SFDR – preparing for compliance

Post-webinar Q&A

25 February 2021

SFDR webinar Q&A

1. **Any thoughts about the difficulties of complying with SFDR in a multi manager structure?**

   Given the nature of a multi-manager structure, the input of all investment managers appointed in respect of each portion of assets will be required in order to reach a conclusion on how the fund should be categorised (i.e. whether an Article 6, Article 8 or Article 9 fund).

   If categorised as an Article 9 fund, the lead investment manager and underlying investment managers need to agree on a framework approach on how the relevant objective of sustainable investment will be achieved while in the case of an Article 8 fund, the lead investment manager and the underlying investment managers should agree on the environmental or social characteristics being promoted by the fund. Indicators to be used to measure the sustainability related performance would also need to be agreed upon.

   We have seen some lead investment managers setting a policy (prepared in conjunction with the underlying investment managers) around the integration of sustainability risk for the relevant fund which each underlying investment manager is then required to comply with. This approach has been adopted to avoid a scenario where each underlying investment manager has its own sustainability risk policy which could prove problematic when complying with the prospectus disclosure obligations under Article 6 of the SFDR in particular.

2. **Are SMICs in scope as well as mancos?**

   Yes, the definition of "financial market participant" includes both UCITS SMICs (which fall within the definition of "UCITS management company" under the SFDR) and internally managed AIFs (which fall within the definition of "AIFM" under the SFDR).

3. **Are UK based IM/Distributors obliged to comply with SFDR directly when providing portfolio management services / distribution services to an Irish financial product?**

   UK authorised investment managers and distributors do not fall within the definition of "financial market participant" under the SFDR and as a result are not directly subject to the provisions of the SFDR.

   UK investment managers will only be required to comply with any obligations arising under the SFDR to the extent that they are contractually obliged to so by the Irish management company/AIFM who will most likely require the UK investment manager's assistance and input in order to comply with its own obligations under the SFDR because of the delegated arrangement in place.

   Similarly, UK distributors appointed in respect of an Irish fund will not fall within the scope of the SFDR itself, nor will they fall within the scope of proposed changes to the MiFID rules relating to product governance. They will however be required to comply with relevant

UK/FCA rules as regards the ESG-related information that they must provide to clients. The situation will change if the UK decides to implement the SFDR or a similar type of disclosure regime and portfolio managers will need to monitor the situation accordingly.

4. **The ESAs or the Commission may issue further guidance or clarifications. Many firms will already have made calls using their best judgment in order to be ready on time for the 10 March 2021 compliance timeframe. What do they do if they got it wrong?**

   Firms will need to consider any guidance or clarifications issued by the ESAs or the Commission. There should not be any penalty in respect of calls made using their best judgment which are not consistent with such guidance or clarifications, but firms will need to consider updating their product classification and disclosures. They will also need to consider the impact on any distribution arrangements and representations which may have been made to investors in relation to the classification of the products, if they determine to change them.

5. **Is the requirement to look at principal adverse impacts ("PAI") at Manco level when complying?**

   Yes. Article 4 of the SFDR which deals with PAI reporting applies to "financial market participants" (which includes management companies) rather than applying to the funds under their management (which are "financial products" under the SFDR)".

   Article 6 of the finalised draft regulatory technical standards provides that the website should disclose the "adverse impacts of investment decisions **of the financial market participant** on sustainability factors".

   It is worth noting that fund prospectuses will be required to include disclosure relating to principal adverse impacts on sustainability factors under Article 7 of the SFDR.

6. **Could you confirm whether KIID updates are required in 2021 for SFDR? Assuming No?**

   SFDR does not explicitly require any update to KIIDs, as the prospectus is the pre-contractual document for SFDR purposes. However, any changes firms make to KIIDs in relation to SFDR may impact on KIIDs and so it is important to review the KIIDs for consistency with the updated prospectus documents.

7. **Are UK Investment Managers with Irish UCITS to be treated as FMPs or only required to comply with product level disclosures?**

   No. UK UCITS investment managers do not fall within the definition of "financial market participant" under the SFDR and as a result are not directly subject to the provisions of the SFDR. The situation will change if the UK decides to implement the SFDR or a similar type of disclosure regime and portfolio managers will need to monitor the situation accordingly.

They will only be required to comply with any obligations arising under the SFDR to the extent that they are contractually obliged to so by the Irish management company (or Irish UCITS fund in the case of a SMIC) who will most likely require the UK investment manager's assistance and input in order to comply with its own obligations under the SFDR because of the delegated arrangement in place.

8. Is there a minimum % for investments that need to be "sustainable investments" to qualify as Article 8 or 9 product?

No, although this question was raised by the ESAs in recent correspondence to the Commission seeking SFDR clarifications.

Under the SFDR, products in scope of Article 8 are those with one or more elements to their investment strategy that seeks to promote an environmental or social characteristic. The sustainable element of the investment strategy could provide for various investment approaches and strategies, from best-in-class to specific sectoral exclusions. The promotion of the sustainable element may be evidenced in the pre-contractual or periodic document, in the product's name or in any marketing communications about the product's investment strategy, financial product standards, labels it adheres to or applicable conditions for automatic enrolment. Under SFDR, products may be in scope of Article 8 irrespective of the level of their investment, in order to achieve the sustainable element of the investment strategy, in sustainable investments (as defined under the SFDR). Notably, however, in their recent request for SFDR clarifications from the Commission, the ESAs asked whether there is a minimum share of investments to attain the sustainable element of the strategy in order for a product to be in scope of Article 8.

Products in scope of Article 9 are those which have as an objective a positive impact on the environment or society. A product will be in scope if it exclusively pursues sustainable investments, i.e. the objective is to invest in economic activities that contribute to an environmental or social objective, provided they comply with the DNSH principle and investee entities follow good governance practices. While products in scope of Article 9 are expected to only invest in sustainable investments, there is no minimum % of the portfolio which must be invested in sustainable investments before a product can be classified as an Article 9 product. Pursuant to the ESA-adopted Level 2 measures, Article 9 products must disclose the % of the portfolio in investments which do not qualify as sustainable investments, what the purpose of those investments is, whether they are subject to minimum environmental or social safeguards and how such investments do not affect the delivery of the product's objective of sustainable investments. Again, the ESAs have specifically asked the Commission to clarify whether a product in scope of Article 9 is subject to a minimum level of sustainable investments/maximum level of investment in "other", i.e. non-sustainable investments.

9. How are 'grey' funds that do not have enough exclusions criteria to be an Article 8 product but do look at sustainability risks within the investment process to be treated?

The SFDR provides that the assessment of sustainability risk, as part of the investment due diligence and ongoing risk management processes, is necessary to comply with the UCITS Directive and AIFMD requirements to act in the best interest of end investors. As the SFDR obligates consideration of sustainability risk, the question has arisen as to whether such

consideration could, of itself, result in the products under management being classified as in scope of Article 8. In fact, this was specifically raised by the ESAs in their recent correspondence requesting SFDR clarifications from the EU Commission. While we await any forthcoming clarification, it is useful to note that although not specifically addressed in the ESA-adopted Level 2 measures, the ESA consultation on the RTS acknowledged this issue and noted that while the "SFDR will include requirements on the taking into account of sustainability risks for all products, the broad concept of 'ESG' integration should not be enough to justify that a product promotes environmental or social characteristics". The ESA's Final Report on the adopted RTS further "remind[s] all stakeholders of the overriding objectives of SFDR, which are to reduce greenwashing and to provide comparable sustainability reporting to investors." Assessment of sustainability risks in compliance with the SFDR, therefore, seems unlikely to bring a product in scope of Article 8 disclosure rules. Fund managers would be well advised to ensure SFDR mandated disclosures are clearly labelled as such to avoid any accusation of 'greenwashing'.

10. How does the SFDR framework fit within external, third party mancos, considering their business/delegated model?

Third party management companies come within the definition of financial market participant ("**FMP**") in the SFDR. Therefore, the entity level website, pre-contractual and periodic reporting requirements apply to the third party management company.

It is likely that investment managers, as delegates of the third party management company, will be asked to classify the funds under management as non-ESG funds, Article 8 funds (light green funds) or Article 9 funds (dark green funds) and to provide a confirmation as to this classification to the third party management company.

In relation to prospectus disclosures, we have seen third party management companies seeking back-to-back certification in relation to the compliance of prospectus updates with SFDR requirements from the investment managers in their structures so that the third party management company can provide the required self-certification to the Central Bank of Ireland ("**Central Bank**") in advance of the 10 March 2021 deadline.

The third party management company, as the FMP, will be responsible for publishing a sustainability risk policy on its website and for updating its remuneration policy to address sustainability risk factors. This section of the third party management company's website may also contain links to the equivalent policy of the investment manager.

FMPs are required to publish a principal adverse impact statement ("**PAIS**") on their websites if they consider the principal adverse impacts of their investment decisions on sustainability factors. Where they do not consider principal adverse impacts, FMPs must provide clear reasons for not doing so including, where relevant, information as to whether and when they intend to consider such adverse impacts. The detailed requirements as to what is to be contained in the PAIS are to be set out in level 2 regulatory technical standards ("**RTS**"). On an interim basis, third party management companies may decide not to publish a principal adverse impact statement on their website by the 10 March 2021 deadline on the basis that

the RTS will not be finalised and formally by that date (the RTS are expected to apply from 1 January 2022). Where a third party management company opts out of the PAIS requirements, should an investment manager wish to opt in and publish a PAIS, third party management companies may accommodate this by publishing relevant materials on the third party management company's website.

11. How is the 500 employee test to be applied – is it to be assessed at Manager level or parent level?

The requirement to publish a website statement on due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors applies to:

- managers with more than 500 employees (Article 4(3) SFDR);
- managers which are parent undertakings of groups with more than 500 employees on a consolidated basis (Article 4(4) SFDR).

From 30 June 2021, these FMPs are required to publish and maintain on their websites a statement on their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors.

In the context of this question it is worth noting that the ESA's **letter** to the European Commission dated 7 January 2021 in relation to priority issues relating to SFDR application raises two questions in relation to the interpretation of article 4(4):

- 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?

12. In Article 6 (1) (b) it talks of 'the results of the likely impacts of sustainability risks on the returns of the strategy'...what does that look like in practice? e.g. is it a qualitative or a quantitative response?

This is a Level 1 requirement and further details are not mandated at level 2. Therefore, very little detail is provided in the legislation as to how the disclosures relating to "*the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available*" should be drafted.

We expect that most managers will make narrative / qualitative disclosures relating to risk impact as opposed to quantitative disclosures.

13. Is there a view on how to address the overlapping AMF and SFDR requirements for prospectus changes given the fast-track submission is supposed to be limited to SFDR only? Have you seen any move towards using the disclaimer option for Art 8 or 9 funds impacted by AMF with intention to comply later?

It should be possible to draft the SFDR prospectus disclosures in such a way that the disclosures also meet the AMF requirements. As they are overlapping requirements, it should be possible to certify that the prospectus updates are related to the SFDR requirements and so are eligible for the Central Bank fast-track process.

While some managers are opting to address the AMF requirements as part of their updated SFDR disclosures, we are also seeing managers include the required disclaimer in fund marketing documentation where they do not comply with the relevant AMF requirements.

14. May I confirm that the sustainability indicators to be used for reporting on how an Art.8 fund measures its attainment of ESG characteristics can be as determined by the manager, i.e. the PAI indicators DO NOT apply?

Article 4 SFDR requires an FMP to publish a principal adverse impact statement ("**PAIS**") on its website if it considers the principal adverse impacts of its investment decisions on sustainability factors. The SFDR RTS provides a list of PAI mandatory indicators for investments in companies, sovereigns and supranationals and real estate assets.

Article 10 SFDR requires Article 8 and Article 9 funds to publish information on their websites on:

> *"the methodologies used to assess, measure and monitor the environmental and social characteristics or the impact of the sustainable investments made for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product."*

The Article 4 and Article 10 website disclosures are two distinct requirements and apply to different sections of the FMP's website. The mandatory indicators set out in the RTS apply to the PAIS only. Chapter IV of the RTS sets out separate requirements for the website product disclosures under Article 10. Article 32 of the RTS requires the FMP to include a section in its website disclosures titled "monitoring of environmental and social characteristics". This section must contain a description of how the environmental and social characteristics and the "*list of the sustainability indicators used to measure the attainment of each of the environmental or social characteristics promoted by the financial product*" are monitored throughout the lifecycle of the product and the related internal or external control mechanisms.

The European Supervisory Authorities ("**ESAs**") stated in their April 2020 **consultation paper** that the level of disclosure under Article 10 should be more than only high-level statements, as Article 10 states the information should be published "*in a way that it is*

accurate, fair, clear, not misleading, simple and concise". The ESAs prefer an approach that requires some common elements but the tailoring is left up to the FMP. The ESAs were conscious not to impose detailed Article 10 website disclosures as this would not take into account the various types of financial products, their characteristics and objectives and the differences between them. Therefore, while the PAIS mandatory indicators may inform the FMP's approach when drafting the Article 10 website disclosure, the Article 10 website disclosure does not need to be fully aligned with the PAIS mandatory indicators.

15. Regarding Principle Adverse Impact Statements – how are you seeing smaller firms address this? Are they complying or explaining? What do explanations look like?

We are seeing a range of approaches to these requirements by smaller firms. Those seeking to explain non-compliance, however, are generally relying on the basis for opting to do so as provided for under the legislation, i.e. on proportionality grounds.

16. Under Article 7, noting that the positive disclosure (i.e., that you do consider adverse impacts at fund level) is required by Dec 2022, but is the negative disclosure (noting that the fund doesn't consider adverse impacts) also due by Dec 2022, or is that effective in March 2021?

Leaving aside arguments relating to a potential drafting-error, management companies may want to consider addressing Article 7(2), which requires those opting to explain non-compliance under Article 4 to include a statement in the pre-contractual document of each product under management noting that the manager does not consider PAIs and the reasons therefor, as part of the SFDR related prospectus disclosures being made in advance of the 10 March 2021 deadline.

17. When determining the relevant product category and what disclosures are needed, must the EU-based FMPs include in their review, products which are not available to EU Investors, e.g. products in North America such as SMAs? Also taking into account if the FMP is providing those products under a different registration (i.e. SEC)?

Non-EU products, unless marketed in the EU, are unlikely to be in scope of the SFDR product requirements although compliance with the manager-level rules may necessitate review of non-EU products under management.

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