



18 April 2023

Key clarifications provided by the European Commission on the SFDR framework

Following on from a number of consultations published earlier this month¹, the developments in the sphere of EU sustainable finance continue with pace, with the European Commission (**Commission**) publishing its [response](#) (**Response**) to [questions](#) posed by the ESAs in September of last year on certain critical aspects of the SFDR framework on 14 April 2023 (**ESA Questions**).

Below we outline some of the key clarifications provided by the Commission in its Response to the ESA Questions which will be broadly welcomed by the asset management industry.

“Sustainable Investment” Definition

Article 2(17) of the SFDR sets down three criteria which must be satisfied in order for an investment to constitute a “sustainable investment”:

- (i) it must be an investment in an economic activity that contributes to an environmental or social objective;
- (ii) it cannot significantly harm any environmental or social objective; and
- (iii) investee companies must follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

Until the Commission published its Response to the ESA Questions, there had been no clarity on how the “contribution” test referenced at (i) above should be applied. The ESA Questions presented a range of different practices to the Commission and asked whether such practices could be considered to meet this “contribution” test. These included for example whether the economic activity being carried out by the investee company itself must contribute to an environmental or social objective, whether it was sufficient that an

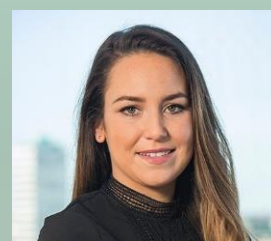
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¹ For an overview of these consultations, please refer to our separate [briefing](#)

economic activity be carried out in a sustainable manner rather than itself contributing to an environmental or social objective or whether certain transition activities would satisfy this “contribution” test.

In its Response, the Commission has confirmed that there is no one specific approach which must be adopted in determining whether or not this contribution test is satisfied, noting that *“the SFDR does not prescribe any specific approach to determine the contribution of an investment to environmental or social objectives”*.

While the Commission’s Response is unlikely to require fund management companies to make substantive changes to their proprietary “sustainable investment” frameworks given that it does not introduce any specific minimum quantitative criteria that must be satisfied in order to meet the “contribution test” as had been feared, it does re-state that the methodology and underlying assumptions used to assess whether investments meet the definition of “sustainable investments” must be disclosed to investors. It also issues a warning against establishing a “sustainable investment” framework which is based on a liberal interpretation of “sustainable investment”, noting that financial market participants have *“an increased responsibility towards the investment community”* and that they should *“exercise caution when measuring the key parameters of a “sustainable investment”*.

Separately, the Commission has implicitly suggested that no “revenue” test must be applied for the measurement of “sustainable investments”, noting that the notion of sustainable investment can *“be measured at the level of a company and not only at the level of a specific activity”*.

Finally, it is worth noting that despite the flexibility afforded by the Commission in its Response as regards the defining of prescriptive criteria for the “contribution” test, it does rule out classifying an investment as a “sustainable investment” solely on the basis that a transition plan has been implemented by the investee company which aims to achieve that the whole investment does not significantly harm any environmental and social objectives *in the future*.

Article 9(3) Products

The Commission has also sought to provide additional clarity on the scope of Article 9(3) of the SFDR.

The Response suggests that:

- (i) A fund which passively tracks a Paris-Aligned Benchmark or a Climate Transition Benchmark can be classified as an Article 9(3) fund without being required to carry out a separate assessment that each of the constituents of the portfolio meet the definition of a “sustainable investment” under Article 2(17) of the SFDR given the reference in the Response that such index-tracking products *“are deemed to have sustainable investments as defined in Article 2, point (17) SFDR as their objective”*; and
- (ii) A fund which pursues an objective of reduction in carbon emissions can also be actively managed provided that it gives investors 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 Agreement². Any actively managed Article 9(3) fund will also have to meet the general requirement that the fund is wholly invested in “sustainable investments” (save for those investments which are used for specific purposes such as hedging or liquidity).

Article 8 funds which promote reduction in carbon emissions as an environmental characteristic

Helpfully, the Commission has confirmed that an Article 8 fund can promote carbon emissions reduction as part of its investment strategy but in such circumstances neither the pre-contractual disclosures nor any related marketing communications should give the impression that the fund has sustainable investment as its objective.

Consideration of PAI at product level

The Commission has also confirmed that in order for a financial product to state in its pre-contractual annex that it considers principal adverse impacts of investments on sustainability factors, the financial market participant must implement procedures to mitigate those impacts and disclose such procedures in the fund’s pre-contractual annex. The Commission’s Response does not specify any specific actions that must be taken in order to mitigate those impacts, simply noting that such actions should be identified in the financial market participant’s investment due diligence processes.

Definition of “employee” for calculating the 500 employee threshold for triggering mandatory entity-level PAI reporting under the SFDR

The Commission confirms that because the SFDR does not contain a definition of who falls within the scope of an “employee” for the purposes of Article 4(3) or Article 4(4) of the SFDR, it must be determined by reference to the definition of “employee” set out under applicable national law. It also confirms that the exemption set down in Article 23 of the Accounting Directive² has no bearing on the disclosure obligations set down in Article 4(4) of the SFDR.

Frequency of periodic reporting for portfolio management services

The Commission confirms that those investment firms providing portfolio management services involving an Article 8 or Article 9 mandate must only provide a completed periodic report annex to their clients on an annual basis. This may be of interest to fund management companies which have extended MiFID IPM permissions.

Conclusion

The Commission’s Responses will be broadly welcomed by the asset management industry given the clarity on the scope of Article 9(3) of the SFDR and the fact that it has not imposed

² Directive 2013/34/EU

any quantitative criteria to assess the “contribution” test for assessing whether an investment constitutes a “sustainable investment”.

That said, certain fund management companies may have further work to do to align their frameworks with the expectations of the Commission as outlined in the Response and should now take the time to identify any specific actions which will need to be taken by them in order to meet those expectations. Reclassification of funds under the SFDR may also be on the agenda of some fund management companies in light of the clarifications provided by the Commission in its Response.

If you have any questions relating to this briefing, please get in touch with your usual contact in our Asset Management and Investment Funds team.

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