

# 24 November 2022

# Key Takeaways For Fund Management Companies From Recent Publications issued on the EU Sustainable Finance Framework

### Introduction

Last week saw a suite of documentation relating to the EU sustainable finance framework being published by the Central Bank of Ireland (**Central Bank**), the European Supervisory Authorities (**ESAs**) and ESMA.

The Central Bank has published its <u>Information Note on Sustainable Finance and the Asset Management Sector</u> which includes the findings of the gatekeeper review carried out by the Central Bank on "Level 1" SFDR and Taxonomy Regulation disclosures and its expectations around the implementation of the next phase of the SFDR which applies from 1 January 2023 (Central Bank SFDR Publication)<sup>1</sup>.

In the case of the ESAs, these publications took the form of a <u>Q&A</u> on the SFDR Level 2 Measures<sup>2</sup> (**ESA Q&A**) which provided some clarity on certain issues arising under the SFDR Level 2 Measures and a <u>Call for Evidence on Greenwashing</u> (**Call for Evidence**).

ESMA also published a <u>consultation paper</u> containing draft guidelines on fund names using ESG or sustainability-related terms (**Consultation on Fund Names**).

In this briefing, we provide an overview of certain key takeaways for fund management companies arising from the ESA Q&A, Call for Evidence, Consultation on Fund Names and Central Bank SFDR Publication (together the **Publications**).

# **Key Points to Note:**

- The Central Bank SFDR Publication outlines some of its specific areas of supervisory focus
- The ESA Q&A
  provides guidance
  on PAI disclosures,
  financial product
  disclosures and
  Taxonomy-alignment
  investment
  disclosures
- ESMA proposes including quantitative requirements on funds using ESG/ sustainabilityrelated terms in their name

<sup>&</sup>lt;sup>1</sup> "Level 1" SFDR and Taxonomy Regulation disclosures relate to those disclosure obligations set down in Regulation (EU) 2019/2088 which have applied since 10 March 2021 and those disclosure obligations set down in Regulation (EU) 2020/852 which have applied since 1 January 2022 respectively

<sup>&</sup>lt;sup>2</sup> The "SFDR Level 2 Measures" are set down in Commission Delegated Regulation (EU) 2022/1288 and apply in large from 1 January 2023.

# Central Bank Supervisory Focus on SFDR related matters

As well as providing feedback on its findings from a spot-check review of SFDR "Level 1" disclosures it carried out earlier this year<sup>3</sup>, the Central Bank has also set out some non-exhaustive details of its supervisory roadmap of additional areas of interest which will be of relevance to Irish fund management companies, noting that these are in addition to ongoing supervisory focus on SFDR disclosures. These include:

- (i) The manner in which Irish fund management companies have adapted their risk management and due diligence frameworks in light of recent changes under the UCITS and AIFMD frameworks and in order to address the Central Bank's <u>Dear</u> <u>Chair Climate Risk Letter</u> published in November 2021;
- (ii) Noting that funds falling within the scope of Article 8 of the SFDR (**Article 8 Funds**) are not currently subject to any minimum sustainability criteria such as minimum investment thresholds/prescribed composition of investments, the Central Bank's supervisory engagement will focus on those Article 8 Funds with a low proportion of their portfolio promoting environmental and/or social characteristics;
- (iii) A focus on funds which have changed classification under the SFDR and the rationale provided to the Central Bank for the re-classification at the time;
- (iv) Assessing the consistency of information contained in the prospectus/fund supplement/key investor document with the information provided to investors or potential investors in marketing materials;
- (v) Identifying whether any Article 8 Funds or any funds categorised as falling within the scope of Article 9 of the SFDR (Article 9 Funds) are subject to fees and costs which are disproportionately higher than those funds falling within the scope of Article 6 of the SFDR where there is no legitimate rationale for such higher costs;
- (vi) Assessing whether securities lending arrangements employed by Article 8 Funds or Article 9 Funds allow them to continue to promote their environmental and/or social characteristics or sustainable investment objective; and
- (vii) Considering further the role of the depositary in monitoring ESG-related investment restrictions.

# Sustainable investment framework

The ESA Q&A confirms that it is up to each individual fund management company to define the criteria to be used to assess whether an investment meets the "substantial contribution" test embedded in the definition of "sustainable investment" under the SFDR and notes that there are "many ways" in which to measure the positive contribution of investments towards environmental or social objectives. However, the ESAs have suggested that it is not possible to interpret "sustainable investment" in different ways for different funds under management.

<sup>&</sup>lt;sup>3</sup> As outlined under the heading "Gatekeeper review" in the Central Bank SFDR Publication

# Guidance for fund management companies reporting under Article 4 of the SFDR

The ESA Q&A provides helpful guidance for those fund management companies reporting on their consideration of principal adverse impacts of investment decisions on sustainability factors (PAI) under Article 4 of the SFDR which should assist them as they prepare their first "full" PAI statement which must be published by 30 June 2023.

In addition, the ESA Q&A notes that when performing PAI calculations under Article 4 of the SFDR, fund management companies should include all assets under management resulting from both collective and individual portfolio management activities.

# Reporting of Taxonomy-aligned investments in periodic reports

The ESA Q&A provides that those Article 8 Funds or Article 9 Funds which promote an environmental characteristic or pursues an environmental objective (i.e. "green" funds) but which do not commit to investment in taxonomy-aligned investments in their pre-contractual disclosures should complete the relevant section of the periodic report annex "based on the actual investments during the reference period".

# Reporting of sustainable investments in periodic reports

The ESAs confirm in the Q&A that Article 8 Funds which do not commit to invest in sustainable investments in their pre-contractual disclosures are not required to disclose on investment in sustainable investments held by the fund during the reference period in their periodic reports. In effect, this means that an Article 8 Fund which does not commit to investment in sustainable investments in its pre-contractual disclosures is not required to assess whether it has any "incidental" sustainable investments within its portfolio as part of its periodic reporting.

### Taxonomy-aligned investment disclosures

Part I and Part V of the ESA Q&A incorporate a number of Q&A addressing the calculation of taxonomy-alignment of specific asset classes (such as debt instruments, real estate and infrastructure) and reliance on estimates amongst others as well including a number of Q&A on taxonomy-aligned investment disclosures in both the pre-contractual and periodic reporting annexes.

# Categorisation of assets for reporting purposes

The ESA Q&A confirms that it is not possible to categorise an investment as meeting more than one single environmental or social objective for reporting purposes, thus understandably precluding any approach which for example relies on "double-counting" a single investment as contributing to both an environmental and a social objective. The ESAs also confirm that when reporting on the taxonomy-alignment of a portfolio, an activity can only be treated as contributing to one of the six environmental objectives set down in the Taxonomy Regulation.

### **Assessment of Good Governance Practices**

The ESAs confirm that the use of reference metrics such as the UN Global Compact, OECD or ILO principles when assessing good governance practices of investee companies is not mandatory under the SFDR framework, noting however that such metrics could be used as part of any such assessment process.

### Scope of Article 9 of the SFDR

The ESA Q&A confirms as follows:

- (i) any fund which has an objective of reduction of greenhouse gas emissions falls within the scope of Article 9(3) of the SFDR as the intention of the legislation is to capture not only reduction in carbon emissions but all greenhouse gases; and
- (ii) the existing benchmark requirements applicable to EU Climate Transition Benchmarks which apply until 1 January 2023 (when more stringent rules begin to apply) under the Benchmarks Regulation framework cannot be considered to comply with the requirements for a "sustainable investment" within the meaning of Article 2(17) of the SFDR.

#### **Fund Names**

While an ESMA Supervisory Briefing published in May 2022 provided some guidance to national competent authorities (NCA) on naming conventions, including for example that the term "sustainable" or "sustainability" should only be used by certain categories of funds<sup>4</sup>, in its Consultation Paper ESMA goes a step further and proposes to set down quantitative thresholds which must be complied with in order to include ESG- and sustainability-related terminology in fund names.

Amongst other proposals set down in the Consultation Paper, ESMA proposes as follows:

- (i) In order to include any ESG-related terms (which will include terms such as "climate change" and "biodiversity"), the fund must use a minimum proportion of 80% of its investments to meet the environmental or social characteristics promoted by the fund or the sustainable investment objective of the relevant fund in accordance with the binding elements of the investment strategy; and
- (ii) In order to use the word "sustainable" or any derivative of that word, the fund should allocate within the 80% bucket referred to in (i) above, at least 50% of minimum proportion of sustainable investments within the meaning of the SFDR.

Also of note is the proposal that in order to use an ESG or sustainability-related term in the name of a fund, that fund must also comply with the exclusion criteria applicable to Parisaligned benchmarks in respect of all investments in the fund.

<sup>&</sup>lt;sup>4</sup> Namely (i) funds falling within the scope of Article 9 of the SFDR, (ii) funds which fall within the scope of Article 8 of the SFDR and which invest in part either in sustainable investments or taxonomy-aligned investments

# Call for evidence for examples of greenwashing

The Call for Evidence published by the ESAs has sought feedback from interested stakeholders on how to understand greenwashing and has also sought concrete examples of potential greenwashing practices across the EU financial sector (which will include EU fund management companies and investment firms) as well as any available data to help the ESAs gain a concrete sense of the scale of greenwashing and identify areas of high greenwashing risks. This includes not only examples of greenwashing at "product" level but also entity-level claims made in respect of what a specific entity is doing at overall firm-wide level.

#### Conclusion

If you would like us to assess the implications of the Publications on your fund range, please get in touch with your usual Dillon Eustace contact or any of the authors of this briefing.

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