets a reduction of ___% of greenhouse gas emissions in the atmosphere by ___.*[mention the date of achievement of the target]*. *[remove this statement and icon where the product does not have a decarbonisation target]*

PAI regime – proposed amendments

4 new mandatory indicators

- Earnings in non-cooperative tax jurisdictions
- Exposure to tobacco
- Interference with trade unions
- Employees earning less than adequate wage

6 new optional indicators

Relating to non-guaranteed hour employees, temporary employees, non-employee workers, disabilities, and complaints handling

Aligned with ESRS for CSRD

Other proposals

- Further mandatory calculation methods
- Confirm derivatives included via equivalent long net exposure
- Must net longs / shorts in individual investments
- Disclose % of info obtained directly from investee companies

DNSH disclosures

- Long-term concern that SFDR's DNSH test is judged subjectively (ESAs prefer Taxonomy)
- **Proposal:** firms must publish quantitative thresholds adopted for DNSH assessment as part of website disclosures
- **Seeking views:** safe harbour for Taxonomy-aligned investments… deemed to meet SFDR's DNSH test for environmental objectives?

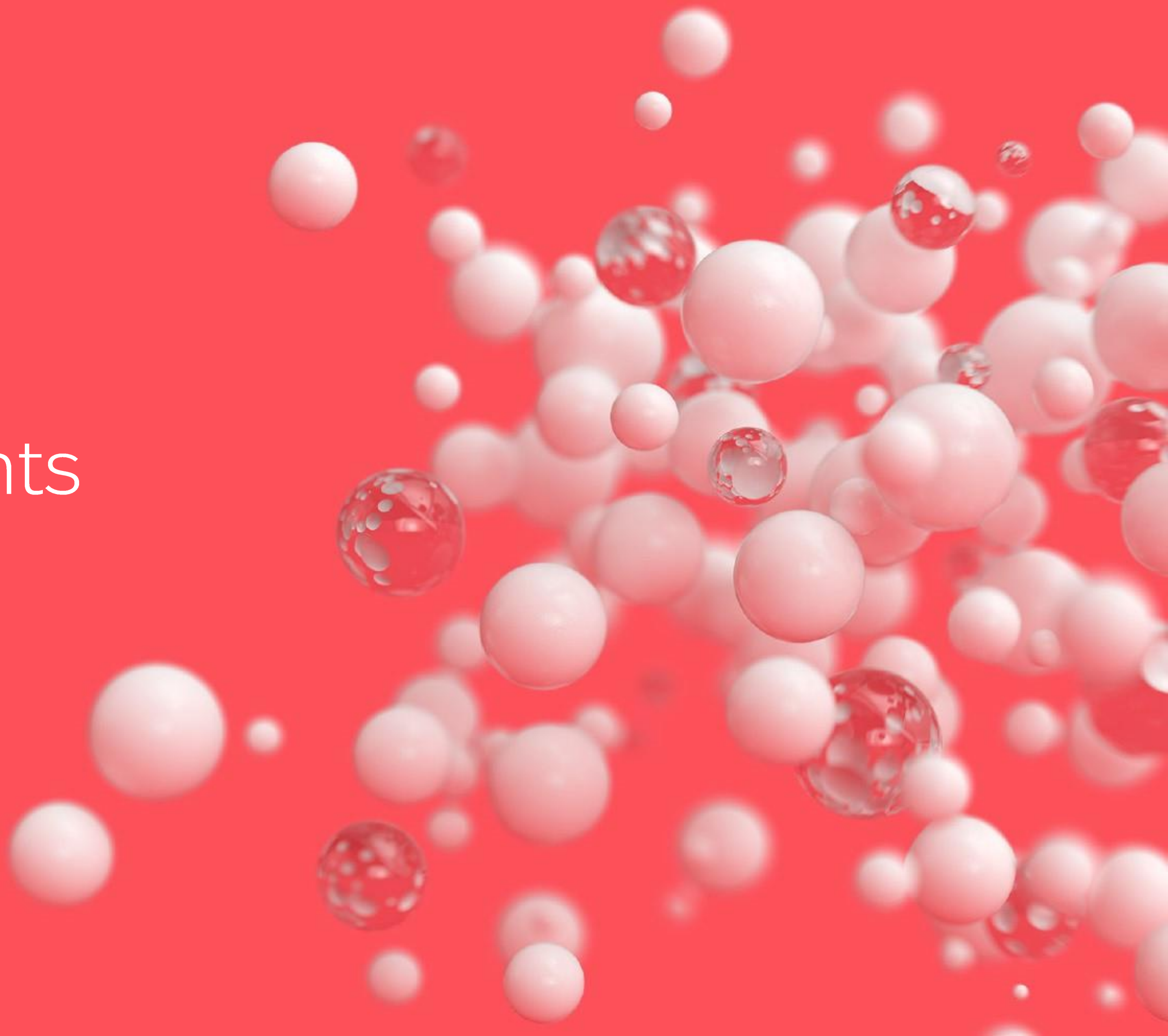
"Technical" clarifications proposed

The devil's in the detail….

1	**Taxonomy disclosures:** re-confirming that derivatives excluded from numerator, and must net shorts at individual position level
2	**SFDR – SI %:** proposal to follow PAI approach for <u>derivatives</u>, i.e. include equivalent long exposure in numerator of % calculation
3	**SFDR – SI %:** proposal to use Taxonomy approach for <u>netting</u>, and net gross long / gross short at issuer level
4	**SFDR – SI %:** proposal to require firms to use RTS Article 17 calculation methodology…
!	*…Does this remove the considerable subjective flexibility currently enjoyed by firms to define calculation formula?*

Part 3

Other SFDR developments

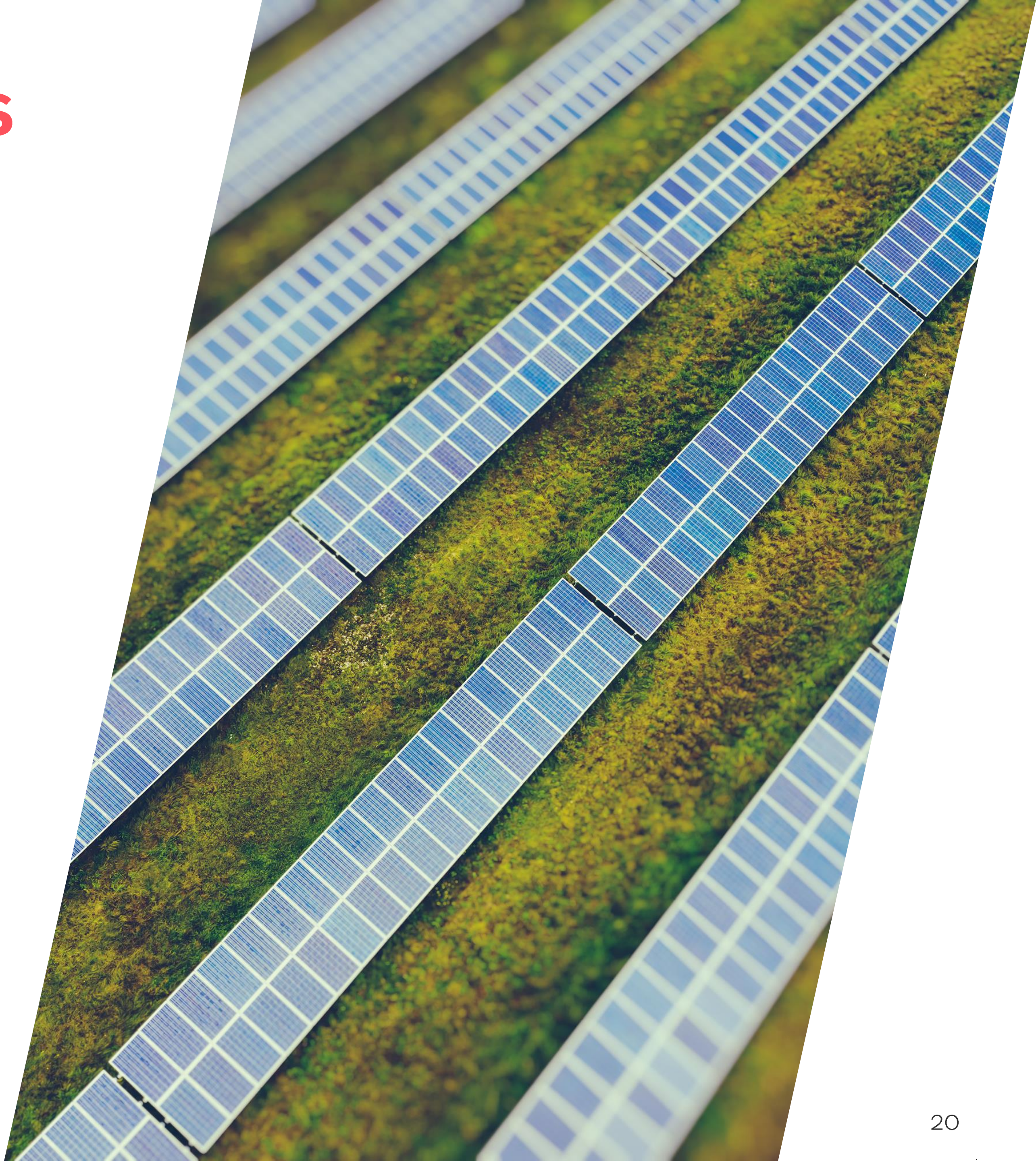


Other SFDR developments

- **Minor amendments to two prior sets of Q&A**
  - Deletion of "wrong" July 2021 guidance on article 9(3) funds
  - Minor changes to guidance on Taxonomy disclosures in May 2022 Q&A

- **ESMA fund names consultation:** not yet seen ESMA's response

- Many article 8/9 AIFs will have first periodic report due by 30 June 2023 (if the fund has a 31 Dec year end) using mandatory template
  - ✓ let us know if we can help!
  - ✓ We have a template guide for article 8



Audience Q&A

simmons + simmons

simmons-simmons.com

STRICTLY PRIVATE AND CONFIDENTIAL