

SFDR Principles explained: New RTS provides guidance on key issues

1. Speed Read

Under SFDR, the European Supervisory Authorities (**ESAs**) have been mandated to develop various Level 2 measures, to take the form of Regulatory Technical Standards (**RTS**). On 4 February 2021, the ESAs published their final report on a draft RTS. Our comparison against the consultation draft can be found [here](#).¹

The recitals and certain articles in this RTS contain useful guidance as to the position being taken by regulators on key issues of interpretation.

This briefing gives further detail on these points, to assist firms in making sense of the new SFDR regime.

¹ https://www.aohub.com/aohub/publications/sfdr-level-2-requirements_1



2. What does the RTS cover?

From a high level perspective, the RTS provides guidance on certain points of interpretation in relation to SFDR, and greenwashing risk. It also sets down detailed “rules of the road” for certain SFDR disclosure requirements – eg principal adverse impacts (PAI) disclosures, and product level disclosures required by Articles 8, 9, 10 and 11.

Please contact us for a copy of our full briefing on the RTS.

Please also note that, in terms of next steps, the European Commission will now review the draft RTS and either adopt or reject. Assuming it adopts “as is”, the co-legislators will have a three month scrutiny period to accept or reject. We understand that the Commission currently intends to adopt the measures at the end of March or beginning of April. However, there is no guarantee that this timeline will be adhered to or that no further changes will be made.

3. What do I need to know about the guidance in the RTS?

Some key points include the following:

“Do not significantly harm” principle (DNSH)

- The RTS makes clear that an Article 8 product must also provide information in relation to the DNSH principle, where the product makes sustainable investments, notwithstanding how counterintuitive this is. Among other things, this includes disclosure as to how the indicators for adverse impact have been taken into account (recital 33 and Article 16).
- In fact, this is a consistent theme throughout the RTS – how interlinked the concept of DNSH is with principal adverse impacts (in particular, as regards the principal adverse impacts indicators).
- When compared to the first draft RTS released in April last year, the revised RTS adds an additional layer to the DNSH requirements. On top of disclosing how the principal adverse impact indicators have been taken

into account (as above), the relevant DNSH reporting will also need to include information on whether the sustainable investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (including the principles and rights set out in the eight fundamental ILO conventions and the International Bill of Human Rights). This is to bring the DNSH disclosures in line with the minimum safeguards outlined in the Taxonomy Regulation.² Under the Taxonomy Regulation, compliance with the minimum safeguards is a separate and additional criteria to the satisfaction of the DNSH test in establishing whether an economic activity qualifies as “environmentally sustainable”. As such, the RTS will significantly broaden how financial market participants have so far been approaching DNSH under SFDR.

Principal adverse impacts (PAI) (Article 4, SFDR)

- **Direct vs indirect holdings**
A principal adverse impacts disclosure must be done on a “look through” basis where the investee company is a holding company, fund or SPV – ie looking through to the underlying assets (recital 4, RTS).
- **If data cannot be obtained**
If you cannot or do not obtain information on the underlying assets, you cannot be considered to take into account the principal adverse impacts of your investment decisions on sustainability factors (recital 4, RTS).

- **Level of effort required**
You should identify principal adverse impacts “*through all reasonable means available*” (recital 8, RTS).
Market standards and regulatory expectations on this front are likely to emerge over time, but on its face, the RTS states as follows: “*For example, they may employ external market research providers, internal financial analysts and specialists in the area of sustainable investments, undertake specifically commissioned studies, use publicly available information or shared information from peer networks or collaborative initiatives.*”

² Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852>

Financial market participants may also engage directly with the management of investee companies to better understand the risk of adverse impacts on sustainability factors. Direct engagement may be particularly necessary in situations where there is an insufficient level of data available.” There is no mention here of proportionality or what may be commercially practicable bearing in mind cost or capacity constraints, but we would seek to argue this can be kept in mind given the reference to “reasonable means” mentioned above.

– Frequency

You should calculate your principal adverse impacts on at least four prescribed dates in a reference period to obtain a representative level of the impact for that

period. You also need to provide a historical year by year comparison of your reports for at least the five previous reference periods (recital 11 and Article 6, RTS).

– Advisers

An adviser must: (a) “clearly describe how the [PAI] information provided by financial market participants is processed and integrated in [your] ... advice”; and (b) where you rely on adverse sustainability impacts criteria to include financial products or financial market participants in your advice, you must disclose those criteria (recital 14, RTS). This is amplified by Article 10 of the RTS which details the precise PAI disclosure requirements for advisers.

Categorisation

– Exclusions or negative screening

In the absence of regulatory guidance, it is unclear whether exclusions are alone sufficient to cause a product to fall within the scope of Article 8 – and if so, where the “line should be drawn”. The RTS does not answer this point, but does suggest Article 8 is intended to be broadly construed. Eg “There are a variety of financial products with **various degrees of ambition** with regard to taking into account sustainability factors. Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to **specific sectoral exclusions**” (recital 18, RTS, emphasis added). The RTS also refers to the fact that, in the ESAs’ view, “many financial products currently rely on exclusion strategies based on environmental or social criteria” (recital 25, RTS).

The reference to sectoral exclusions in particular may support the argument that fairly limited exclusions can “tip” a product into Article 8, although we would wish to argue that this is subject to a basic materiality threshold – eg a mandate should only be considered to satisfy the characteristics test if it has environmental or social characteristics that may together be considered to comprise a key or material feature in relation to the relevant product, considered as a whole. In particular, the exclusions must have a meaningful impact on the composition of a particular portfolio, rather than being of a more notional or academic nature. Further advice on this point is available on request, although, in the absence of further regulatory guidance from the Commission, the matter remains unclear.



– Principal adverse impacts sufficient

The RTS unhelpfully notes that: *“One of the ways in which financial products can promote environmental or social characteristics is to take into account principal adverse impacts of investment decisions”* (recital 19, RTS). This is likely to be the subject of industry discussion, as it is not clear what this means.

– Binding criteria only

The RTS suggests that only binding criteria should be taken into account when categorising a particular product (recital 20, RTS).

– Product name and marketing material

The RTS notes the following, although the meaning of this is not clear. It is therefore again likely to be the subject of further industry debate and discussion:

*“To ensure comparability, where a financial product promotes environmental or social characteristics in a pre-contractual or periodic document, in its **product name or in any marketing communication** about its investment strategy, financial product standards, labels it adheres to or applicable conditions for automatic enrolment, the financial product should include the pre-contractual and periodic disclosures set out in this Regulation. Also, where the financial product intends to pursue in part sustainable investment, that information should also be included in that information”* (recital 22, RTS, emphasis added).

– Guidance on greenwashing risk

The term ‘greenwashing’ is described as *“the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards”* (recital 25, RTS).

– Disclosures

The RTS suggests firms should be alive to the need to avoid disclosures or statements that risk misleading potential clients or investors as to the ESG credentials of a particular product. Eg it states that firms *“should not disclose excessively on sustainability, including through product categorisation, where that is not commensurate with the way in which those characteristics are applied to the financial product”* (recital 20, RTS).

– Non-binding criteria

The RTS suggests firms *“should not mislead end investors by disclosing selection criteria which they may disapply or override at their discretion”* (recital 20, RTS). This suggests that firms may wish to sense check their new and legacy Article 6 product documentation before 10 March 2021, as well as reporting templates, new marketing material etc, to ensure that references to non-binding ESG criteria, principles, strategies etc are referred to in a way consistent with this regulatory guidance.

– Non-E/S investments

The RTS requires a firm to be “fully transparent” as to the “allocation” of an Article 8 product in investments that are not “E” or “S” in nature; eg *“hedging instruments, unscreened investments for diversification purposes, investments for which data is lacking or cash held as ancillary liquidity”* (recital 21, RTS). Consistent with the principles noted above, this suggests a concern for a firm to be clear with potential investors and clients as to the product’s ESG credentials and not “oversell”.

– Exclusions and negative screening

The RTS appears to warn firms against greenwashing risk to the extent they showcase exclusion strategies are material *“while in fact they actually lead to the exclusion of only a limited number of investments or are based on exclusions required by law”* (recital 25, RTS). It also requires disclosures as follows: *“In order to prevent mis-selling and greenwashing, disclosure of any commitment with regard to a minimum reduction of the set of potential investments as a result of the application of the exclusion strategy is necessary to give end investors better visibility over the materiality of the offered strategy.”*

– Sovereign bonds

It is challenging to consider how aspects of SFDR apply to investments in assets such as sovereign bonds. However, wording in the RTS makes clear that this should in fact be considered in the context of the principal adverse impacts regime at minimum (recital 4, RTS).

– Projects

In the context of investments that exclusively finance a project or type of project, such as an investment in a green bond, social bond or project bond, the RTS confirms that *“the assessment of the adverse impacts of the investment decisions should be limited to the adverse impacts of the targeted project or type of project”* (recital 5, RTS).

Further guidance in relation to Article 8 and 9 products

– Non-E/S investments

The RTS makes clear that an Article 8 product can include investments that (considered alone) are not “E” or “S” in nature; eg *“hedging instruments, unscreened investments for diversification purposes, investments for which data is lacking or cash held as ancillary liquidity”* (recital 21, RTS).

– Non-sustainable investments

The RTS describes Article 9 products as those which *“exclusively pursue sustainable investments”* (recital 18, RTS) and further provides that *“... products that have sustainable investment as an objective are expected to make **only** sustainable investments”* (recital 23, RTS) (emphasis added). Somewhat paradoxically, the RTS then states that, despite this, *“...it is appropriate to require disclosures on the amount and purpose of any remaining investments to demonstrate how those investments do not prevent the financial product from attaining its sustainable investment objective”* (recital 23, RTS). These statements are not easily reconcilable, and, in particular, it is not clear if the bar for Article 9 products is perhaps higher than initially thought on the basis of the April 2020 draft RTS. This paragraph is likely to be the subject of further industry discussion.

– Exclusions or negative screening

The RTS notes that an Article 8 product may include investments that (considered alone) are not “E” or “S” in nature but to which the relevant firm applies *“baseline environmental or social safeguards such as those referred to in Regulation (EU) 2020/852”*. This refers to the minimum safeguards in the Taxonomy Regulation:³

“Article 18 Minimum safeguards

1. The minimum safeguards referred to in point (c) of Article 3 shall be procedures implemented by an undertaking that is carrying out an economic activity to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

2. When implementing the procedures referred to in paragraph 1 of this Article, undertakings shall adhere to the principle of ‘do no significant harm’ referred to in point (17) of Article 2 of Regulation (EU) 2019/2088.”

In this case, the RTS directs the relevant firm to *“explain those safeguards so that end investors receive accurate information on the entirety of the investments made by the financial product”* (recital 23 and Article 16, RTS).

– Product governance

The Level 2 measures refer to various matters required to be done in relation to different types of products in scope of SFDR. They also refer to monitoring during the “lifecycle” of the relevant product and require a website disclosure as to the internal or external control mechanisms used to monitor compliance with the “disclosed environmental or social characteristics” (for Article 8 products) or “sustainable investment objective” (for Article 9 products) (recital 26, RTS). To address these types of requirements, you may wish to consider updates to your internal product governance policies/procedures.

– Index and benchmarks

The RTS contains various comments relating to the use of an index or benchmark in relation to Article 8 and 9 products, requiring transparency at index/benchmark level (recitals 28, 29 and 38, RTS).

– Direct vs indirect holdings

The RTS acknowledges that a product can directly invest in securities issued by an investee company or make indirect investments; eg via a fund or funds or derivatives. There is a concern for a firm to be transparent re what is held directly vs indirectly, and also (as regards derivatives) explain how the use of derivatives is compatible with the product’s “E” or “S” characteristics or sustainable investment objective (as the case may be) (recital 31, RTS).

– Sustainable investments of an Article 8 product

The RTS requires an Article 8 product to expressly state it does not have sustainable investment as an objective, so the matter is clear for investors. The product disclosures must also disclose the proportion of the product that comprises sustainable investments vs not (recital 32 and Articles 13 and 16, RTS).

³ Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852>

Website (recitals 34 and 35, RTS)

The RTS makes clear that a firm's website can/should be used to expand on topics covered in pre-contractual disclosures, and provide further information (although always consistent with the pre-contractual disclosures).

It expressly requires a firm to inform end customers about the fact that more product-specific detailed information can be found on the website and provide a link – this must be done before *“a contract is closed”*.

The website disclosure must include a *“clear, succinct and understandable summary”* of relevant information provided in periodic reports.

Website disclosures must be made bearing in mind confidentiality and data protection issues.

– Periodic reports

The RTS provides various guidance on this, including a need for alignment/consistency with the pre-contractual disclosures, and a requirement to disclose the impacts of the top investments in the product (generally meaning the top 15). A year on year comparison with the previous five reference periods is also required to ensure comparability over time (recital 37, RTS).

– Translations

You should provide a summary of your principal adverse impacts disclosure in a language customary in the sphere of international finance (eg English) plus *“in a language of all the Member States where [your] financial products are marketed”* (recital 13, RTS). For other RTS disclosures, you are required to prepare a summary in a language customary in the sphere of international finance (eg English) and (where a product is marketed outside the firm's Member State) a summary should be provided in one of the official languages of that other jurisdiction (recital 39, RTS).



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