

YPOG Briefing: SFDR and Principal Adverse Impacts

Berlin, May 31, 2022 | Lennart Lorenz, Antonia von Treuenfeld, Stefanie Nagel and Anne Maria Weiske

The Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088, “**SFDR**”) obligates financial market participants, including VC and PE fund managers, to disclose certain ESG-related information on their website, in pre-contractual documents and in periodic reports. Crucial for the implementation of the SFDR are the Regulatory Technical Standards (“**RTS**”), which concretize the SFDR on a second regulatory level and contain comprehensive guidance as well as templates on how information should be disclosed.

So far, the RTS have only been available in various draft versions. As such neither final nor binding, they were nonetheless applied by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – “**BaFin**”) to interpret the SFDR since 2021, based on a corresponding recommendation¹ of the European Supervisory Authorities (“**ESAs**”). On April 6, 2022, the European Commission finally adopted the RTS with slight amendments compared to their last draft version from October 2021. Even though both the European Parliament as well as the European Council have a three-month veto right, it is rather unlikely that this right will be exercised since such objection would reject the RTS in their entirety and therefore would trigger a new drafting process. Consequently, the version now adopted is likely to enter into force as of January 1, 2023.

However, also in this version of the RTS, several practical questions remain unanswered. In particular, the “principal adverse impacts” (“**PAIs**”) and corresponding statement pursuant to Art. 4 SFDR (“**PAI Statement**”) often cause considerable difficulties for financial market participants. This YPOG Briefing therefore focuses on the PAI Statement and the changes resulting from the amended version of the RTS.

1. Principles of Art. 4 SFDR – comply or explain?

Since March 10, 2021, fund managers are obligated to disclose on their website whether they consider PAIs, *i.e.*, adverse impacts of their investment decisions on sustainability factors. Sustainability factors mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters. The SFDR provides for two possible options: In case of the consideration of such impacts (“**Comply-Approach**”), fund managers must disclose the **most important** adverse impacts on sustainability factors identified by using certain predefined indicators as reference. These indicators, along with other formal requirements, are specified in Table 1 through Table 3 of Annex I of the RTS (“**Annex I**”). In case fund managers do not consider PAIs (“**Explain-Approach**”), they must explain why they do not take into consideration **any** adverse impacts of their investment decisions.

Fund managers are **generally free** in their decision to consider PAIs in their decision-making process. While in the past it was unclear whether the classification of a fund as an “impact product” according to Art. 9 SFDR – or possibly even as a “simple” ESG product according to Art. 8 SFDR – necessarily requires the consideration of adverse impacts (Comply-Approach), this has already been

¹ Cf. ESA, JC 2022, 12 24, Rn. 12.

clarified in the draft version of the RTS as of October 2021: Since then, the templates for product-related disclosures allow fund managers of both categories to declare not to consider PAIs (Explain-Approach). For impact products pursuant to Art. 9 SFDR, this admittedly is a theoretical option as most of the sustainability indicators must be taken into account by them for other reasons (see below). Yet, it should be mentioned that the freedom of choice only applies in one direction: The classification of a product according to Art. 8 SFDR does not necessarily mean that PAIs must be taken into consideration. If, however, a fund considers PAIs, this is an environmental or social characteristic which leads to a product qualification pursuant Art. 8 SFDR.²

2. What does a decision for the Comply-Approach mean?

Currently, the PAI Statement must only include the information laid down in Art. 4 SFDR. As of January 1, 2023, when the RTS enter into force, the format as specified in Annex I as well as the disclosure of the indicators set out therein will become mandatory. PAI Statements must then be published until June 30 each year in the format of Annex I, always referring to the reference period of the previous year. The first PAI Statement must be disclosed as of June 30, 2023, and thus relates to the calendar year 2022.³

In addition to the 14 mandatory sustainability indicators included in Table 1 of Annex I (*i.e.*, carbon footprint, GHG emissions, emissions to water, proportion of hazardous and radioactive waste, board gender diversity etc.), fund managers also must select at least one additional climate or environment-related indicator, as well as at least one indicator from the areas of social and employee, human rights, anti-corruption or anti-bribery matters. All in all, fund managers must report on a total of at least 16 indicators.

In order to adequately reflect changes in the portfolio composition, the indicators must be queried quarterly on March 31, June 30, September 30 and December 31, and presented in the PAI Statement as an average of the data collected, including a historical comparison of up to five previous periods.⁴ Moreover, as per the final version of the RTS, fund managers are also required to indicate any planned actions and set targets for the upcoming reference period in addition to the actions already taken for each indicator. If data required for the measurement of adverse impacts cannot be obtained from the portfolio companies, it shall be supplemented by independent research, in cooperation with external experts or data providers, or by reasonable assumptions, all of which shall be disclosed accordingly (*cf.* Art. 7(2) RTS). Each fund manager shall publish a consolidated PAI Statement, hence only one table as set forth in Annex I, which contains the aggregated data of all investments of all funds made available by the fund manager.

3. Disclosure channels and manner of presentation

The specifications on the format and content of the PAI Statement arising from Annex I only apply to the disclosures on the fund manager's website. However, a statement on PAI also must be included in the pre-contractual information as of December 30, 2022, at the latest, and in the periodic reports as of January 1, 2023.

The **RTS remain silent** on whether these disclosures must mirror the website disclosures in form and content, *i.e.*, whether they should follow the table format of Annex I and contain information on the specific indicators. From our point of view, this should not be necessary: The templates for the pre-contractual disclosures only require fund managers to include a clear and reasoned

² Such as recital 10 RTS.

³ Art. 4(1) RTS as well as recital 40 RTS; ESA, JC 2022, 12 24, Annex para. 2.

⁴ Recital 5 RTS; Art. 6(3) RTS; Art. 10 RTS.

statement if and how PAIs are taken into account by the respective fund without referring to the specific indicators and further details. In turn, the templates for the annual reports pursuant to Art. 11(2) SFDR (analogously) only require an explanation on how the respective fund has taken PAIs into account – also without explicit reference to the table in Annex I.

4. Special features in the statement according to Art. 4 SFDR

Despite the specifications on the PAI Statement outlined above, several variables exist in this context. Yet, neither the SFDR nor the RTS provide clear guidance in all instances.

Art. 3(3) RTS clarifies the practical question of which reference dates should be chosen by fund managers which commence their activities during the year and are thus unable to report on the full reference period of a whole year: In this case, for the first PAI Statement, the reference period is redefined as the period from the start of consideration during the year, *i.e.*, the collection of the relevant data, until December 31 of the respective year. These fund managers also compile data on a quarterly basis but may obtain data on fewer than four reporting dates per year.

Apart from that it remains unclear whether the aforementioned also implies that a fund manager **may change its general decision** from the Explain-Approach towards the Comply-Approach, with the consequence that in this case such shortened first reference period applies from the effective date. This is particularly relevant for fund managers which, due to legal and practical uncertainties, opted for the Explain-Approach when the SFDR came into force but are now reconsidering their decision in light of increasing experience in the market and the growing legal certainty. The SFDR and the RTS do not explicitly grant such a possibility, but at the same time also do not exclude a re-evaluation. In addition, a switch from the Explain-Approach to the Comply-Approach would increase the fund manager's commitment to ESG and would constitute a greater contribution to the transition to a sustainable European financial market, which is unlikely to contradict the legislative intention or the supervisory practice of BaFin.

Certainly, this argument does not apply in the reverse case, *i.e.*, the question whether it is possible to switch from the Comply-Approach to the Explain-Approach. But even such switch is not explicitly excluded. However, it could be problematic insofar as the fund manager oftentimes will have communicated its original decision to consider principal adverse impacts on the website or in pre-contractual documents and thus may possibly have created a basis of trust which the respective investors have relied on.

The question of whether a fund manager can issue a **"split"** PAI Statement, *i.e.*, whether it is possible to consider the adverse impact on sustainability factors regarding some but not all financial products made available by the financial market participant, has **not yet been conclusively clarified**⁵. The wording of the SFDR suggests that some kind of split is not completely ruled out: While the PAI provisions for the website statement refer to the fund manager, those for the pre-contractual information only refer to the respective product.⁶ This distinction between manager and product level is also reflected in the templates for pre-contractual information and periodic reports, which ask about the consideration of PAIs by the respective product, but not by the fund manager. Finally, the fact that funds may qualify as products pursuant Art. 8 SFDR only because they consider PAIs also suggests that a product-specific PAI Statement must be possible irrespective of the fund

⁵ Cf. question no. 1, ESA, JC 2022 26.

⁶ Art. 4 (1) SFDR as well as Art. 7 SFDR; see also the corresponding distinction in the overview of the periods of application in ESA, JC 2022, 12 24.

manager's decision. At least in cases where the Explain-Approach has been chosen at the level of the fund manager, it should be possible to choose the Comply-Approach for individual products.⁷

5. Sustainability indicators and "do no significant harm"

Lastly, the sustainability indicators of the PAI Statement are relevant in connection with the principle of "do no significant harm" ("**DNSH**"), *i.e.*, the avoidance of significant negative effects on environmental or social objectives. DNSH is part of the definition of sustainable investments as set forth in Art. 2 No. 17 SFDR. Products pursuant to Art. 9 SFDR as well as those under Art. 8 SFDR which make sustainable investments must publish a **statement** regarding **DNSH** as part of their pre-contractual disclosures and their periodic reports. As a result, they must explain how their sustainable investments have contributed to an environmental objective without doing significant harm to any of the other environmental objectives. How exactly compliance with DNSH may be **assessed** and **measured** is still **unclear**.

It can be inferred from the SFDR that the details of DNSH should correspond to the sustainability indicators of Annex I in terms of content, methods and presentation.⁸ According to the RTS, particularly the mandatory indicators from Table 1 should be considered. As a result, the above-described possibility for funds pursuant to Art. 9 SFDR to follow the Explain-Approach is a mere theoretical one as they are obliged to collect the relevant data for the classification of their investments anyway. In addition, further indicators of Tables 2 and 3 of Annex I should also be considered where relevant for the determination of DNSH. What is deemed relevant in this regard may be decided by the fund manager.

Of further relevance for the determination of DNSH are the minimum safeguards as laid down in Art. 18 of the Taxonomy Regulation (Regulation (EU) 2020/852, "**Taxonomy**").⁹ These minimum safeguards are procedures implemented to ensure the alignment with the OECD Guidelines and the UN Guiding Principles. It should be noted that despite the interlace with the Taxonomy, DNSH as used in the SFDR should be distinguished from "significant harm to environmental objectives" pursuant to Art. 3(b) and Art. 17 of the Taxonomy. Therefore, there is no exemption from the DNSH assessment requirement for Taxonomy-aligned investments, with the consequence that such investments are also required to conduct a separate DNSH assessment in accordance with the respective principles of the SFDR.

The YPOG ESG-Team will report on further developments and is available for discussions on this topic – especially in light of the recent statement of the European Commission, inviting the ESAs to amend the RTS once again and also further develop the requirements for the PAI Statement. In addition, the ESAs have recently asked the European Commission for clarifications on the RTS, the response to which is likely to have a significant impact on the advisory practice. Stay tuned – seems like this will not be our last Client Briefing on principal adverse impacts.

⁷ Cf. the different subjects of reference in Art. 7 SFDR.

⁸ Art. 2a (1) SFDR; Recital 10 RTS.

⁹ Recital 22 RTS; P. 5 RTS.