

Impact of SFDR on non-EU managers

Isabel Høg-Jensen and Marylou Poncin of Bonn Steichen & Partners discuss the impact of the Sustainable Finance Disclosure Regulation on non-EU alternative investment fund managers

The EU Sustainable Finance Disclosure Regulation (SFDR) lays down harmonised rules for financial market participants and firms providing non-discretionary investment advice (referred to as financial advisors) and came into

force on March 10 2021.

The SFDR is applicable to MiFID II investment firms, management companies of undertakings for the collective investment in transferable securities (UCITS), and alternative investment fund managers (AIFMs) that are located in the EU. The SFDR applies to firms providing discretionary portfolio management (referred to as financial market participants).

Regulation (EU) 2020/852 of June 18 2020, the so-called Taxonomy Regulation, sets out an EU-wide framework (the first classification system) according to which investors and businesses can assess whether certain economic activities are 'sustainable'.

The European Supervisory Authorities (ESAs) provided the 'Final Report on draft Regulatory Technical Standards' (SFDR RTS) on February 4 2021, completed by a draft set consolidated RTS integrating taxonomy-related product disclosures. The SFDR RTS will come into force on January 1 2022.

While the SFDR is targeting, among others, EU AIFMs, certain rules have a significant impact on non-EU based managers. This article will focus on the impact the SFDR (including the draft RTS and the Taxonomy Regulation) may have on non-EU AIFMs and on non-EU delegates of EU-AIFMs located outside Europe carrying out portfolio management or risk management functions for EU-AIFMs.

This article outlines the requirements imposed by the SFDR, the draft RTS and the Taxonomy Regulation and assesses how entities outside of Europe can be indirectly impacted.



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impact of sustainable investments. Where an index is used, provide information on how the index is aligned with that objective and how it differs from a broad market index;

- For Article 8 funds, the website disclosure must describe the environmental or social characteristics (E&S) (including information on methodologies used to measure and monitor E&S characteristics including data sources, screening criteria, and relevant sustainability indicators used); and
- For Article 9 funds, the website disclosure must describe the sustainable investment objective of the financial product and overall sustainable positive impact by means of sustainability indicators (if an index is used, how it is aligned with the objective and how it differs from a broad market index).

The SFDR RTS are significantly elevating the regulatory provisions for mandatory minimum sustainability disclosures. They establish further requirements at entity as well as at product level (for Articles 8 and 9 products) and prescribe how certain disclosures under the SFDR have to be made in terms of content, methodology and presentation.

SFDR RTS: reporting on the principal adverse impact

If asset managers decide to take into consideration the principal adverse impact (PAI) of investment decisions on sustainability factors, they must publish a statement (on their website) along with a description of the due diligence policies including information on the identification and prioritisation of the PAI and indicators and a description of the PAI and of any actions taken in relation thereto or, where relevant, planned to be taken and information on responsible business conduct codes and adherence to internationally recognised standards for due diligence and/or reporting.

If the PAI is not taken into consideration, clear reasons must be published as to why this was not done, including, where relevant, information as to whether, and when, they intend to consider PAI.

From June 30 2021, managers with more than 500 employees (including as a parent of a group) will have no choice but to take the PAI into consideration. Others

Obligations under the SFDR

The SFDR requires asset managers to make a number of sustainability-related disclosures, both at 'entity level' and at 'product level'.

Entity level

The disclosure at entity level is the disclosure required by the asset managers and includes:

- Written policies on the integration of sustainability risks into their investment-decision making process;
- A description of whether they consider principal adverse impacts on sustainability factors in their investment decision making processes; and
- How remuneration policies are consistent with the integration of sustainability risks.

Product level

At product level, the disclosures required are in respect of the funds and financial products that the asset managers manufacture and manage and includes:

- An explanation of how sustainability risks may impact financial performance (using qualitative or quantitative factors);
- Clear explanations of whether and how a financial product considers principal adverse impacts on sustainability factors;
- For financial products which promote ESG, information on how those characteristics are met;
- For financial products which have sustainable investment as their objective, a description of such objective providing information on the methodologies used to access, measure and monitor the

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below this threshold may still choose not to do so.

The SFDR RTS establishes a framework of reporting on the PAI by June 30 each year, requiring (except in the first year) some of the information to be disclosed by way of reference to the previous calendar year(s), including a historical comparison covering up to five reference periods.

Consequently, for managers who either opted in to consider PAI from March 10 2021 or are required to publish a PAI statement from June 30 2021:

- The first PAI statement should have been published on the website by March 10 2021 or June 30 2021 (as applicable) using a principles-based approach to disclose the high-level SFDR disclosures described above;
- The following PAI statement, which must be made in accordance with the SFDR RTS, must be published on the website by June 30 2022, but is not required to include the information relating to a reference period;
- The next PAI statement must be published on the website by June 30 2023 and will need to include the information relating to the reference period of 2022;
- By June 30 2024, the PAI statement would also have to include the completed ‘historical comparison’ section of the PAI annex, comparing the first reference period (2022) with the second reference

period (2023). By June 30 2028, the historical comparison section would include a comparison of the five previous reference periods.

Interaction with Taxonomy Regulation

According to the Taxonomy Regulation, asset managers will be obliged to provide information on the environmental objective to which the investment underlying the financial product contributes and provide a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

From January 1 2022, the periodic reports for Article 8 and Article 9 products will include:

- For Article 8 funds, a description of the extent to which these environmental or social characteristics are met, using quantitative and qualitative indicators (stating to which environmental objective the sustainable investments contribute and how they did not cause significant harm);
- For Article 9 funds, a description of the overall sustainability-related impact of that fund, using quantitative and qualitative indicators (by reference to the relevant sustainability indicators/benchmark index) (stating to which environmental objective the sustainable investments contribute and

how they did not cause significant harm);

- The proportion of sustainability-related investments held by the product (i.e. aligned with the taxonomy) and how indicators of the PAI statement are taken into account; and
- The actions taken to attain the environmental or social characteristics or (as applicable) the sustainable investment objective.

In accordance with the SFDR RTS, a separate annex to the manager’s periodic reports should contain the above-mentioned information (the reports should cross-refer to such annex).

What is the impact for non-European AIFMs?

Non-EU AIFMs (including UK AIFMs) are in scope if they register any AIFs for marketing under Article 42 of the AIFM Directive (national private placement), in any country of the EU.

Thus, non-EU AIFMs are required to make product level disclosures as described above in respect of all AIFs registered for marketing in the EU. Non-EU AIFMs are also in scope if they manage or advise EU-domiciled AIFs, even if those AIFs are not privately placed in the EU.

What is the impact for non-European portfolio managers?

SFDR has an indirect impact on non-European managers providing portfolio

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management, risk management or non-discretionary investment advice to EU-domiciled AIFs in scope of SFDR.

Indeed, if an EU AIFM has delegated the portfolio management (or the risk management) function to a non-EU portfolio manager (which is a very familiar structure in Luxembourg) the portfolio manager would be required to assist the EU-AIFM to comply with the SFDR. While non-EU portfolio managers might not have a direct regulatory obligation to abide by the SFDR, they may be contractually required to do so by the delegating EU-AIFM.

The European Commission and the Technical Expert Group on Sustainable Finance have published a FAQ that provides that the disclosure obligations applicable to asset managers in the Taxonomy Regulation are applicable to anyone offering financial products in the EU, regardless of where the manufacturer is based.

The European Commission clearly states that international influence of the Taxonomy Regulation will exist despite there being no intention to bind third countries on their own sustainability or sustainable finance activities.

The main area impacting non-EU delegated entities would be the following:

Integration of sustainability risks

If the portfolio management function has been delegated to a third party – the portfolio manager – the EU-AIFM will need input in order to be able to integrate the sustainability risk in the decision-making process. Therefore, the non-EU delegated portfolio manager should ensure that this risk is taken into account when they take investment decisions for EU-domiciled AIFs in order to allow the delegating EU-AIFM to comply with its own requirement.

Consistency of remuneration policies with the integration of sustainability risks

The AIFMD requires that remuneration policies of EU-AIFMs are consistent, promote sound and effective management.

Delegation cannot be used to circumvent these remuneration rules. Therefore, the EU-AIFM should ensure that non-EU delegates performing portfolio or risk management are subject to regulatory requirements on remuneration that are equally as effective as those applicable to EU-AIFMs.

Article 3 and 5 of SFDR request that the website of the assets managers includes information in staff remuneration policies as to how these policies are consistent with the integration of sustainability risks. Thus, a contractual arrangement could be put in place to ensure that non-EU delegates complies with those requirements.

For example, the remuneration policy can mention that according to a sound and prudent risk management, the portfolio manager does not encourage risk taking (including sustainability risks) or that variable remuneration can depend on the achievement of specific professional and technical objectives and in identifying such objectives the policy could state that the portfolio manager does not encourage an excessive assumption of risks related to sustainability.

Reporting obligations regarding the PAI

As mentioned above, EU-AIFMs can decide to take into account the PAI of investment decisions on sustainability factors and EU-AIFMs with more than 500 employees must take the PAI into consideration.

If the EU-AIFM considers the PAI, the non-EU delegates will have to take into account while taking investment decisions. The non-EU delegates will also have to

ensure that the information needed by the EU-AIFM to meet its reporting obligation are properly delivered to it. The AIFM and its non-EU delegate may set up contractual arrangements to ensure an adequate flow of information.

Periodic report

As mentioned, for Article 8 and 9 products, the SFDR, the Taxonomy Regulation and the consolidated draft RTS impose transparency as to how they either promote E&S or have a sustainable investment objective.

In line with how the SFDR product disclosure RTS are structured, the periodic disclosure for taxonomy-related products will mirror the pre-contractual disclosures as laid down in those RTS. In other words, where these taxonomy-related product RTS make proposals for derogations to pre-contractual SFDR RTS disclosures for taxonomy-related disclosures, similar derogations are proposed for the periodic disclosures.

The difficulties for EU-AIFMs might lie, for instance, in calculating the extent to which investments are aligned with the taxonomy through the use of the proposed (three) different key performance indicators (KPIs) in order to weigh a company in a fund portfolio's share of the taxonomy. The EU-AIFM should therefore ascertain that the information in this respect is properly delivered to it by the non-EU delegates.

Disclosure for investors

Sometimes investors in funds or segregated accounts managed by the non-EU portfolio manager are themselves subject to SFDR. In that case, those investors may for the purpose of fulfilling their own obligations under SFDR require commitments from the non-EU portfolio manager to provide information or to abide by certain obligations.

Planning ahead

Non-EU entities should pay attention to disclosure requirements already in force and to those that will come into force during the coming months.

The entities should identify whether they are caught either as a non-EU AIFM actively marketing under AIFMD national private placement regimes or as a delegate of an EU-AIFM, and then decide how to approach the entity-level requirement mentioned above.