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Useful reminders in ESMA publications on SFDR

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On 22 November 2023, the European Securities and Markets Authority ("**ESMA**") published three aides to stakeholders to support with navigating three areas of the European Union's ("**EU**") sustainable finance regulation:

1. sustainable investments and environmentally sustainable activities;[1]
2. Do No Significant Harm ("DNSH") regime;[2] and
3. use of estimates.[3]

The Sustainable Finance Disclosure Regulation ("**SFDR**") and the Taxonomy Regulation are covered, alongside the Benchmarks Regulation (specifically the EU Climate Transition and Paris-aligned benchmarks) where relevant.

The three documents are set out to be a "purely factual presentation" of the existing EU legislation, as well as the relevant guidance provided by the European Commission and the European Supervisory Authorities (the "**ESAs**"). It is not intended to add to, interpret or replace any legal texts and has no legal effect. ESMA even sets out that the documents should not be construed as guidance.

Fitting with this status of the three documents there is no new information provided. However, they are useful reminders and consolidated sources of information on the three areas covered and we highlight a few areas asset managers are recommended to remain aware of:

1. Good governance assessment as a "pre-condition", or otherwise there is a breach of Article 8 or 9 SFDR: ESMA reminds financial market participants that should investee companies not meet the pre-condition of good governance then the financial product will be in breach of Article 8 or Article 9 of SFDR. As sustainable finance strategies are set, the focus is typically on the environmental or social characteristics to be promoted or the sustainable investment objective, alongside the sustainability indicators and other areas of SFDR-required disclosures. However, good governance being described as a "pre-condition" is a reminder of how critically important this element is and that it should not be a secondary feature or ancillary to the sustainable investment strategy. As a reminder, good governance under SFDR covers sound management structures, employee relations, remuneration of staff and tax compliance, but how the assessments of investees companies in these areas is carried out is flexible and not prescribed. ESMA does refer to ESA guidance that set out financial market participants could refer to the UN Global Compact and OECD and ILO principles the good governance assessment, but this is not mandatory.[4]

2. Sustainable investment frameworks – a consistent approach to all areas of the sustainable investment definition, across financial products: as a reminder the definition of "sustainable investment" in Article 2(17) SFDR covers:

- an investment in an economic activity that contributes to an environmental or social objective;
- the investment does not significantly harm any environmental or social objective; and
- investee companies follow good governance practices in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

ESMA refers to previous guidance which set out that it is possible for financial market participants to create their own sustainable investment framework for their financial products providing that they do not interpret the areas of Article 2(17) differently across financial products offered.[5] As set out above, the areas of Article 2(17) in the sustainable investment definition cover contribution, DNSH and good governance. Where asset managers have a range of sustainability-related strategies this requirement for consistency could prove very challenging to meet as the relevance of an area for one strategy could be much higher than another. For further information on this and practical support please do reach out to us on our contact details below.

3. Safe harbor for Taxonomy-aligned sustainable investments: ESMA reminds financial market participants that investments in Taxonomy-aligned environmentally sustainable economic activities can be automatically qualified as "sustainable investments" in the context of the product level disclosures under SFDR. This clarification addresses the issue of the double assessment of those investments under both the Taxonomy Regulation and SFDR, which could be useful for any financial products with a proportion of Taxonomy-aligned investments.[6]

The SFDR and Taxonomy Regulation remain complex to navigate, which is one of the triggers for the consultation papers on SFDR which we covered in our update here. These ESMA aides may be useful reference points when reviewing those covered concepts under SFDR and/or the Taxonomy Regulation as they do draw together the range of materials that cover those areas.

For further information, please reach out to UKRegulatory@proskauer.com

1 ESMA30-379-2279 Concepts of sustainable investments and environmentally sustainable activities in the EU Sustainable Finance framework (europa.eu)

2 ESMA30-379-2281 'Do No Significant Harm' definitions and criteria across the EU Sustainable Finance framework (europa.eu)

3 ESMA30-1668416927-2548 Concept of estimates across the EU Sustainable Finance framework (europa.eu)

4 ESA’s Guidance as provided to question 13 on 17 November 2022 JC 2023 18 Consolidated JC SFDR QAs (europa.eu)

5 ESA’s Guidance as provided to question 16 on 17 November 2022 JC 2023 18 Consolidated JC SFDR QAs (europa.eu)

6 Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and its link to the Sustainable Finance Disclosure Regulation (SFDR), June 2023, Q&A 4.

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