



YPOG Briefing

ESG Update

Berlin, July 27, 2021 | By: Joel El-Qalqili and Antonia von Treuenfeld

SFDR Update

Yesterday, the European Commission has issued a response to various key questions relating to the Sustainable Finance Disclosure Regulation ("**SFDR**") (the "**Commission Decision**"). In short, the SFDR requires financial market participants and financial advisors (for the purpose of this short briefing, we will look at VC and PE fund managers only) to disclose certain ESG-related information on their website, in pre-contractual documents as well as in their periodic reporting. In early January, the European Supervisory Authorities had put forth key questions relating to the SFDR to the European Commission for clarification. Since March 10 this year, the SFDR applies and since then market participants have to cope with SFDR-compliance despite major uncertainties even relating to the applicability of the SFDR. Against that background, the European Commission's responses are welcomed although some of the clarifications are incompatible with recently evolved market practice. Among the statements of the Commission Decision we consider the following to be of particular importance:

Applicability to sub-threshold AIFMs

The Commission Decision declares that the SFDR is applicable to sub-threshold AIFMs (even without a EuVECA or EuSEF registration). Market participants (and some national regulators), who have so far taken the view that the SFDR would in such cases not be applicable, should now take note of the Commission Decision and adjust.

Pre-contractual and periodic reporting obligations for sub-threshold AIFMs

The Commission Decision also declares that sub-threshold AIFMs have to include SFDR disclosures in pre-contractual (Art. 6, 8, 9 SFDR) information and periodic reporting (Art. 11 SFDR). This is remarkable, since the relevant obligations to disclose pre-contractually or to report periodically depend on certain basic obligations under the AIFMD, *i.e.* the obligation to provide pre-contractual information pursuant to Art. 23 AIFMD and to report pursuant to Art. 22 AIFMD – and such obligations do not apply to sub-threshold AIFMs. However, the Commission has decided that such obligations should be applied "by analogy". Market participants who have so far taken the view that there are no specific pre-contractual disclosure and periodic reporting obligations for sub-threshold AIFMs should adjust.

Mandatory use of EU Climate Transition Benchmark or EU Paris-aligned Benchmark

The Commission Decision further declares that funds which aim to make sustainable investments within the meaning of Art. 9 SFDR must, if they pursue the objective of a reduction of carbon emissions (Art. 9 (3) SFDR), track an EU Climate Transition Benchmark or EU Paris-aligned Benchmark if such a benchmark "exists". At the moment it is not entirely clear how to comply with such requirement in VC and PE contexts.

Product qualification under Art. 8 SFDR



The Commission Decision clarifies that a financial product which complies with certain environmental, social or sustainability requirements or restrictions which are “promoted” in the financial product’s investment policy, qualifies as Art. 8 SFDR product. So far it had been disputed whether investment exclusions defined in the fund’s limited partnership agreement would trigger Art. 8 SFDR, if such exclusions were not referred to and promoted otherwise. It appears that such view needs to be revisited and market participants may need to adjust.

Furthermore, the Commission Decision sheds more light on the aspects to consider when assessing whether a fund qualifies under Art. 8 SFDR. Marketing communications, advertisements, factsheets referring to the fund, the fund’s name and various other kinds of information must be taken into account when assessing whether the product qualifies under Art. 8 SFDR.

RTS are delayed by half a year

Apart from the European Supervisory Authorities’ questions which the European Commission has now responded to (cf. above), the European Supervisory Authorities have also submitted so-called Regulatory Technical Standards (“**RTS**”) to the European Commission for review on February 2, 2021, which were to apply as of January 1, 2022. Until now, these have not been adopted. Instead, the adoption of the RTS will be further delayed and therefore, the planned application of the RTS will be postponed by half a year to July 1, 2022.

This newly envisaged timeframe gives all financial market participants (including fund managers) half a year more time to prepare and implement the RTS, which will form the basis for their principal adverse impact statement. This part of the disclosures relates to principle adverse impacts of investments on environmental, social and employee concerns, respect for human rights and the fight against corruption and bribery. As of today, the SFDR already requires fund managers to disclose whether or not they consider such negative impacts. If they do so, the RTS will require them to disclose 16 indicators. While these indicators are not binding until the RTS come into force on July 1, 2022, they can (and should) already serve as guidance in interpreting the SFDR obligations already in place.

Taxonomy Update

In addition, the requirements of the Taxonomy Regulation (“**Taxonomy**”) will apply as of January 1, 2022. The Taxonomy provides a classification system to assess whether or not an economic activity is environmentally sustainable. In addition, the Taxonomy supplements the SFDR’s product-related disclosure requirements for products that have a sustainable investment objective (Art. 9 SFDR) or promote environmental or social characteristics (Art. 8 SFDR). For such products, disclosure is required, among other things, as to how and to what extent the investments finance economic activities that are to be classified as environmentally sustainable. Whether an economic activity is environmentally sustainable is determined based on four requirements:

1. the activities must make a substantial contribution to at least one of the environmental objectives or areas (“*substantial contribution*”) set forth in Art. 9 Taxonomy;
2. they do not significant harm the other environmental objectives (“*do no significant harm*” – DNSH, cf. Art. 17 Taxonomy);
3. they must meet minimum social safeguards (cf. Art. 18 Taxonomy);
4. they must comply with the technical screening criteria established by the Commission.

Those requirements are specified in further detail within the Taxonomy and in particular by various delegated acts issued by the European Commission.



A total of 2 delegated acts have been issued to date. First, the "Climate Delegated Act" was issued at the beginning of June 2021, which defines technical screening criteria for the first two climate targets (Art. 9 a and b Taxonomy) and is to be applied as of January 1, 2022. At the beginning of July 2021, a delegated act on Art. 8 Taxonomy was issued, which regulates the content, methods and presentation for non-financial reporting requirements. However, this only affects large companies as defined in Section 289 b of the German Commercial Code (e.g. companies with more than 500 employees). In the coming months, the "Environmental Delegated Act" is expected to follow, which will regulate screening criteria for the remaining four climate targets.

Outlook

Overall, it is clear that the European requirements for the disclosure of sustainability-related information are progressing rapidly and that VC and PE fund managers and their products need to adapt and comply. With the Commission Decision's statements, some of which contradict the recently evolved market practice, many market participants will need to review and in some cases revise their disclosures. We recommend taking swift action and start familiarizing with the European requirements of the SFDR and the Taxonomy as soon as possible.

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