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EU Regulators Provide Guidance on SFDR Level 2 Requirements

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Just six weeks before the application of the regulatory technical standards (“**RTS**”) adopted under the Sustainable Finance Disclosures Regulation (“**SFDR**”) on 1 January 2023, the European Supervisory Authorities (“**ESAs**”) published a **questions and answers document** (“**Q&A**”) addressing questions of interpretation and practical issues relating to the use of the templates provided in the RTS. The questions and answers address the following areas:

- current value of investments in principal adverse impacts (“**PAI**”) and Taxonomy-aligned disclosures;
- PAI disclosures;
- financial product disclosures;
- multi-option products;
- Taxonomy-aligned investment disclosures; and
- financial advisers and execution-only financial market participants (“**FMPs**”).

In a number of instances in the Q&A document, the ESAs refer to the **clarifications** document published in June 2022 in response to the question posed. These questions primarily relate to the calculations required to be performed to complete Annex I SFDR – the Principal Adverse Impact Statement.

A selection of clarifications provided by the ESAs in the Q&A are set out in the table below.

Guidance on PAI Calculations / Taxonomy-alignment Calculations

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| <p>Meaning of "all investments"</p> | <p>Should include direct and indirect investments – eg, investments through funds or funds of funds.</p> <p>For fund managers, includes all assets under management resulting from both collective and individual portfolio management activities.</p> <p>In relation to Taxonomy-alignment calculations, there is no limitation to the definition of "all investments of the financial products" in the denominator, which therefore includes all types of securities or financial contracts. The investments used in the numerator and the denominator should be valued at market value.</p> |
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Short positions

The ESAs believe that publishing short positions separately from the main PAI indicator calculations would not help the comprehensibility of PAI disclosures. The calculations for short positions should apply the methodology used to calculate net short positions set out in the Short Selling Regulation. The PAI of long and short positions should also be netted accordingly at the level of the individual counterpart, but without going below zero.

PAI Disclosures

Should FMPs disclose what share of PAI impacts have been estimated and what share has been calculated on the basis or reported information?

It would be good practice, but not obligatory, for FMPs to include:

- the proportion of investments for which the FMP has relied on data obtained directly from investee companies, in order to calculate the corresponding indicator;
- the proportion of investments for which the FMP has relied on data obtained by carrying out additional research, cooperating with third party data providers or external experts or making reasonable assumptions, in order to calculate the corresponding indicator.

Financial Product Disclosures

Deleting sections of the templates that are deemed not relevant to the product

The ESAs have clarified that it is permissible to remove sections of the templates that are deemed not relevant for the financial product only if those sections are accompanied by a red text instruction that explicitly limits the scope of the application of the section.

Good governance

In response to a query as to how an Article 8 SFDR product can assess good governance and whether a reference to the UN Global Compact is sufficient or whether there should be alignment with OECD or ILP principles, the ESAs state, *“The use of reference metrics, such as the UN Global Compact, OECD or ILP principles is not prescribed, but could form part of the “policy to assess” the management structures, employees relations, remuneration of staff and tax compliance”*.

Can an FMP apply different interpretations of "sustainable investment" to different financial products it offers?

The ESAs note that it is possible for FMPs to create their own framework for their financial products as long as Article 2(17) (relating to the definition of "sustainable investment") is complied with. FMPs should not interpret Article 2(17) SFDR differently for different financial products it makes available.

Taxonomy-alignment Disclosures

Where FMPs opt to obtain an assurance by one or more auditors or a review by one or more third parties in relation to the compliance of investments with Article 3 Taxonomy Regulation, should the third party review the internal process or the data as such?

The review does not necessarily have to include the internal process as it should primarily address the investments made by the financial product in Taxonomy-aligned economic activities.

Should pre-contractual disclosures be a minimum ambition or the actual achieved level of Taxonomy-aligned investments?

The disclosure of the minimum extent of Taxonomy-alignment of investments in the financial product is a commitment which should be met at all times. The ESAs have clarified that this also applies to:

- disclosures of the minimum proportion of the investments used to meet the environmental or social characteristics or sustainable investment objective(s) of the product;
- sustainable investments.

The ESAs state that the pre-contractual disclosure should not include “targets” for Taxonomy-alignment, nor the actual achieved level of Taxonomy-aligned investments, but only the minimum proportion which the financial product commits to meet.

Use of "equivalent information" from investee companies or third party providers

In exceptional cases and only for those economic activities for which complete, reliable and timely information could not be obtained, FMPs are allowed to make complementary assessments and estimates on the basis of information from other sources. Assessments and estimates should only compensate for limited and specific parts of the desired data elements and produce a prudent outcome. FMPs should clearly explain the basis for this conclusions and provide reasons for having to make such complementary assessments and estimates.

Activities contributing to several environmental and / or social objectives

Double counting should be avoided. One activity can only contribute to one of the objectives set out in Article 9 Taxonomy Regulation. If the activity contributes to more than one objective, the FMP should choose the objective to which the activity contributes most or that is better aligned with the environmental objective of the fund or investment.

Periodic Reports

Disclosure of actual sustainable investments during the reference period

Article 8 SFDR products that do not commit to making sustainable investments do not need to disclose sustainable investments during the reference period in their periodic reporting. This differs from the position with regard to Taxonomy-aligned investments, which must be disclosed in periodic reports irrespective of the commitments made in the pre-contractual disclosure.

The EU's sustainable finance framework is a complex and detailed set of rules and guidance and clarifications from regulators is welcome to assist FMPs in implementing the requirements. The timing of the publication of some of the guidance can present challenges, with late stage adjustments having to be made in light of clarifications issued in advance of regulatory deadlines. It is also the case that, despite the application date of 1 January 2023 for the SFDR Level 2 requirements, there are a number of challenges and interpretation difficulties remaining. It is hoped that future publications such as the Commission's answers to the [ESAs' questions](#) submitted in September 2022 (expected to be answered in a phased basis early in 2023) and the findings of the CSA in 2023 will further assist managers in meeting their obligations.



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