

European Commission Replies on SFDR Priority Issues

In January of this year, the European Supervisory Authorities (the "ESA") issued a letter¹ to the European Commission seeking interpretative clarity on certain priority issues of Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector ("SFDR").

The European Commission has now published (26 July 2021) its long-awaited reply to the ESA letter in a Q&A format² (the "SFDR Q&A"). While certain of the clarifications from the European Commission are found wanting in parts, the publication of the SFDR Q&A must be welcomed by industry.

In this update, we focus on the priority issues which the SFDR Q&A has provided further colour on.

SFDR Priority Issues

The ESA are tasked with preparing the regulatory technical standards to accompany SFDR ("draft RTS"). In its letter to the European Commission, it identified certain priority issues, namely:

- Application of SFDR to registered / sub-threshold AIFMs
- Application of SFDR to non-EU AIFMs
- 500 employee test and mandatory compliance with the principal adverse impact statement ("PAI")

¹ <https://www.esma.europa.eu/document/letter-eu-commission-priority-issues-relating-sfdr-application>

² <https://www.esma.europa.eu/document/ec-qa-sustainability-related-disclosures>

- Criteria for an Article 8 classification and a definition of 'promotion'
- Criteria for an Article 9 classification
- Application of SFDR to segregated mandates and dedicated structures

Application of SFDR to Registered AIFMs

Unsurprisingly, the European Commission has confirmed that SFDR applies to registered / sub-threshold AIFMs. It has formed its view by reference to the definition of a financial market participant ("FMP") under SFDR which traces back the definition of an 'alternative investment fund manager' to Article 4(1)(b) of AIFMD. The definition of AIFM under AIFMD contemplates both authorised and registered AIFMs.

Application of SFDR to Non-EU AIFMs

The European Commission has confirmed that SFDR applies to Non-EU AIFMs, where those Non-EU AIFMs are either managing EU funds or marketing funds in the EU via a national private placement regime. Again, in forming its view, the European Commission has referred to the definition of an FMP under SFDR, which traces back the definition of an alternative investment fund manager to Article 4(1)(b) of AIFMD. The definition of AIFM under AIFMD makes no distinction between EU and Non-EU AIFMs.

While there had been divergent views on the application of SFDR to Non-EU AIFMs, the European Commission's clarification on this point is not surprising from our perspective. This is precisely how the Maples Group formed our own view that Non-EU AIFMs (managing EU financial products or making available financial products in

the EU) were in scope of SFDR. Please see our previous client update, *Sustainable Financial Disclosures: Key Deadlines for Global Investment Managers*³, for further details.

The European Commission's confirmation that SFDR does apply to these Non-EU AIFMs cannot come as a surprise, as had it determined otherwise, it would have created an unlevel playing field between EU AIFMs and Non-EU AIFMs operating in the European Union.

500 Employee Test and PAI

The European Commission has confirmed that the calculation of the 500 person headcount should take into account the number of employees of an FMP which is a parent undertaking and of each of its subsidiary undertakings, regardless of whether they are established inside or outside the European Union.

The European Commission's reply is consistent with our long-standing interpretation of the Article 4(4) derogation. It is a two-limbed test, the FMP needs to be a parent entity (limb 1) and a parent of a large group (limb 2).

In determining both the large group criteria and the 500 employee headcount, one looks at the parent FMP and its underlying subsidiaries and not the wider group (which the FMP may form part). In circumstances where the relevant FMP is a parent undertaking of a large group with a 500 employee headcount (between itself and its subsidiaries), it is caught by Article 4(4) and such FMP must publish and maintain a PAI.

Criteria for an Article 8 Classification

The ESA sought clarity on the criteria for determining whether or not a financial product meets the Article 8 categorisation⁴.

³ <https://maples.com/en/knowledge-centre/2020/10/sustainable-financial-disclosures-key-deadlines-for-global-investment-managers>

⁴ A financial product which promotes, among other characteristics, environmental and/or social characteristics, provided that the companies in which the investments are made follow good governance practices.

The SFDR Q&A did not provide any minimum sustainability criteria for financial products to fall under an Article 8 categorisation, rather the European Commission noted that for a financial product to meet an Article 8 categorisation, the FMP must do more than simply integrate the consideration of sustainability risks into the investment decision-making process.

The European Commission also reaffirmed that the criteria that must be satisfied for a financial product to be considered as Article 9⁵ is significantly higher than for an Article 8 categorisation.

Definition of 'Promotion' under Article 8

This is the most surprising development in the SFDR Q&A. The European Commission has included an extremely broad definition of 'promotion' in the context of an Article 8 categorisation. Heretofore, it had been widely felt by industry bodies and stakeholders that promotion likely required the financial product to actively promote environmental and / or social characteristics in a way that was additional to the objective of maximising risk-adjusted returns.

The European Commission's definition of promotion in the context of Article 8 includes "*any claims, information, reporting, disclosures, impressions or general ambitions that investments pursued consider environmental or social characteristics in terms of investment policies, goals, targets or objectives*". As such, the test as to whether a financial product 'promotes' environmental and / or social characteristics is a subjective one, provided that such claims are disclosed in its pre-contractual disclosures. The extent to which the relevant Article 8 financial product meets its environmental and / or social claims is to be set out in the periodic report disclosures (as per the Article 11 requirements).

⁵ A financial product has sustainable investment or a reduction in carbon emissions as its objective.

In an another surprising turn, the European Commission also confirmed that a financial product will meet the criteria for Article 8 categorisation if it complies with international environmental, social or sustainability requirements or restrictions or applies its own proprietary exclusionary / screening lists codes, provided that these characteristics are promoted in the investment policy of the financial product. Again, it had been widely held that subscription to the UNPRI, the SASB or other sustainability frameworks or standards and / or the application of exclusionary and screening lists would not necessarily have met the test for promotion.

This expansive definition of what is understood by the promotion of environmental and / or social characteristics will certainly lead to the broadening of funds for consideration as Article 8. However, it would be our view that this definition should be approached cautiously. It seems to be at odds with the European Commission's own commitment to propose minimum sustainability criteria, or a combination of criteria for financial products that fall under Article 8, as set out in its Strategy for Financing the Transition to a Sustainable Economy⁶ published on 6 July 2021. It is quite possible that the European Commission could revisit the SFDR Q&A when it introduces the minimum sustainability criteria in the future.

Criteria for an Article 9 Classification

The European Commission did not set out a minimum share / percentage of sustainable investments required in order to meet Article 9 categorisation. However, an Article 9 financial product should primarily consist of sustainable investments, but may also include investments for certain specific purposes such as for hedging and liquidity purposes, once these are in line with the sustainable investment objective. Article 9 of SFDR remains neutral in terms of the product design, or investing styles, investment tools, strategies or methodologies to be employed or other elements, the pre-contractual disclosures

⁶ https://ec.europa.eu/info/publications/210706-sustainable-finance-strategy_en

must include information on how the mix, i.e. sustainable investments and non-sustainable investments, complies with the sustainable investment objective in order to comply with the 'no significant harm principle' as set out in Article 2(17) of SFDR.

This is consistent with our long-standing view that non-sustainable investments are allowed for Article 9 financial products where they do not prevent the financial product from attaining its sustainable investment objective.

Regarding Article 9 financial products that have the objective of a reduction in carbon emissions, i.e. an Article 9(3) financial product, the European Commission notes that where an EU Climate Transition Benchmark or EU Paris- aligned Benchmark exists, the financial product must track it. Where such a benchmark does not exist the pre-contractual information must include an explanation of how the continued effort of attaining the objective of a reduction in carbon emissions is ensured in order to achieve the long-term global warming objectives of the Paris Agreement. It is not clear whether the requirement to track the index if it exists applies only to passive funds. If funds are required to track an index where one exists it would essentially not allow any active funds have the objective of reducing carbon emissions.

The European Commission indicated that both the Low Carbon Benchmark Regulation criteria and the SFDR sustainable investment tests should be applied for EU Paris Aligned or Climate Transition Benchmark, and suggested that benchmark administrators are responsible for the implementation of these standards.

Application of SFDR to Segregated Mandates and Dedicated Structures

The European Commission took a conservative approach to its reply on this issue. It simply reiterated that segregated mandates and dedicated structure are financial products for the purposes of SFDR, and therefore are bound by

the same requirements as products falling within that definition.

The European Commission added that when making website disclosures, FMPs "*must ensure compliance with Union and national law governing the data protection, and where relevant, also ensure confidentiality owed to clients*". This is an indirect reference to Recital 35 of the draft RTS. Recital 35 acknowledges that compliance with website obligations under SFDR should not require FMPs to breach EU law on confidentiality and business information, i.e. the Trade Secrets Directive (EU) 2016/943. This Directive seeks to protect against the disclosure of sensitive business information (while also recognising the importance of confidentiality to business competitiveness and the commercial value of client lists). Nothing under SFDR compels FMPs to breach confidentiality terms (when seeking to adhere to their website disclosure obligations).

The European Commission also suggest that where FMPs "*makes use of standardised product solutions, transparency of those solutions might be a way for complying with requirements on website disclosures*". While this is strictly not consistent with Article 31 of the draft RTS (which mandates that disclosures are financial product specific), it displays a willingness on behalf of legislators to afford FMPs some flexibility in how they approach balancing their confidentiality obligations with their website disclosures obligations under SFDR.

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