FINNIUS

Further interpretation of the ESG requirements: working with green in an impressionistic style or will it remain a watercolour?

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In our earlier blog, we indicated that there was much uncertainty about the actual application and interpretation of the requirements under the Sustainable Finance Disclosure Regulation (**SFDR**) for fund managers. Think of it as a watercolor in the (further) sustainable regulatory landscape. Last month, this has changed: the AFM presented its results of a survey (in Dutch only) regarding the question whether and if so, how fund managers implement the requirements of Articles 6, 8 and 9 SFDR in the pre-contractual phase. Bottomline: Things can (and must) be improved. This blog highlights the points of improvement that the AFM has formulated from the results of its investigation. We will also briefly look ahead at the Taxonomy Regulation. After all, as of 1 January 2022 this regulation also provides (on a phase-to-phase basis) a list of additional requirements in the context of ESG that is also relevant to fund managers.

SFDR; a recap

As a short refresher; the SFDR aims to give investors more insight into the sustainability risks and to make it easier to compare the sustainability of financial products. Fund managers must provide information at both entity and product level (i.e. the fund) on how they integrate sustainability aspects. This requires transparency about (i) whether or not (principal) adverse impacts on sustainability factors are taken into account in their investment decisions, (ii) the integration of sustainability into the remuneration policy, and (iii) how the fund manager implements sustainability objectives and characteristics in the pre-contractual documentation and periodic reporting. In the latter case, information must be included about, among other things, the way in which sustainability risks are integrated into their investment decisions and its effect on the return on investments. The motto: the greener the ambitions, the more comprehensive the transparency obligation.

Parties that promote environmental (E) and/or social (S) characteristics without seriously compromising other environmental or social objectives and in respect of which the companies in which investments are made follow good governance practices (G) fall within the scope of Article 8 SFDR. Funds that aim to make sustainable investments (in the sense of the SFDR)(**Definition**)[1] fall within the scope of Article 9 SFDR.

AFM market research into the disclosure of information by fund managers under SFDR

We note that the AFM's investigation focused explicitly on the fund documentation and therefore on the obligations at product level. The AFM points out that, due to the fact that the European Commission (**EC**) has not yet issued definitive Regulatory Technical Standards[2], fund managers currently only have to apply the "high level" SFDR requirements. As soon as the final RTS are applicable, fund managers will have to check again whether they comply with the standards formulated therein. The AFM expects however that fund administrators will start preparing for the implementation hereof in a timely manner and that they will take the insights gained from the AFM's investigation into account while further implementing the SFDR and the accompanying technical standards based on the draft RTS as currently available (link).

In general, the AFM concludes that the investment objective of the funds is often formulated too broadly, as a result of which it does not correspond to the sustainability classification made, and that the integration of sustainability risks in the investment decision-making process of fund managers, as well as the interpretation of transparency obligations under Article 8 or 9 SFDR, must be expressed more clearly. One could say that the market currently seems greener than it actually is. Of course, it is noted that this study is based on fund documentation at the time of entering into force of the SFDR on 10 March 2021. Since then, there has been further guidance from the European Commission[3] and the expectations projected on market parties has been clarified, so some tolerance would be appropriate here. We discuss each of the points for improvement as indicated by the AFM in more detail below.

1. *Concrete integration of sustainability risks in the investment decision-making process*

According to the AFM, fund managers must not only describe the sustainability risks, but also provide **concrete** insight into how they (practically) take these risks into account when making investment decisions. By doing so, the impact of the sustainability risks becomes measurable. It seems that this is not happening at all or in an inadequately manner. The concrete implementation in the investment decision-making process by the fund managers is therefore a point for attention, while in its report the AFM does not address the parameters for determining when something is integrated concrete enough. In practice, this means in my view that a great deal of effort is required from fund managers in terms of “fingerspitzengefühl”. To address this, I would argue that it is particularly important to formulate realistic risks in respect of which fund managers should explain how (and to what extent) such risk will direct their investment decisions. General terms and highly hypothetical risks are likely to be insufficient in this context and would also make it very challenging in practice for fund managers to be able to substantiate how they determine (the impact of) such risks.

2. *Direct relationship between risk and impact*

With regard to the impact analysis of the aforementioned risks on the return on investments, the AFM states that fund managers must include in the pre-contractual information documents a **direct connection** between the sustainability risks to which the fund’s investments are exposed and the (expected) impact on returns.[4] Depending on the available data, a quantitative or qualitative estimate of the impact can be made. Fund managers must visibly tailor this estimate to the fund in question. In practice, this can lead to different conclusions about the estimated impact per relevant sustainability risk identified for the relevant fund.

3. *Integration of concrete and measurable promotion of "E" or "S" characteristics and compliance "G"*

"Article 8" funds often appear to formulate the "E" and/or "S" characteristics in a manner that is too general. This type of fund should first of all explain what environmental and/or social characteristics the fund is promoting and how these are being met. In addition, fund managers should address how these "E" and "S" characteristics are **binding**. In my opinion, this can be the case if these characteristics are a visible part of the investment policy of the fund and are included as such in the fund documentation, without the fund manager being able to independently waive these characteristics when making investment decisions. The latter situation would, after all, directly undermine the binding nature of such characteristics. In this way, the sustainability characteristics of the fund become known to the investors (which is in line with the rationale of the SFDR) and they can, where necessary, remind the fund manager of its contractual obligation to take these characteristics into account when making investment decisions.

The study also shows that fund managers of "Article 8" funds must be able to demonstrate how the underlying holdings meet the "G" requirement. In practice, this can potentially lead to problems if, for example, a PE fund manager – indirectly through the fund – holds a minority stake in the underlying holdings and does not have enough control over their business operations to be able to compel all the necessary information on the ESG characteristics of the investments. Another example would be a situation wherein a fund-of-funds structure only indirectly obtains information on the (ESG characteristics of the) underlying holdings. We recommend that fund managers of these type of funds in any event elaborate in their internal policy documents on how they will attempt (in a process-oriented manner) to ascertain whether the underlying holdings meet the "G" requirement.

4. *Selected sustainability classification vs. concrete and measurable sustainability objective*

Fund managers of "Article 9" funds apparently do not make the transition from the defined investment universe to a sustainable investment objective (and its implementation). Also, the investment objective of the fund manager often appears to be broader than the Definition.[5] Examples of situations in which the sustainability classification under Section 9 SFDR deviates from the Definition in practice are funds that focus on '*impact by engagement*', whereby the underlying investments do not (yet) meet the Definition themselves; funds that invest in '*best of class*' companies, where these companies belong to the best X% of the sector but do not (yet) meet the Definition themselves; (real estate) funds where only part of the portfolio actually meets the Definition; or funds that track a broad ESG market index but where the activities of the underlying companies do not (yet) fall within the scope of the Definition. This appears to be in line with EC guidance (dating from July this year), in which the EC states that *all* investments must fall within the scope of the Definition. In order to qualify as an "Article 9" product, fund managers must therefore apply a "tight" focus when making investments.

In a financial market that is becoming more sustainable and in the absence of definitive RTS, it is understandable that fund managers are unsure as to how to interpret their obligations under the SFDR. The fact remains, however, that if fund managers wish to distinguish themselves in the market and profile themselves (to a greater or lesser extent) as a player focused on sustainability, they must comply with (far-reaching) transparency obligations. One good turn deserves another, also in the area of sustainability. The AFM's research shows that there is still room (or necessity?) for improvement, but it also offers fund managers the opportunity to give more direction to their investment policy and the way in which ESG elements are imbedded therein. This should in any event be done in a concrete, measurable and binding manner, according to the AFM. Partly in the light of the guidance provided by the AFM and the EC, I believe that it is currently very challenging for fund managers to qualify as an "Article 9" product and that, in order to qualify as an "Article 8" product, fund managers must pay close attention to a thorough description of the "E" and/or "S" characteristics and the way in which this is stated in the fund documentation.

Sneak preview: Transparency requirements under the Taxonomy Regulation, what is yet to come?

Just as fund managers seem to be getting a better grip on the application of the SFDR, there is another layer of transparency obligations that will (possibly) become relevant as of 1 January 2022: the Taxonomy Regulation![6] Under the Taxonomy Regulation, the (degree of) environmental sustainability of a particular economic activity must be established on the basis of an exhaustive list of six environmental objectives[7]. The Taxonomy Regulation provides guidance on the categories of economic activities that fall within the qualification "environmentally sustainable".[8] Fund managers also fall within the scope of the Taxonomy Regulation and will therefore have to take into account this additional dimension of disclosures in their information documentation. The information that will need to be included will depend on the sustainability classification chosen, but again, the greener the classification, the more information must be provided. In addition, the Taxonomy Regulation, like the SFDR, contains a *comply-or-explain* methodology. It is important to note that even if a fund is a "grey" product (i.e. an "Article 6" product), the pre-contractual and periodic information documents will need to contain additional information.[9] The Taxonomy Regulation is therefore not only relevant to "Article 8" or "Article 9" products. We would advise fund managers to keep an eye on developments in this respect to ensure that their information documentation is in line with this legislation from 1 January 2022, where necessary.

Conclusion

The current state of affairs regarding the (interpretation of the) SFDR and fund managers has been clarified by the findings of the AFM, but without a definitive RTS unfortunately it has not yet become a green impressionist style painting. We recommend that fund managers study the report of the

AFM and actively and traceably decide whether they need to make any changes as a result of this report. The expansion of the transparency obligations that will apply to fund managers under the Taxonomy Regulation will require an even greater focus on the sustainability classification and the way in which information is provided on the type of product. Hopefully the final RTS for the SFDR and Taxonomy Regulation will provide more practical guidance for fund managers in the (near) future. To be continued!

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[1] Ex Article 2 under (17) SFDR: An investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

[2] These will enter into force on 1 July 2022, but are expected to be finally adopted by the EC earlier.

[3] European Commission Q&A: Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088) (https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf).

[4] According to the AFM, the generic remark that these risks can affect the return is not sufficient.

[5] The mere fact that fund managers apply boundaries to their policy in the context of sustainability cannot in itself be regarded as a sustainability objective.

[6] As mentioned previous in one of our blogs, this Regulation is part of the UN’s sustainable development agenda (the “Agenda 2030”) and aims to stimulate private investments in sustainable activities by making financial products available (in a harmonised way) that pursue environmentally sustainable objectives.

[7] These objectives are; climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.

[8] In this case, the economic activity must (i) contribute to one of the six objectives mentioned above in accordance with the requirements laid down in the TV, (ii) not significantly harm any of the

environmental objectives (the so-called “no significant harm principle”), (iii) be conducted in accordance with the minimum safeguards (avoidance of adverse social impact) and (iv) meet the technical screening criteria laid down by the EC for each objective. At present, such technical screening criteria have only been established by the EC for the first two objectives.

[9] Among other things, the following statement must be included: “*The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities*.”

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