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# Dechert on ESG: Preparing for SFDR



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## Preparing for SFDR

### A brief recap

The main operative provisions of the Sustainable Finance Disclosure Regulation (SFDR)<sup>1</sup> will apply from 10 March 2021. The SFDR included provisions requiring the European Supervisory Authorities (ESAs) to prepare level 2 regulatory technical standards (RTS) to provide further detail and to assist in the application of the SFDR provisions. The SFDR states that six of the RTS must be delivered to the EU Commission by 30 December 2020 and one must be delivered by 30 December 2021. The ESAs prepared draft RTS<sup>2</sup> that were open for consultation until 1 September 2020 and, notwithstanding the deadline of 30 December 2020, the ESAs are still finalising the draft regulatory technical standards.

In a letter from the EU Commission to the ESAs, published on 30 October 2020,<sup>3</sup> it was announced that the RTS would no longer apply from 10 March 2021 and, instead, will become



closer to 1 January 2022, the date on which the Taxonomy Regulation goes into effect.

## ESAs' letter to the EU Commission January 2021

On 7 January 2021 – less than eight weeks before the SFDR 'go live' date – the Chair of the Joint Committee of the ESAs wrote to the EU Commission highlighting that the ESAs have encountered several important areas of uncertainty in the interpretation of SFDR and that there are *“certain priority questions pertaining to the SFDR that would benefit from a more urgent clarification to facilitate an orderly application of SFDR from 10 March 2021.”*<sup>4</sup> The questions raised by the ESAs encompass many of the questions that market participants are grappling with as they try to prepare for 10 March 2021.

The ESAs raise questions in the following areas, which are discussed in more detail below:

- 1) Do the provision of SFDR apply to non-EU AIFMs and registered AIFMs?
- 2) How should you apply the 500-employee threshold for principal adverse impact reporting at entity level to parent undertakings of a large group?
- 3) What is the meaning of “promotion” in the context of products ‘promoting’ environmental or social characteristics?
- 4) How should you apply Article 9 SFDR?



The specific areas of concern raised by the ESAs are the following:

### **1) Application of SFDR to non-EU AIFMs and registered AIFMs**

SFDR applies to financial market participants (FMPs) and financial advisers, which are defined to include AIFMs. An 'AIFM' is further defined by reference to Article 4(1)(b) of AIFMD,<sup>5</sup> meaning that SFDR applies to AIFMs in general by virtue of the reference to Article 4(1)(b).

The ESAs ask:

- i) whether the provisions of SFDR apply to **non-EU**<sup>6</sup> AIFMs, for example when they market a sustainable EU Alternative Investment Fund under a National Private Placement Regime?
- ii) whether, notwithstanding the general application of SFDR to AIFMs, the SFDR apply to 'sub-threshold' AIFMs referred to in Article 3(2) AIFMD?

### **2) Application of the 500-employee threshold for principal adverse impact reporting at entity level to parent undertakings of a large group**

From 30 June 2021, Article 4(4) SFDR requires FMPs "*which are parent undertakings of a large group as referred to in Article 3(7) of the Directive 2013/34/EU<sup>7</sup> exceeding on the balance sheet date of the group, on a consolidated basis, the criterion of the average number of 500 employees during the financial year shall publish and maintain on their websites a*



*sustainability factors.”*

The ESAs have asked:

- i) 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?
- ii) 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?

### **3) Meaning of “promotion” in the context of products promoting environmental or social characteristics**

Article 8 SFDR applies: *“Where a financial product **promotes**, among other characteristics, environmental or social characteristics, or a combination of those characteristics.”*

The ESAs note that an orderly application of SFDR would be helped if examples of different scenarios that are within, and outside, the scope of Article 8 SFDR were provided. These examples would, in the ESAs' view, give much needed clarification on the “level of ambition of the characteristics.”

Specifically:

- i) Can the name of a product, which may include words like “sustainable,” “sustainability,” or “ESG” be considered to qualify a product to be promoting an environmental or social characteristic or to be having sustainable investment as its objective?



investments,<sup>19</sup> would a reference to taking into account a sustainability factor or sustainability risk in the investment decision be sufficient for Article 8 to apply? If the answer is yes, how can FMPs that disclose mandatory information according to Article 6(1) or Article 7(1) SFDR ensure that this is not automatically considered as “promoting environmental or social characteristics”?

iii) Must a product to which Article 8 applies invest a minimum share of its investments in environmental or social characteristics in order to be considered to be promoting environmental or social characteristics?

iv) In the absence of active advertising of an environmental or social characteristic of the product, would an intrinsic characteristic of the product, such as a sectoral exclusion (e.g., tobacco) which is not advertised, also qualify as “promotion”?

v) Would complying with a national legal obligation, which applies to the FMP, such as a ban on investment in cluster munitions, also bring the product into the scope of Article 8?

#### **4) Application of Article 9 SFDR**

Article 9(1) and (2) SFDR apply “*where a financial product has sustainable investment as its objective.*” The ESAs have asked whether:

i) a product to which Article 9(1), (2) or (3) SFDR applies must only invest in sustainable investments as defined in Article 2(17) SFDR? If not, is a minimum share of sustainable investments required (or would there be a maximum limit to the share of “other” investments)?



*information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.*

*By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council is available, the information referred to in Article 6 shall include 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.*

The ESAs have asked:

ii) Where an EU Climate Transition Benchmark (EU CTB) or EU Paris-aligned Benchmark (EU PAB) exists, is it necessary for a product to track an EU PAB or an EU CTB on a passive basis for Article 9(3) SFDR to apply to it? If the answers are yes, and if the minimum standards of an EU PAB or an EU CTB do not require the index components to be sustainable investments, can the product fall within the scope of Article 9(3) SFDR?

## **5) Application of SFDR product rules to MIFID portfolios and other tailored products**

SFDR applies to FMPs that are ‘an investment firm which provides portfolio management,’<sup>9</sup> which is further defined by reference to MiFID.<sup>10</sup> SFDR also applies to financial advisers that are ‘an investment firm which provides investment advice.’<sup>11</sup> The ESAs have asked:



discretionary client-by-client basis, do the disclosure requirements in SFDR apply at the level of the portfolio only, or can they apply at the level of standardised portfolio solutions?

ii) If the disclosure requirements of SFDR apply at the portfolio level, how is it possible to maintain confidentiality obligations to the client in view of the disclosures required, especially the website disclosures required by Article 10 SFDR?

## Conclusion

The questions raised by the ESAs, if answered (possibly by way of a Q&A document along the lines of the document published for the AIFMD),<sup>12</sup> will provide financial market participants with much-needed guidance as to how to prepare for 10 March 2021, although with the clock running down, answers would be welcomed sooner rather than later.

## Footnotes

1) Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR), as amended by Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation).

2) For more information on the draft RTS, please see our OnPoint ESA's Consultation on the Draft Regulatory Technical



- 3) To view the letter from the EU Commission, please click [here](#).
- 4) To access the letter from the ESAs, please click [here](#).
- 5) Directive 2011/61/EU (the Alternative Investment Fund Managers Directive (AIFMD)).
- 6) Please note any emphasis in bold and underline is our own.
- 7) Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.
- 8) Defined in Article 2(17) SFDR.
- 9) Article 2(1)(b) SFDR.
- 10) Point (1) of Article 4(1) of Directive 2014/65/EU.
- 11) Article 2(11)(d) SFDR.
- 12) To view the AIFMD Q&A, please click [here](#).

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