Sept 2021 version

**Informal Q&A on the Sustainable Finance Disclosure Regulation**

Further to AIMA discussions with members on the application of the EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector ('SFDR'), AIMA has put together the following list of questions and answers, based on discussion with AIMA members to help firms gauge how to approach the implementation of SFDR-related requirements.

This informal Q&A document maybe updated in due course as further questions are posed and as industry or regulatory perspectives on these points evolve. The discussion as summarised here should not be seen as explicit guidance and individual firms might have a different interpretation of the rules.

If members have any questions on the SFDR, please contact Marie-Adélaïde de Nicolay (madenicolay@aima.org ).

**Pending RTS related to the SFDR**

- Draft Regulatory Technical Standards ('draft SFDR RTS') supporting the implementation of SFDR were published by ESMA in February 2021 recommending an application date of 1 January 2022. AIMA provided comments to EU policy-makers on those draft RTS (available here) to EU policy-makers and engaged with the Commission regarding Article 8 scope. The SFDR draft RTS are now being reviewed by the European Commission and it is unclear when these will be published. After publication, they will be subject to a 3-month scrutiny period (that can be prolonged by another 3 months) by the Council and European Parliament, which can either reject or adopt the draft.
- A consultation on draft RTS for products in scope of Articles 5 and 6 of the Taxonomy Regulation (applying to SFDR Article 8 and 9 products) is ongoing. Those draft RTS clarify the reporting of the alignment of the environmentally sustainable investments with the Taxonomy Regulation for Article 9 products seeking an environmental objective and Article 8 products that are investing in environmentally sustainable activities (so a subset of Article 8 products). The ESAs intend to publish their final report in the beginning of the summer.

**Other regulatory documents**

- In its letter to EP and Council on the SFDR RTS application date (7 July 2021) (the 'July 2021 Letter') , the Commission informed stakeholders that it plans to "bundle" all SFDR-related RTS (including the RTS related to the implementation of Article 5 and 6 of the Taxonomy Regulation) in one single delegated act and defer the dates of application by 6 months, to 1st July 2022 instead of 1st January 2022.
- In a letter ('the SFDR Letter') to ESMA[1], the European Commission confirmed that firms would still need to comply with the SFDR Level 1 regulation, but it remains unclear how firms would

[1] Available at :

be expected to comply with those Level 1 measures which require technical standards to supplement the headline Level 1 rules.
- In its SFDR Letter, the EC states the following (all emphasis added):

  "The Regulation lays down at Level 1 general principles of sustainability-related disclosures in three distinct areas.

  As regards the **integration of sustainability risks** in investment decision-making processes, financial market participants, in accordance with applicable sectoral legislation, already consider sustainability risks in their internal processes. The Regulation requires transparency in this respect, with no further details in regulatory technical standards.

  As regards **financial products that qualify under Articles 8 and 9** of the Regulation, in accordance with applicable sectoral legislation, product manufacturers must already describe in the product documentations how the levels of sustainability are achieved. This means that the manufacturers must comply with the disclosure principles set out in Articles 8 and 9 of the Regulation.

  As regards **transparency of adverse sustainability impacts**, numerous financial market participants already currently comply with the non-financial reporting requirements under Directive 2013/34/EU or adhere to international standards and might consider using that information. Even without the full regulatory technical standards, there are no impediments to financial market participants and financial advisers complying with the Level 1 requirements laid down in the Regulation."

It is worth noting that the statement in relation to the disclosure of principal adverse impacts is not clear. It seems that the expectation is to use indicators provided by the current NFRD framework when available, or by other international standards, but the extent to which this is applicable to firms operating in other markets (smaller firms not reporting under NFRD, private markets or sovereigns for example) is not clear.

On 7 January 2021, the ESAs sent a list of "priority questions" to the EC which would "benefit from urgent clarification to facilitate an orderly application of SFDR from 10 March 2021." Those questions mainly relate to the following topics:

- the application of SFDR to non-EU Alternative Investment Fund Managers (AIFMs) and registered AIFMs;
- application of the 500-employee threshold for principal adverse impact 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.

**Answers to these questions by the EC may affect the responses to the questions stated in this informal Q&A. The EC has answered the ESAs' questions on 14 July 2021 with a Q&A (the '[SFDR Q&A'](SFDR Q&A)).**

**Note on the SFDR Q&A**

The European Commission's answers to the ESAs list of priority questions can be summarised as follows:

**Application of SFDR to sub-threshold AIFMs**
The Q&A confirms the application of the SFDR requirements to sub-thresholds AIFM both at the entity level and in the pre-contractual documentation and periodic reports. Since sub-threshold AIFMs are not subject to the AIFMD Article 23, the reporting should be done in the documentation required in national law

**Application of SFDR to non-EU AIFMs**
The Commission notes that in the absence of a third country passport, the SFDR applies to non-EU AIFMs which market their funds in the EU via the national private placement regimes (NPPRs – Article 42 of the AIFMD). The exact position of the EC is: "*Where an AIFM from a third country enters the market of a given Member State by means of a National Private Placement Regime, that AIFM must ensure compliance with Regulation 2019/2088, including the financial product related provisions*."

The specific reference to « financial products » confirms the fact that the rules apply at the product level. It does not entirely shed light on the entity-level requirements and whether non-EU AIFMs marketing their funds in the EU via NPPRs should comply with entity-level provisions in respect of their EU-marketed funds, such as the publication of their sustainability risks policy, the update of the remuneration policy and the compliance with principal adverse impact considerations.

AIMA members confirm that there is no consensus in the industry on this matter and compliance with SFDR needs to be assessed on a case by case basis. Some firms are taking a similar approach than the AIFMD whereby it was always the product that was intended to be in scope under AIFMD Article 42.

**500-employees thresholds for the PAI considerations' disclosure**
In the context of a financial market participant being a parent undertaking belonging to a group, the 500-employee threshold should be calculated taking into account the group (as referred to in Article 3(7) of Directive 2013/34/EU on consolidated financial statements). However, the information reported should be adapted to the specific situation of the "parent undertaking" (i.e the financial market participant in scope of the SFDR) and not to the group as a whole.
As an example an EU AIFM in scope of SFDR with less than 500 employees but which is a parent to a larger group totaling more than 500 employees in the EU should be reporting on PAI considerations the purpose of the investment decisions made by the EU AIFM.

**Article 9 scope**
Article 9 funds should be entirely composed of "sustainable investments" , except for instruments used for hedging or liquidity purposes. "Sustainable investments" are defined in Article 2(17) of

the SFDR as "*an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance*."
The investments should also comply with the "do no significant harm" (DNSH) principle.

To be noted that instruments used for specific "hedging or liquidity" purposes can be used, provided they meet 'minimum environmental or social safeguards, i.e. investments or techniques for specific purposes must be in line with the sustainable investment objective'.

It should be noted that the SFDR "sustainable investment" definition includes activities listed in the EU Taxonomy but is not limited to them, so investment managers have a degree of latitude in terms of defining their own sustainable investment universe.

The Q&A confirms that the SFDR is neutral as regards "*investing styles, investment tools, strategies or methodologies*" to be applied by the fund manager, but the product documentation must "*include information on how the given mix complies with the 'sustainable investment' objective*" and the "*do no significant harm principle*"

**Article 8 scope**

The Q&A provides information on several aspects of the SFDR Article 8 provisions:

- It confirms that no minimum investments are required for a product to be classified as Article 8.
- The reduction of negative externalities "*such as principal adverse impacts on sustainability factors*" "*may*" lead to the categorisation of a fund as an Article 8 fund. The Q&A does not seem to imply that the consideration of such negative externalities automatically brings the fund in Article 8.
- Article 8 funds can also be invested in "sustainable investments" in part.
- The integration, per se, of "sustainability risks" (as defined in Article 2(22) of the SFDR as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment) is "*not sufficient for Article 8 to apply*".

**Meaning of "promotion"**

- The Q&A also intends to clarify the scope of Article 8. Article 8 provisions should apply to any fund that meet 2 conditions:

- It complies with certain environmental, social or sustainability requirements or restrictions laid down by law, including international conventions, or voluntary codes;
- Such characteristics are "promoted" in the "investment policy".

- The Q&A further clarifies the meaning of "promotion" in this context, which seems to be interpreted in a broad way as it encompasses for example, "direct or indirect claims, information, reporting, disclosures as well as an *impression* that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition".
- Such "impressions" can appear in:
    - pre-contractual and periodic documents
    - marketing communications,
    - advertisements,
    - product categorisation,
    - description 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
    - or compliance with sectoral exclusions or statutory requirements

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

A few comments on this definition:

1- The meaning of promotion has been the focus of many industry participants as the scope of Article 8 was not clear. The definition of promotion is broad and not necessarily related to the concept of marketing, but rather to whether a product considers E or S characteristics in its investment policies.

2- The focus is on disclosures and on ensuring that any ESG claim attached to a product is backed by the substantial disclosure requirements detailed in the draft RTS.

3- The definition is however focused on the product. However, adherence to voluntary codes (for example UNPRI) is often done at the level of the firm and might potentially not apply to all products managed by the firm, depending on the underlying strategy of each funds and the relevance of E or S characteristics of those funds. A distinction should therefore probably be made between the commitments at the level of the firm, and the actual products managed by the firm to which those commitments specifically apply and are referenced in the product's documentation.

4- AIMA members seem to agree on the fact that the Q&A does not change much as regards the product classification that was made on the basis of the level 1. Members based their classification on the ESG claims of the product, considering that one of the primary objective of the SFDR is to mitigate green washing. Members acknowledged that the bar to classify funds as Article 8 has been lowered, but they are still applying caution to their classification exercise, noting the proposal made by the Commission in its renewed sustainable finance strategy to add further minimum sustainability criteria to Article 8 funds in the near future.

5- Members noted that the exclusion criteria's or UNPRI principles can be considered as part of sustainability risk management and that in those cases they would often clearly declare no intentions of considering such a product as product with E or S characteristics.

*****New Questions *** (July 2021)**

**SFDR level 2 delay and disclosure deadlines following the July 2021 Letter:**
**- Will the PAI June 2023 reporting start date be pushed back by 6 months as well ?**

[As per the ESAs draft SFDR RTS: "t*he RTS establishes a framework of reporting on principal adverse impacts by 30 June each year with a reference period of the previous calendar year.*

*However, where a financial market participant publishes the principal adverse sustainability impacts statement in accordance with the RTS for the first time, the RTS does not require the disclosure of information relating to a previous reference period. This means that the earliest information relating to a reference period to be disclosed in accordance with the RTS would not be made until [June] 2023 in respect of a reference period relating to 2022.]*

It is not certain that the PAI report disclosure will be pushed back by 6 months since the "30 june of each year" deadline is independent from the draft SFDR RTS deadline to which the pushback applies.

**- Will the pre-contractual templates need to be in place by 1 July 2022 and how to approach the 1 July 2022 deadline for periodic reports ?**

For periodic reports published before 1 July 2022, firms should do a principles-based high level report on the basis of the level 1 text. Members are also taking the view that even if the periodic report is due after July 2022 but covers a period during which the RTS do not apply then complying with the full set of details of the RTS might also not be necessary.

The July 2021 Letter also seems to apply the Taxonomy Regulation requirements related to articles 5 and 6 (the Taxonomy Regulation level 1 applies from 1st January 2022) as the Commission expressly mentions those RTS in the letter. Members mentioned that the Taxonomy Regulation is so detailed that it would be difficult to apply a "principles-based" disclosure should the RTS not be ready by 1 January 2022. This is also to be linked to the application of the Taxonomy Regulation requirements to issuers (Article 8 of the Taxonomy) which will only be applicable from 1 January 2022. There will only be very scarce data for periodic reports to be published in the course of 2022 covering the period of 2021 and even the 2022 period.

As regards PAI disclosures at the product level (Article 7 of the SFDR) which are not subject to RTS but only to level 1 and are due by 30 December 2022, the expectations seem to be that the disclosure does not need to be as detailed as under Article 4 and so should not be affected by the content of the RTS anyway

AIMA

**SFDR public disclosure vs US general solicitation rules: are members aware of the conflict between the SFDR fund-level public disclosure rules and the US rules on general solicitation, and how are members approaching this conflict ?**

Members who discussed this topic were aware of the challenge the EU rules could pose in relation to the.US general solicitations rules but it did not seem to impact their own operations.

**RTS - Article 8 pre-contractual disclosure: How to apply the requirement regarding the *"committed minimum rate to reduce the scope of the investments considered prior to the application of the investment strategy"*? Is there a positive obligation to designate a minimum rate that would potentially be reduced each year ?**

Members were not reading this sentence as a commitment, but rather as an expectation of the reduction of the investable universe.

**Draft SFDR RTS - Recital 19: how have members approached this Recital? Is a view emerging in the industry according to which this Recital does not mean that, if you consider PAI, you might have inadvertently tipped all your products/services into Article 8 SFDR ?**

*"(19) One of the ways in which financial products can promote environmental or social characteristics is to take into account principal adverse impacts of investment decisions. Financial products that have a sustainable investment objective must also consider adverse impact indicators as part of their disclosures of no significant harm to sustainability objectives. For these reasons, financial products should indicate whether they consider principal adverse impacts of investment decisions on sustainability factors as part of their disclosures in this Regulation."*

It seems that members have always seen PAI and Article 8 as distinct and this view remains, including when reading Recital 19: by disclosing PAI you do not bring all your products in Article 8 as there is no express promotion of E or S characteristics. Reducing the PAI of a portfolio does not seem like a characteristic which is binding enough to be able to classify your products as Article 8.

**- Treatment of feeder funds: how to treat a feeder fund investing in an Article 8 fund ? In the case of fund platforms where a feeder entity or similar is established to make investments on behalf of clients in a particular closed ended fund: some of these underlying funds are classified as Article 8 funds for SFDR purposes, but it is unclear whether a feeder fund (that is managed separately) should also be treated as an Article 8 vehicle, or whether it can choose to be on the basis it invests solely in an underlying article 8 fund.**

Members were of the view that it really depends on how the feeder fund is presented but feeder funds could be classified as Article 8 where there is a non-discretionary feeder with a look through to a master fund which has no prospectus itself (similarly to how feeder funds are treated under AIFMD) and does have E or S characteristics. If the feeder can invest elsewhere and has a discretionary mandate, then the structure needs to be thought about more carefully.

The categorisation of an Article 8 feeder fund should always be carefully documented.

As regards funds of funds, the situation is more complex as the information is not necessarily available and they can be invested in a mixture of funds of funds, with different characteristics, evolving over time. It also depends on whether there is a binding criteria at the level the fund of funds' documentation which ensures that binding E and/or S characteristics also appear at the level of the underlying funds regardless of the turnover of the portfolio.
Members also noted that some fund of fund managers are putting pressure on their underlying managers to categorise their funds as Article 8.

Members also discussed **Article 8 classification** and referred to the renewed sustainable finance strategy[2] and the fact that Commission's lawmakers are already thinking of introducing minimum sustainability criteria for Article 8 products in the RTS when reviewing the SFDR RTS in 2022. Members discussed the fact that this tended to prove that the choice to ensure that Article 8 categorisation relied on positive criteria was safe. For example any E or S negative screening would need to have a meaningful impact on the investment universe rather than being an irrelevant screen for a product to be categorized as Article 8.

Members further commented on the fact that it seemed also to be the view of the Luxembourg CSSF that very basic, irrelevant negative screening policies were not enough to classify a fund as Article 8.

**Derivatives: How do members treat derivatives in the context of SFDR disclosure, are there some look-through methodologies emerging ?**

As regards the use of derivatives in the context of an Article 8 or 9 fund, provided that the derivative helps achieving the E or S characteristics or objectives, then it should be fine to use this instrument. There should however be a look through of this derivative, probably dependent on the nature of derivative. For example managers are usually aware of the basket of values related to a total return swap and should be able to look through and do the analysis regarding the characteristics. Some members notably used guidance offered by the French SRI label.[3]

There is also some guidance in the context of hedging, which is seen as a neutral instrument.

Other members still outlined the complexities related to ESG reporting in the derivatives markets as regards access to information, the control over the quality of E and S features within the derivative and whether it was actually a deliberate feature of the instrument or incidental and how to take account of those elements in the context of ensuring binding characteristics of the product.

Some members mentioned that they have all sorts of funds that use derivatives, and try to understand whether they should distinguish between index or baskets of stocks where the fund has very direct exposure.

[2] Available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390 (6 July 2021)
[3] Available here: https://www.lelabelisr.fr/wp-content/uploads/SRI-Label-Guidelines_EN_july2020updates_modifications.pdf (July 2020)

**Short positions: how are firms approaching the disclosure of short positions in the SFDR and in the more broader responsible investment context ? Are people using the netting mechanism or adding the positions, or disclosing long and shorts separately, or simply disregarding shorts ?**

As regards short selling, members discussed the increasing use of short selling to express an ESG view and contribute to an E or S characteristics. The UNPRI referenced short selling in recent papers[4] and some regulators (including the FCA) seem open to the idea of short selling contributing to E or S characteristics.
As regards the reporting of short selling, some members reported internal debates on this matter. For some positions short positions could be netted off with long ones, but when it comes to carbon emissions or PAIs the general view was that it is better to report the positions separately, long vs short.

Members also discussed the idea of buying carbon offsets when the strategy does not have links to E or S characteristics (for example credit distress strategies) in order to qualify as Article 8 funds. Members were hesitant to account for carbon offsets to get carbon neutral and tend to rather focus on encouraging issuers to be transitioning their core business models. Buying offsets was described by members as a weak Article 8 fund characteristic.

- **Delegated Acts integrating sustainability factors in the AIFMD and UCITS Directive and MiFID level 2**

**Under the amendment, Article (30) now requires AIFMs to manage the conflict of interests with respect to the integration of sustainability risks, and the final report by ESMA, explains a bit further that this might include *"conflicts of interest arising from remuneration or personal transactions of relevant staff as well as any sources of conflicts that could give rise to greenwashing, misselling, misrepresentation of investment strategies or churning"*. It is unclear how the Manager might implement policies to avoid this type of conflict of interest. Are you able to share any advice on how to implement this?**

The mitigants would be robust policies and clarifications around the product governance, around the checks that need to get done, audit trail records, etc.

***** Older Questions*****
**Q. What is members' feedback on the implementation of SFDR as of April 2021 ?**

Reference was made to the Morningstar survey on the implementation of SFDR. Members shared their relatively prudent approach as regards the classification of funds as Article 8 and consider this space as challenging as there is no consistency in the market on the criteria used for classification. Some criteria mentioned were the ability for the manager to be able to justify its classification if called by a supervisor, as well as "playing the long game" rather than tick the box. Some managers are revisiting some of their internal criteria in view of the general trend in the

[4] Available here: https://www.unpri.org/hedge-funds/technical-guide-esg-incorporation-in-hedge-funds/5729.article (March 2020)

market, as well as some allocators expectations (it was mentioned that some allocators are leaning towards distribution of Article 8 funds only). A possible "race to the bottom" was mentioned although it is also expected that as the market matures, investors, distributors and fund managers will have a more sophisticated approach to the SFDR classification. The MiFID II delegated acts introducing the concept of "sustainability preferences" (referring to either sustainable investments or principal adverse impacts) should also contribute to refining the offer for sustainable funds.

- Considerations of short positions and derivatives

- Reference was made to ESMA's advice on the implementation of the Taxonomy at the level of financial institutions (Article 8 of the TR) and the ability to be able to use netting mechanisms to account for short positions. Members discussed how to go through the internal process and how to report on the value of short or derivatives positions (delta notion value or others), including for indices and ETF. Members discussed setting up and summing up binding criteria on quantitative strategies as well as reporting on carbon footprint, working with data vendors knowledgeable of the HF space.

- As regards commodities or FX, some members are starting to collect data on commodities contracts, talking with derivatives exchanges on this (metal, silver, agriculture products) as data is scarce. The objective is to understand how to be taxonomy compliant. Members discussed trading existing futures contracts on oil, and whether this contributed, or not, to support the use of more oil-based activities. Oil is considered as a sensitive commodity and for some it's becoming difficult to hold oil-related assets in any manner.

- As regards the reporting on those positions, the rapid movements of portfolios were also mentioned as a challenge as a long positions can be shorted the day after and a snapshot does say much to the investor.

## SCOPE – FINANCIAL MARKET PARTICIPANTS

1. **How to treat non-EU AIFMs under the SFDR:**
    - **To what extent the product disclosure obligations apply to non-EU AIFMs?**
    - **To what extent the entity disclosure obligations apply to non-EU AIFMs?**

Most firms are taking the view that product-level requirements (Articles 6, 8, 9, 10 and 11 of the SFDR) apply to AIFs managed by non-EU AIFMs when they are marketed in the EU via the national private placement regimes ('NPPR' – Article 42 of the AIFMD). There are split views as to whether, entity-level requirements (Articles 3, 4 and 5 of the SFDR) would apply to non-EU AIFMs when they are marketing AIFs in the EU. Some firms take the view that, similarly to AIFMD entity-level requirements, the SFDR entity-level requirements do not apply to non-EU AIFMs even when such firms market their funds in the EU, when others do apply these requirements at the level of the manager, but only in relation to the funds that are being marketed in the EU.

If a particular AIF is made available by a non-EU AIFM exclusively in response to a reverse enquiry from an EU investor, then such AIF would not be in scope of SFDR product-level requirements (even where the non-EU AIFM has other AIFs which have been registered under NPPRs).

Article 7 is a product-level requirement but its application is limited to those firms that disclose principal adverse impacts ('PAI') at the level of the entity, as per Article 4. The application of Article 7 to AIFs managed and marketed in the EU by non-EU AIFMs would therefore depend on whether the non-EU AIFM discloses PAI as per Article 4.

In the case of a non-EU investment firm with a segregated mandate from an EU client, members have expressed diverging views. Some are of the view that the requirements do not apply because the MiFID disclosure obligations under Art 24 MiFID (per Art 6(3)(h) SFDR) would clearly apply to authorised MiFID firms only. Some are of the view that this is further supported by the fact that Art 2(5) SFDR refers to 'investment firm' as defined in Art 4(1)(1) MiFID. On the face of it, this MiFID definition may look location-neutral, but arguably it does not include non-EU investment firms. Indeed, Art 4(1)(57) MiFID provides for a separate definition for 'third-country firm' which reads as follows: "a firm that <u>would be</u> (…) an investment firm if its head office or registered office were located within the Union" (emphasis added). Reading paras (1) and (57) together, it seems that para (1) only includes EU firms, whereas 'third-country firms' are a different type of institution. Hence, if SFDR only refers to para (1), it somehow gives the impression that 'third-country firms' are excluded from SFDR.

Others are of the view that the rules are clearly meant to apply on an extraterritorial basis, to a certain extent, and would apply to contracts between a non-EU investment firm and an EU client. This may also depend on how the individual member states deem portfolio management to be taking place. The principles of investor protection and level playing fields will be key in determining how the scope is interpreted.

**-Applicability of the requirements to existing mandates or existing funds: with MiFID II, has the industry taken the view that almost all new pre-contractual disclosures required by MiFID II needed to be given to existing clients by the date MiFID II came into force – i.e. to ensure the new law was complied with. Would the same approach prevail under the SFDR,– i.e. with portfolio management and advisory clients?**

As regards whether pre-existing contracts with segregated mandates should be (i) updated with product-level disclosure, and (ii) whether this should be done by 10 March 2021, it seems again that views are split. Some EU AIFMs or UCITS Mancos delegating to investment firms seem not to be considering updating their existing investment management agreements on the basis that requirements apply to "pre-contractual" disclosures, while others are being advised to do so on the basis that the expectation is that the SFDR applies to existing financial products.

As regards closed-ended funds, the view among AIMA members again was split but it seems that the private equity industry is relatively comfortable with considering that the requirements do not apply as these funds are not being marketed anymore.

Existing open-ended funds should however update their private placement memorandums or their prospectus. It was mentioned that the “fast-track” procedures put in place by the CSSF and the CBI for prospectuses demonstrate that the supervisors’ expectations is that requirements apply to pre-existing funds. Some members shared that a common practice is to update the pre-contractual documents on the website, and send to clients a notification informing them on the changes with a hyperlink to the document.

**- Applicability of the requirements to sub-threshold AIFMs**

Theoretically, the SFDR does not differentiate between sub-threshold or fully authorised AIFMs and sub-threshold AIFMs are caught by the SFDR’s definition of an AIFM[5]. In practice, there seems not to be a consensus, but some participants raised the fact that under the AIFMD, the pre-contractual disclosures and periodic reporting requirements (AIFMD Article 22 regarding annual reports and AIFMD Article 23(1) regarding pre-contractual disclosure) do not apply, which could mean that at least the product-level disclosure requirements would not apply to sub-threshold AIFMs.

The counter-point to this view is that the disclosure rules in SFDR do not expressly turn on an AIFM’s authorisation status under AIFMD, and do not turn on whether or not the AIFM is required to produce Article 23-compliant disclosure documents

Sub-threshold AIFMs are also usually governed by local rules and so the applicability of the SFDR could be down to the local supervisor/regulator’s rules.

**- Applicability of the product requirements to Article 34 AIFMD (non-EU AIFs not marketed in the EU managed by EU AIFMs) funds**

There is not yet a consensus in the industry as to whether SFDR product-level disclosures apply to a non-EU AIF which is managed, but not marketed in the EU, by an EU AIFM (known as “Article 34 funds”).

On the one hand, Article 34 funds are effectively exempt from the requirement to produce AIFMD Article 23 disclosures, and SFDR product-level disclosures are required to be made in the Article 23 disclosure document. Where a particular fund is not required to produce an Article 23 document, it may be inferred that there is no requirement to include SFDR disclosures.

On the other hand, SFDR is not jurisdictionally limited to making disclosures only to EU investors. As a general proposition, an in-scope EU AIFM would be required to make SFDR disclosures to both EU and non-EU investors. As such, the absence of EU marketing does not exempt an EU AIFM from making SFDR disclosures. In addition, nothing in SFDR states that an AIFM is exempt from making SFDR disclosures where it does not produce Article 23 disclosures. (It was perhaps merely a drafting oversight, to assume that all in-scope AIFs produce Article 23 disclosures.)

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[5] By reference to the definition of an AIFM in AIFMD Article 4(1)(b)

**- How to calculate the 500-employee threshold related to PAI disclosure in group scenarios when each of the EU FMP subsidiary or branch taken in isolation has less than 500 employees but the total employee number at group level is above 500.**

On the 500 employees test, the **legal position** is as follows:

- Generally, a financial market participant can disclose that it does not consider principal adverse impacts *[Article 4(1) SFDR]*.

- The exception to this general proposition is that an FMP must consider PAI if either of the following situations applies:

  (A) **Individual entity basis:** It is mandatory to comply if an individual financial market participant has more than 500 employees *[Article 4(3) SFDR]*; or

  (B) **Consolidation (sub-) group basis:** it is mandatory to consider PAI if an individual financial market participant is the parent undertaking of a "large group" (as defined) which has more than 500 employees in the consolidation group *[Article 4(4) SFDR]*. For these purposes, "large group" means a group of parent and subsidiary undertakings:
  (1) which are including in a consolidation group for EU accounting consolidation purposes; and
  (2) which, on a consolidated basis, exceed the limits of at least two of the three following criteria on the balance sheet date of the parent undertaking:
  (a) balance sheet total: EUR 20 000 000;
  (b) net turnover: EUR 40 000 000;
  (c) average number of employees during the financial year: 250.

- These two carve-outs are the only scenarios expressly specified in SFDR. There is general commentary in the market which refers more broadly to groups with more than 500 employees, but it is important to emphasise the precise definition – i.e. consolidation (sub) groups sitting below an EU financial market participant.

- In particular, there is no requirement to look at the group structure above any EU entity.

Our view is that the market is now moving towards taking a formal legal reading of the two tests, and not applying the exception unless strictly required to do so.

**- How to treat already existing closed-ended funds and should investment managers adapt their investment strategy to comply with the requirements ?**

Most, but not all, members take the view that since a fund is no longer being marketed, then the pre-disclosure requirements do not apply and documentation should not be updated retroactively. Members were more cautious as regards the periodic reports. Although such reports reflect updates of ESG elements appearing in the pre-disclosure documents and would therefore not need to be updated in the absence of such ESG elements in the initial pre-disclosure documents, members were leaning more to the conservative side and would probably choose to periodically disclose the SFDR requirements, if relevant for their funds.

A reference was also made to Article 22(2)(d) of the AIFMD which requires the disclosure of "any material changes to the information" disclosed to investors in pre-contractual documentation, and the question was asked to what extent SFDR-related disclosure would be considered as "material changes".

**SCOPE – ARTICLE 8**

**- Scope of Article 8 as regards broadly used exclusion strategies / how to interpret "promoting" an environmental or social "characteristics"? In particular: (i) does "promoting" require the ESG feature of the product to be actively promoted in its marketing materials or is it sufficient for it to be mentioned as part of the product's mandatory disclosures; and (ii) If the use of a screen brings a product within the scope of Article 8, is the "characteristic" the screen itself or is it the environmental or social outcome being furthered by the screen?**

Members are planning a pragmatic approach to compliance for funds that are making no ESG claims, are fully unconstrained but have a standard exclusion strategy (for example a tobacco screen) and are being distributed to institutional investors. The view is that it is likely that the supervisor will not focus on these funds as there is no intent of "greenwashing" or misleading the investor.

One also have to keep in mind that in order to be classified as an Article 8 fund, the underlying companies in which the investments are made should follow "good governance practices".

It is worth noting that NCAs could have diverging views on Article 8 scope, with some of them leaving the choice of the classification of the product (mainstream, Article 8 or Article 9) to the asset manager and others potentially more eager to apply a broader scope.

A comment was made regarding side letters signed with specific investors. The view expressed by ESMA in an informal forum is that if a manager changes the product as a result of the investor's preferences, this is clearly an Article 8 product and this investor should benefit from website and periodic disclosures.

- **How to treat the "good governance" requirement under Article 8, notably when combining an exclusion policy with a "positive" good governance requirement. In addition, how are people approaching "good governance" standards ? Are managers looking through to underlying assets in investment funds that are held in fund portfolios for the purpose of assessing GG and DNSH ?**

Some members commented that the "promotion" did not apply to "good governance" requirements, which therefore does not warrant a binding element in the fund documentation. Some members are addressing the reference to "good governance" by showing adequate systems and controls. It was also noted that the "E" or "S" characteristics do not need to apply to the whole

fund but can apply to a portion of the fund's underlying investments and that there should be a similar approach for the "good governance" criteria.
In general and as regards corporates, managers are taking a broad view on this topic, ensuring they have a policy on this topic, on their assessment of the underlying corporate's governance and on their engagement policy.

**- how the good governance assessment should be applied to the following types of fixed income securities/issuers:**

- **Quasi-sovereigns**
- **High Yield**
- **Bank Loans (via assignments and participations)**
- **EM debt**

**Are members seeing any basis for excluding any of these entirely from the analysis? If not, are they seeing the same standard being applied to all of them? Do they have a view as to whether debt being secured or not (and hence the governance of the companies being potentially less relevant to the potential returns on the investment) should make a difference in this analysis?**

It was discussed that applying the "good governance" criteria to sovereigns or similar instruments is a challenge cannot be done with an absolute measure. Members will look at it in the context of asset classes, look at the good governance criteria in a relative context and explain their approach.

- **Closed ended funds: For pre-existing private closed-ended funds with E and S caracteristics, if members lean more towards the conservative side and choose to periodically disclose SFDR requirements, would they decide, as a consequence, to comply with any March 2021 pre-contractual disclosure obligations ?**

Some members asked whether an alternative view/question would be whether it is supportable to conclude that historic references to environmental or social characteristics should be viewed in their pre-SFDR context and not necessarily lead to a conclusion that the product engages Article 8 SFDR. For example, if a product referred to environmental or social characteristics generally, it could be credible to read in in some cases that those disclosures related to the firm's general obligation to maximise risk-adjusted investment returns.

Should one conclude that a legacy fund engages Article 8, the follow-on implications of reaching a conservative view include:

· Reviewing legacy products to determine whether they promoted E or S characteristics.
· Preparing Article 10 SFDR website disclosures for such products by 10 March 2021.
· Preparing Article 11 SFDR periodic reporting disclosures from 1 January 2022.
· Potentially reporting per Article 6 Taxonomy Regulation (including DNSH) in relation to such products.

Some members also commented on the fact that the "good governance" requirement was vague enough to allow for a choice between the classification of legacy funds as mainstream products or Article 8 funds.

**- When and how does an Article 8 fund need to consider the PAI indicators (per Article 16(2) of the SFDR draft RTS).**

Article 8 funds may (but need not) make investments which fall within the specific SFDR definition of a "sustainable investment". To the extent that the fund is making sustainable investments, then the "do no significant harm" requirement applies, such that the financial market participant must ensure that in making a sustainable investment, it is not significant harming sustainability, by reference to the 50 PAI indicators.

Such requirement does not apply where an Article 8 fund makes investments which are not "sustainable investments" (as defined).

- **Article 8 vs Mainstream products (Article 6)**

In the absence of guidance or commentary from the ESAs, members seem to agree that Article 8 requires the product to *actively* promote environmental and/or social characteristics in a way that is unrelated/additional to (i.e. a qualification of) the firm's core objective of maximising risk-adjusted returns. It follows from reaching this position that neither of the following would, absent other active promotions of E or S characteristics, be sufficient to engage Article 8:

- Fund-level sustainability-related disclosures regarding investment processes if they are made only to comply with a legal obligation (e.g. a sustainability risk disclosure per Article 6 SFDR) or relate to the firm's obligations to maximise risk-adjusted investment returns (i.e. references to environmental or social characteristics are–implicitly or explicitly–tied exclusively to value).
- The sponsoring firm's subscription to UNPRI, SASB, certain SDGs or other sustainability frameworks or standards, in particular where those frameworks focus on management of financially material ESG issues (i.e. sustainability risk) or mandate reporting rather than directly affecting decision-making (i.e. they do not qualify and obligation to maximise risk-adjusted returns).

Members further discussed that classifying a fund as Article 8 would result in making investment decisions that would not only be tied to the risk-adjusted value of an investment, but also decisions linked to the external impact of E or S characteristics, tied for example to the "do no significant harm" criteria.

**- "Sustainable investments": If a fund includes SIs ( or investments likely to meet the criteria of SIs) could it be marketed as an Art 8 product without SI's for March 2021 ? i.e. is there is optionality to base an Art 8 categorisation on promotion of E or S characteristics that it might have rather than on SI's even if the product contains SIs ?**

Members seem to be of the view that this really depends on the promotion the fund is making. With the Taxonomy Regulation disclaimer provided by Article 6, it seems that a fund could still make sustainable investments and not promote them. It could also being promoted as an Article 8 funds with sustainable investments as it seems this possibility has been foreseen by the Taxonomy Regulation Article 6.

**- PAI: Does Article 8 automatically trigger the consideration of principal adverse impact ('PAI') ? if not, does exclusion policies based on negative externalities (i.e. adverse impact) trigger the disclosure at the entity-level of PAI ?**

Members discussed the interaction of fund-level PAI disclosure (Article 7 and potentially 8 and 9) with firm-level PAI disclosure (Article 4). An interpretation was that the mandatory requirement applies at the level of the firm with Article 4, which still gives a choice as to which funds should be considered in the aggregation of the PAI. If the firm can and choses to opt-out from Article 4 obligations, then there is no requirement to apply Article 7 (PAI at fund level) (but there is the obligation to include a disclaimer statement as per Article 7(2)).
As regards Articles 8 and 9, members discussed the fact that there was no legal obligation to consider or disclose PAI as such. The obligation can kick in if the relevant fund invests in sustainable investment (as per Article 2(17) SFDR definition) and therefore needs to apply the DNSH principle, which has been presented as similar to PAI by the ESAs.

**<u>OTHER</u>**

***** New May 2021*** _Can an SFDR Art 9 funds hold investments that are not considered as "sustainable" and is there a threshold**?

Recital 23 of the draft RTS of SFDR seems to address this question by stating that "while products that have sustainable investment as an objective are expected to make only sustainable investments, it is appropriate to require disclosures on the amount and purpose of any remaining investments to demonstrate how those investments do not prevent the financial product from attaining its sustainable investment objective."

AIMA also understands that the EC is considering proposing a high threshold for sustainable investments in Article 9 funds in its response to the letter sent by the ESAs on 7 January.

**- Complying with Level 1: To what extent are members leveraging the *draft* Level 2 technical requirements as guidance for their disclosure as of 10 March 21.**

Members are generally sceptic around the wisdom of using the draft Level 2 as guidance, as people do not want to be seen to be endorsing it. That being said, managers will probably use it as "inspiration" rather than copying it, as they need something to go on.
It was also noted that the supervisors and the European Commission's expectations is to comply on a principle-based and high-level basis as per the SFDR letter referenced above.

**- Are managers amending contracts with third party managers to ensure that they apply GG, DNSH and SI standards to investments ? What's the approach if the sub-managers are not set up to do this / apply different standards ?**
There were no comments on this question.

**- Article 3 and 4 entity-level disclosure: How are those members looking at the Article 3 and 4 website disclosures, who do not necessarily offer specific ESG products yet, i.e. not in scope of Articles 8 and 9? Are they intending to disclose integration of sustainability risks at their over-arching enterprise level or drilling down product by product?**

As regards PAI disclosure, it was mentioned that such exercise was difficult for hosting platforms, given the multiplicity of funds, as well as for bigger firms. Many firms are currently considering whether to consider and disclose PAI, also in light of reputational risks. There is also a sense that supervisors are sympathetic with this exercise and understand that firms will comply on a best effort basis.

Many firms in the private equity and debt sector are choosing to opt out from the disclosure requirement as they are not able to comply with the upcoming indicators disclosure requirement.

Firms who choose or are required to comply with PAI seem to opt for a mix of a principle-based approach and a reduced list of indicators.

- **Art 6 Comply or explain: Which strategies could reasonably opt out from sustainability risk assessment/based on which arguments?**
No comments

**- Website disclosures: an IMA is technically viewed as a "financial product" for the purposes of the SFDR, how to deal with website disclosures vs commercial sensitivities if the product promotes E and S characteristics and falls into Article 8 or 9?**

The view from members was that this could indeed become an issue, notably for large pension funds but that a pragmatic approach should prevail.

Members mentioned that the intention to publicly disclose such elements was clear and so hiding the information behind a password was maybe not ideal. Some members noted that they chose to anonymize the information published on the website in order to address the confidentiality issues.

- **Application of the SFDR to loan funds and CLOs: have members already looked into this and have they experienced challenges or can they share experience?**

It was mentioned that CLOs are not a financial product and the regulation does not require a look-through so members are not considering specific disclosure for CLOs.

Any investment management agreement / collateral management agreement (or similar) between a financial market participant and a CLO vehicle, which involves the provision of portfolio management services, would be deemed to be a financial product *[see article 2(6) and 2(12)(a) SFDR]*

- **Approach to disclosing "results of the likely impacts of sustainability risks on the returns of a financial product" – are member firms intending to make this disclosure in qualitative or quantitative terms?**

A consensus emerged to disclose the potential impacts of sustainability risks in qualitative terms rather than quantitative.

*****New*** (January 2021)**
**- Is "transition risk" eg. the risk of decrease in value of investments in fossil fuel providers because of switch to low carbon energy being considered to be captured by the definition of " sustainability risk " under SFDR.**

Given transition risk is considered as such in the TCFD framework it should be captured by the definition of "sustainability risk" under the SFDR.

**- UK onshoring of SFDR**

The has not onshored the SFDR yet. The UK government mentioned that it intended to "match" the EU ambition as regards sustainable finance regulation and has publicly mentioned it will start its own work on Taxonomy. In private discussions it also referred to work on a disclosure regime for financial market participants and has been surveying the current implementation challenges with the SFDR, but it has not given any further indications of the direction of travel it would take.

**<u>Other questions (not discussed)</u>**

- **Passive funds:** For a passive/tracker ESG fund like an ETF which has adopted an ESG adjusted benchmark. Does that product by virtue of it only tracking/investing in an ESG benchmark make it an 'Article 8 product' or does it remain an 'Other'? How are managers disclosing the integration of sustainability risk in investment decision making in the context of index products ? What reliance is being placed on index providers in this context ?

- **Green bonds:** are managers assessing Green Bonds alignment with SI requirements as per the below and if not what is the approach ?

- investment is an investment in an economic activity that contributes to an E or S objective - assess at instrument level

- DNSH - assess at instrument level

- good governance - assess at issuer level

- **Money Market Funds :** Are managers looking at Money Market Funds as Art 8 or 9 ? Do they foresee any challenges

-For **futures and FX forward** financial instruments, do members recommend specific databases for data collection ?