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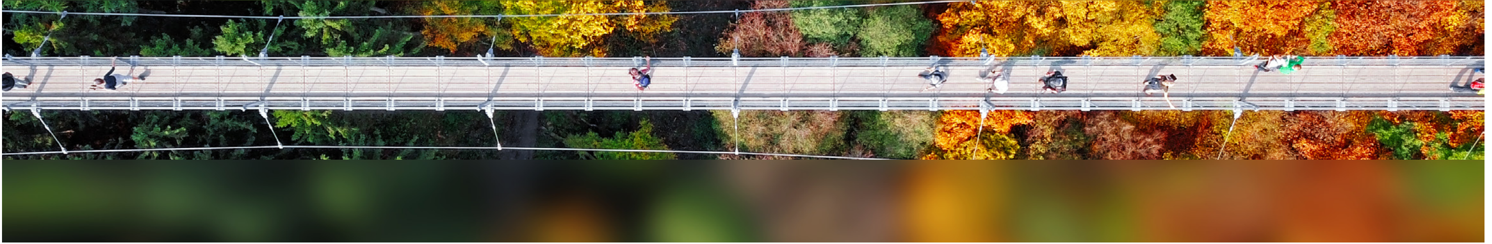

SFDR: LATEST EUROPEAN COMMISSION Q&A PUBLISHED

On 14 April 2023, the European Commission's responses to a series of fundamental SFDR-related questions were published. The responses confirm that it is for firms to determine whether investments qualify as 'sustainable investments' and remind firms of their duties to exercise caution when making this determination. The responses also provide helpful clarifications regarding a number of other interpretational points.

Key points

- On 14 April 2023, a further Commission Q&A on the SFDR was published.
- The Q&A reinforces the SFDR's status as merely a disclosure regulation, requiring firms to make sustainability-related disclosures but leaving firms to determine their underlying approach to sustainability.
- In particular, the Commission confirms that it is for firms to determine whether investments are 'sustainable investments', whilst warning that firms should 'exercise caution' when making this assessment. The message is clear: freedom should not mean a race to the bottom in terms of determining the threshold at which an investment may be deemed 'sustainable'.
- In addition, the Q&A provides a series of helpful clarifications relating to: products that promote a reduction in carbon emissions; PAI reporting; the 500 employee threshold for mandatory PAI reporting; and the periodic disclosure frequency for portfolio management firms.
- Considering and embedding this Q&A against a backdrop of further SFDR-related consultations will ensure that 2023 continues to be a busy year for firms' SFDR projects.

Background

The EU's Sustainable Finance Disclosure Regulation (SFDR) began to apply in March 2021. Since that date, firms' implementation projects have caused a series of interpretational questions to surface. This has led to the publication of European Commission (Commission) Q&As on the SFDR in **July 2021** and **May 2022** (see our earlier **briefing**).

In September 2022, the European Supervisory Authorities (ESAs) submitted a further eight interpretational questions to the Commission. These related to:

- how to interpret the phrase 'sustainable investment';
- products that have the objective of reducing carbon emissions;
- the nature of product-level principal adverse impacts (PAI) disclosures;
- how to interpret the 500 employee threshold that triggers mandatory PAI disclosures; and
- the frequency with which firms providing portfolio management services should publish their periodic SFDR reports.

On 14 April 2023, the Commission's **responses** to these questions were published, alongside amendments to **previously adopted** answers. The responses emphasise the status of the SFDR as merely a disclosure regulation, leaving firms to determine their underlying approach to sustainability, and be answerable for the ESG diligence they undertake. In particular, the Commission confirms that it is for firms to determine whether investments are 'sustainable investments'. This flexibility is likely to be welcomed by firms, although leaves scope for divergence over firms' resultant approaches. The Commission therefore provides a corollary warning: firms must exercise caution when determining whether an investment is sustainable. In other words, freedom should not mean a race to the bottom in terms of determining the threshold at which an investment may be deemed sustainable. This, together with the Commission's responses to the remaining questions in the Q&A, is summarised below.

How to interpret the phrase 'sustainable investments'

The SFDR defines a sustainable investment as an investment: (i) in an economic activity that contributes to an environmental or social objective; (ii) that does not significantly harm any of those objectives; and (iii) where the investee company follows good governance practices.

ESAs' question 1: The ESAs' first question was how the definition of 'sustainable investments' should apply to investments in instruments that do not specify the use of proceeds, such as investments in the equity or debt of an investee company that has multiple economic activities.

Commission response: The Commission confirms that the SFDR does not prescribe a specific approach to determining the contribution of an investment to environmental or social objectives. Firms should, however, disclose the methodology that they use. The Commission also confirms that '[…] *the notion of sustainable investment can therefore also be measured at the level of a company and not only at the level of a specific activity.*'

Clifford Chance comment

This response confirms that firms have discretion to select their own methodology for determining whether an investment contributes to environmental or social objectives. This confirmation is likely to be welcomed by the industry, in particular when compared to the Taxonomy Regulation's more prescriptive weighting approach. It is, however, also likely to result in the adoption of divergent approaches and standards. The confirmation that the notion of sustainable investment can be measured at the level of a company likewise provides interpretational flexibility but leaves open the possibility that firms could reach different conclusions in respect of similar investments.

ESAs' question 2: The ESAs' second question related to how to interpret the phrase 'investment in an economic activity that contributes to an environmental/a social objective'. Amongst other things, the question asks whether an economic activity could be deemed to contribute to the environmental objective of climate change mitigation if a transition plan were to be implemented in respect of that economic activity.

Commission response: The Commission again confirms that it is for firms to assess whether investments qualify as sustainable investments, warning that this gives firms *'an increased responsibility towards the investment community which means that they should exercise caution when measuring the key parameters of a sustainable investment'*. The response goes on to confirm that *'referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient.'*

Clifford Chance comment

The Commission's confirmation of the flexibility afforded to firms under the SFDR is accompanied by a clear warning not to test the limits of what they deem to be 'sustainable'. In addition, firms must take note of the Commission's comment regarding transition plans. Firms that have deemed investments to be 'sustainable' on the basis of adopting transition plans will need to carefully consider whether this statement necessitates any change in approach.

Products that have the objective of reducing carbon emissions

Article 9 of the SFDR sets out enhanced disclosure requirements for certain products, including, under article 9(3) SFDR, products that have the objective of reducing carbon emissions.

ESAs' questions 3 – 5: The ESAs raised three questions in respect of these products. These were, in summary: (i) whether products with a passive investment strategy could fall within Article 9(3) SFDR; (ii) whether products that promote carbon emissions reduction could fall within Article 8 SFDR as opposed to Article 9 SFDR; and (iii) the extent to which products that track Paris Aligned Benchmarks (PABs) or Climate Transition Benchmarks (CTBs) would be deemed to satisfy the definition of 'sustainable investment'.

Commission response: The Commission's response clarifies that:

- products that have an objective of reducing carbon emissions can fall within the scope of Article 9(3) of the SFDR whether they have a passive or an active investment strategy;
- products that promote carbon emissions reduction can categorise this as an 'environmental characteristic', thereby falling within Article 8 of the SFDR as opposed to Article 9; and
- products that passively track PABs or CTBs are deemed to have 'sustainable investment' as their objective. By contrast, firms must explain why they consider that products that are *actively* managed, i.e. that do not simply track a PAB or CTB, have sustainable investment as their objective.

Clifford Chance comment

These responses are likely to be welcomed by the industry in an area in which there have already been Commission Q&As and in which there was considerable interpretational uncertainty. In particular, there was a lack of clarity over which products needed to satisfy the requirement contained in Article 9(3) for 'a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.'. In a welcome clarification, the Commission's response confirms that products that passively track PABs or CTBs do not need to provide this information.

The nature of product-level principal adverse impacts (PAI) disclosures

Article 7 of the SFDR contains the so-called product-level PAI reporting requirements. These requirements are triggered where a firm 'consider[s] [the] principal adverse impacts of investment decisions on sustainability factors' in respect of its financial product. A firm that considers PAI in respect of a product must comply with the enhanced disclosure requirements provided under Article 7.

ESAs' question 6: The ESAs' sixth question asked whether Article 7 PAI reporting requires merely disclosure of PAIs or also disclosure of actions taken by the firm to address PAIs.

Commission response: The Commission confirms that '[…] *the description related to the adverse impacts shall include both a description of the adverse impacts and the procedures put in place to mitigate those impacts.'*

Clifford Chance comment

There has been considerable debate over the PAI disclosure obligations. Part of this debate has centred on the questions of whether: (i) 'consideration' of PAI requires a firm to merely consider PAI or to consider and attempt to mitigate PAI; and (ii) the disclosure required under Article 7 should be merely the disclosure of PAI or also the disclosure of actions taken to mitigate PAI. On point (ii) the Commission's response confirms that disclosure both of PAI and of mitigants to PAI is required under Article 7 SFDR.

How to interpret the 500 employee threshold that triggers mandatory PAI disclosures

ESAs' question 7: Articles 4(3) and (4) of the SFDR state that firms with over 500 employees, or firms that are parent undertakings in groups with over 500 employees, must provide PAI disclosures. The ESAs' seventh question asked how to interpret this 500 employee threshold.

Commission response: The Commission's response confirms that the definition of employee should be construed by reference to applicable national law.

Clifford Chance comment

Interpretation of the 500 employee threshold has been a long-standing grey area and was raised in the Commission's July 2021 Q&A. The response in the 2021 Q&A covered geographical interpretational issues, confirming that employees of both EU and non-EU entities should be included when determining headcount, but left open the question of how to interpret the word 'employee' itself. In the absence of a definition of employee within the SFDR, the Commission has now had to direct firms to national law, which will lead to further divergences between firms operating in different jurisdictions.

The frequency with which firms providing portfolio management services should publish their periodic SFDR reports

Article 11(1) of the SFDR requires firms to include certain disclosures in their periodic reports. Article 11(2) confirms that, for MiFID investment firms and credit institutions that provide portfolio management services, the periodic reports in question are those made under Article 25(6) of MiFID. Under the relevant MiFID provisions, these reports should be provided on a quarterly basis.

ESAs' question 8: The ESAs' eighth question requested clarity on whether Article 11(1) reporting should be completed annually, as appeared to be envisaged under recital 21 to the SFDR, or quarterly, in line with the MiFID quarterly reporting requirement.

Commission response: The Commission's response confirms that reporting should be completed annually in every fourth quarterly report.

Clifford Chance comment
This welcome clarification will ensure that firms with quarterly reporting obligations under MiFID remain subject to only an annual reporting requirement under Article 11 of the SFDR.

Next steps

Firms should consider whether the Commission's responses necessitate changes to their existing SFDR policies and practices and, if they do, make those changes.

The publication of the Commission's Q&A has also occurred against a backdrop of continuing SFDR developments. Two days prior to the publication of the Commission's Q&A, the ESAs published a **public consultation** on potential changes to the SFDR Delegated Regulation (Regulation (EU) 2019/2088). The consultation proposed numerous changes, including extensive changes to the recently-finalised SFDR reporting templates. In addition, publication of the ESAs' progress report on its greenwashing Call for Evidence is expected in May 2023 and publication of the Commission's wider consultation on the SFDR is expected in Q3 2023. As a result, 2023 will continue to be a busy year for firms' SFDR projects.

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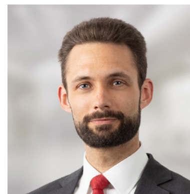

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