

# EUROPEAN COMMISSION RESPONDS TO ESA'S QUESTIONS ON THE INTERPRETATION OF SFDR, INCLUDING WITH RESPECT TO THE DEFINITION OF "SUSTAINABLE INVESTMENTS"

Date: 31 May 2023

## Asset Management and Investment Funds Alert

By: Áine Ní Riain, Gayle Bowen

On 14 April, the long-awaited responses (the Q&As) of the European Commission (the Commission) to questions put to it by the European Supervisory Authorities (the ESAs) in relation to the interpretation of the Sustainable Finance Disclosure Regulation (SFDR) were published.<sup>1</sup>

The ESAs wrote to the Commission in September 2022 with a series of questions concerning certain fundamental aspects of the SFDR, including some particularly fundamental questions around the definition of “sustainable investments.”

The Q&As supplement other answers provided by the Commission to the ESAs on the interpretation of the SFDR in July 2021 and May 2022. On 17 May, the ESAs helpfully published a [consolidated version of all of the previous questions and answers](#), allowing for easier access and review by fund market participants (FMPs).

## APPLYING THE DEFINITION OF “SUSTAINABLE INVESTMENTS” TO INVESTMENTS THAT DO NOT SPECIFY THE USE OF PROCEEDS

“Sustainable investments” under SFDR are defined in Article 2(17) as being an investment (i) in an economic activity that contributes to an environmental or social objective, (ii) that does not significantly harm (DNSH) environmental or social objectives, and (iii) in investee companies that follow good governance practices.

The first Q&A concerned how the definition applies to investments that do not specify the use of proceeds. Whether, for instance, an investment in a company with one economic activity contributing to an environmental objective, alongside others that may not, could in its entirety be considered a sustainable investment or be only partially be considered has been a question that industry had grappled for some time, with diverging positions being taken between FMPs. The question was especially important for FMPs managing Article 9 funds, as a previous [Commission question and answer](#) clarified that Article 9 funds must be composed exclusively of sustainable investments save for “investments for certain specific purposes such as hedging or liquidity.”

The Commission has helpfully confirmed that sustainable investments may be measured at investee entity level or at the level of the specific activity. The Commission stated that FMPs must disclose the methodology applied to make their assessment of sustainable investments, noting that the definition in SFDR does not prescribe a specific approach to determine the contribution to environmental and social objectives.

## **HOW TO INTERPRET “INVESTMENT IN AN ECONOMIC ACTIVITY THAT CONTRIBUTES TO” AN ENVIRONMENTAL OR SOCIAL OBJECTIVE**

The second question addressed by the Commission was whether an economic activity on the part of an investee should in itself contribute to an environmental or social objective or whether any economic activity could potentially contribute simply by virtue of the activity being conducted in a sustainable manner, or whether any economic activity can contribute to climate change mitigation if it is only covered by a transition plan.

Again, the Commission's Q&A was helpfully broad in interpreting whether economic activities contribute to environmental or social objectives, affording FMPs a “policy choice.” The Commission restated that the SFDR does not set out minimum requirements qualifying the concepts of contribution, DNSH, or good governance. Rather, FMPs must conduct their own assessments and disclose the assumptions underlying those assessments.

The Q&A also confirmed that a transition plan aiming to achieve that the entire investment would overall not significantly harm any environmental or social objectives in the future would not be considered a sustainable investment.

## **ARTICLE 9(3), CARBON EMISSIONS REDUCTIONS, AND BENCHMARK QUESTIONS**

On the question of whether funds that have an SFDR Article 9(3) objective of a reduction in carbon emissions may be active or passive, the Commission confirmed that Article 9(3) funds may be actively or passively managed.

On the specific requirements applicable to those active funds that fall under Article 9(3) that have designated a reference benchmark, the Commission stated that SFDR is a transparency regulation and does not prescribe the use of Paris-aligned benchmarks (PABs) or climate transition benchmarks (CTBs). The SFDR requires, however, a detailed explanation of how the effort of attaining the specific objective is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

The Commission also addressed the question of whether funds that track PAB or CTB may be deemed to automatically fulfill the conditions of Article 9(3) and Article 2(17) of SFDR. The Q&A confirmed that where funds are passively tracking PABs and CTBs, they are not required to include in their pre-contractual disclosures a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of the long-term global warming objectives of the Paris Agreement as required by Article 9(3), second paragraph. The Commission states the reason for this is that “these products are deemed to have sustainable investments...as their objective.” This has caused some confusion, as it suggests that the Commission is of the view all PAB and CTB tracking funds must be Article 9 funds and cannot be Article 8 funds. This is unlikely the Commission's intention. Rather, it is likely that the Commission is stating that it is permissible to regard the underlying investments held for tracking these benchmarks as sustainable investments. However, further clarification on this point would be helpful.

## **FUNDS “PROMOTING” CARBON EMISSIONS REDUCTION**

The Q&As also confirmed that Article 8 of SFDR does not limit the types of characteristics that may be promoted by funds, and funds may therefore promote the reduction of carbon emissions as part of their investment strategy without having a sustainable investment objective and coming within Article 9 of SFDR. The Commission, however, was clear that none of the pre-contractual, website, marketing, and periodic disclosures relevant to the fund may mislead investors into believing that the promotion of a reduction in carbon emissions was more than a mere characteristic of the fund's strategy or that the fund was a product to which Article 9(3) would apply.

## **PRINCIPAL ADVERSE IMPACTS (PAI) DISCLOSURES**

The Commission confirmed that pre-contractual disclosures of PAIs in respect of funds should include both a description of the adverse impacts on sustainability factors and the procedures put in place to mitigate those impacts.

## **PAI THRESHOLD OF 500 EMPLOYEES AT ENTITY LEVEL**

With reference to the understanding of “the average number of 500 employees” in Article 4 of SFDR, the Commission confirmed that the definition of “employee” shall be governed by national laws.

## **PERIODIC DISCLOSURE FREQUENCY FOR INVESTMENT FIRMS PROVIDING PORTFOLIO MANAGEMENT**

Finally, the Commission confirmed that FMPs that are investment firms providing portfolio management need only report under SFDR annually, in every fourth quarterly report required under Article 25(6) of Directive 2014/65/EU (MiFID II).

## **CONCLUSION**

These updates from the Commission will need to be considered by all FMPs and applied in their website, pre-contractual, periodic, and marketing disclosures as appropriate. Generally, these updates are welcomed by industry, with their emphasis on SFDR as “a transparency regulation” and the Commission's confirmations throughout regarding the relevant articles' neutrality in terms of product design. The delay in getting these responses will be considered regrettable by some, particularly for the many FMPs that felt compelled to reclassify their PAB/CTB tracking funds from Article 9 to Article 8 late last year in the absence of the confirmation from the Commission that they need not establish that the underlying investments held for tracking purposes are sustainable investments, which appears to now have been confirmed.

## **FOOTNOTES**

<sup>1</sup> At the same time, the Commission also provided some [light amendments](#) to their previous questions and answers published in July 2021 and May 2022.

## KEY CONTACTS



**ÁINE NÍ RIAIN**  
SENIOR ASSOCIATE

DUBLIN  
+353.1.486.1734  
AINE.NIRIAIN@KLGATES.COM



**GAYLE BOWEN**  
PARTNER

DUBLIN  
+353.1.486.1733  
GAYLE.BOWEN@KLGATES.COM

---

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.