IIGCC

Member briefing

The European Commission's responses to key SFDR questions

Key summary

- On 14 April 2023, the European Commission published a series of answers to questions on the interpretation of the EU Sustainable Finance Disclosure Regulation (SFDR). The questions were submitted by the European Supervisory Authorities (ESAs) in September 2022.
- The scope includes areas that have created considerable implementation challenges for investors to date. These include clarity on the definition of 'sustainable investments'; the application of Paris Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs); and the consideration of Principal Adverse Impacts (PAIs) at fund-level.
- In general, the Commission's responses reiterate that SFDR is a disclosure-based regime, which can be interpreted in a flexible manner. The onus remains on investors to disclose their approaches to sustainable investment, and how these are consistent with its requirements.
- However, the Commission has taken a more prescriptive approach in some areas. Investments covered by transition plans would not be considered in and of themselves to be 'sustainable,' which has implications for investors looking to align portfolios with net zero

ESA questions 1 and 2: Clarification and application of SFDR definitions

SFDR establishes a high-level definition of what constitutes a 'sustainable investment':

- An investment in an economy activity that contributes to an environmental or social objective (including climate change mitigation and adaptation);
- That does not significantly harm (DNSH) any other environmental or social objectives;
- And where the investee company follows good governance practices.

In our Q&A on the interaction between the Net Zero Investment Framework (NZIF) and SFDR, we assessed that assets categorised as either ‘achieving net zero’ or ‘aligned’ per NZIF’s alignment maturity scale should qualify as sustainable investments for the purposes of SFDR.

The Commission has re-affirmed that SFDR does not prescribe any specific approach to determining whether an investment is sustainable. Instead, investors must disclose the methodology they have used to assess the sustainability of their holdings and the extent to which they contribute to environmental or social objectives. Helpfully, the Commission has now confirmed that sustainable investments can be measured at the level of the investee company and not just the specific activity level. For example, a company that derives 20% of its revenue from renewables can be counted as a sustainable investment in full, rather than only the renewable segment of the business.

While this policy approach means that investors can continue to exercise flexibility when it comes to assessing the sustainability of their investments, the Commission emphasises the need for firms to ‘exercise caution’ when doing so to avoid accusations of greenwashing. The continued lack of prescription means there remains a risk that investors will continue to take a broad range of approaches to measure the sustainability of their investments. Not only could this reduce the ability to meaningfully compare funds, but it may continue to expose investors to legal and reputational risk when it comes to the sustainability-related claims they make as part of their SFDR reporting.

Crucially, the one exception to this flexible approach is the assessment of companies with a transition plan as sustainable investments in and of themselves. These investments also need to ensure they currently meet the requirement to do no significant harm to other environmental and social objectives. The Commission’s logic seems to be that a company with a transition plan in place may presently be causing harm (e.g. due to its current emissions), even if there is a credible plan in place to reduce emissions over the short, medium and long term.

Implications:

- It appears that investments covered by a transition plan could qualify as sustainable for the purposes of SFDR **if** the investor can credibly demonstrate that the investee complies with the DNSH test today, rather than in the future (and follows good governance practices).
- There are no quantitative and qualitative thresholds for assessing harm, and while it is up to investors to determine whether the harm caused by a company’s activities (e.g. GHG emissions) are within their risk tolerance, it is worth noting that the regulators have stressed the need to be prudent when conducting these assessments.

- Going forwards, it will be essential for investors to clearly set out why and how transitioning assets (particularly carbon-intensive assets) also meet the DNSH test. This will require disclosure against, and consideration of, the PAI indicators (including GHG emissions), as well as reporting on procedures, policies and activities to mitigate these impacts (e.g. engagement activities).

Interoperability with other disclosure regimes: When considering the link between SFDR and the proposed UK sustainable investment labelling regime, this clarification could be seen as enabling funds with a 'sustainable improvers' label under the UK regime (e.g. investing in transitioning assets) to qualify as Article 9. However, the UK regime does not propose to introduce DNSH criteria at present, so investors will need to consider how they can ensure funds marketed in both the UK and the EU can meet the requirements of both regimes.

ESA question 3: SFDR and financial products that have a reduction in carbon emissions as their objective

The Commission has made several clarifications on the application of PABs and CTBs. Passive funds tracking an EU PAB or CTB will suffice to meet the criteria for an Article 9 fund (which includes funds with emissions reduction objectives). In addition, actively managed funds can also pursue this objective without strictly tracking a PAB or CTB, provided they meet the sustainable investment criteria outlined above.

Implications:

- Investors are likely to welcome the latest interpretation of PABs and CTBs, which could lead to a reversal of some investors' decisions to downgrade passive funds tracking an EU PAB or CTB from Article 9 to Article 8.
- Given the challenges with PABs and CTBs identified by the Paris Aligned Investment Initiative (see NZIF implementation guide), investors are also likely to welcome this confirmation that active funds pursuing carbon emission reductions do not necessarily need to track these benchmarks. However, they will still need to consider how their funds meet the three tests for sustainable investments discussed above.

ESA question 4: SFDR and financial products that promote a reduction in carbon emissions

The Commission has confirmed that Article 8 funds (e.g. funds that promote environmental characteristics, but which do not have sustainable investment as an objective) can promote carbon emission reductions as a characteristic of the fund.

However, the Commission stresses that investors must ensure their disclosures and marketing materials do not mislead the public into thinking that a fund promoting these characteristics has a specific objective to reduce emissions (e.g. an Article 9 fund). Article 9 funds must be comprised almost entirely of sustainable investments (per the definition established under SFDR), with some limited exceptions for instruments used for the purposes of liquidity management or hedging.

Implications: While this flexibility is welcome, investors using NZIF will likely be setting emissions reductions objectives for their funds alongside wider financial objectives. This means it will be important to ensure that relevant funds are categorised as Article 9 where these objectives are communicated prominently in disclosures as a core feature of the fund.

Investors could categorise funds investing in transitioning assets as Article 8, and therefore would not be required to hold only 'sustainable investments' within their portfolio (for example, assets that are 'aligning' per NZIF's maturity scale may be more suitable to hold in these funds). However, they would not be able to promote the fund as pursuing decarbonsiation objectives – it would merely have to be a 'feature' of the product.

ESA question 6: Consideration of PAIs at fund-level

The ESAs asked the Commission whether investors would meet the requirement to 'consider' PAIs, such as GHG emissions, at fund-level by disclosing PAI metrics alone (rather than reporting on the policies and actions they have put in place to mitigate these PAIs).

The Commission has confirmed that disclosure of PAIs alone will not be sufficient to meet this requirement. They expect fund-level disclosures to also set out any engagement and due diligence the investor has undertaken to address these PAIs.

Implications: Investors using NZIF should be able to use reporting on their engagement-related targets and actions to encourage their holdings to decarbonise, thereby meeting this requirement under SFDR. This should also help to evidence how transitioning assets meet the DNSH requirements per the sustainable investments test.

Contact us

For further information about our work on EU sustainable finance policy, please contact Leo Donnachie.