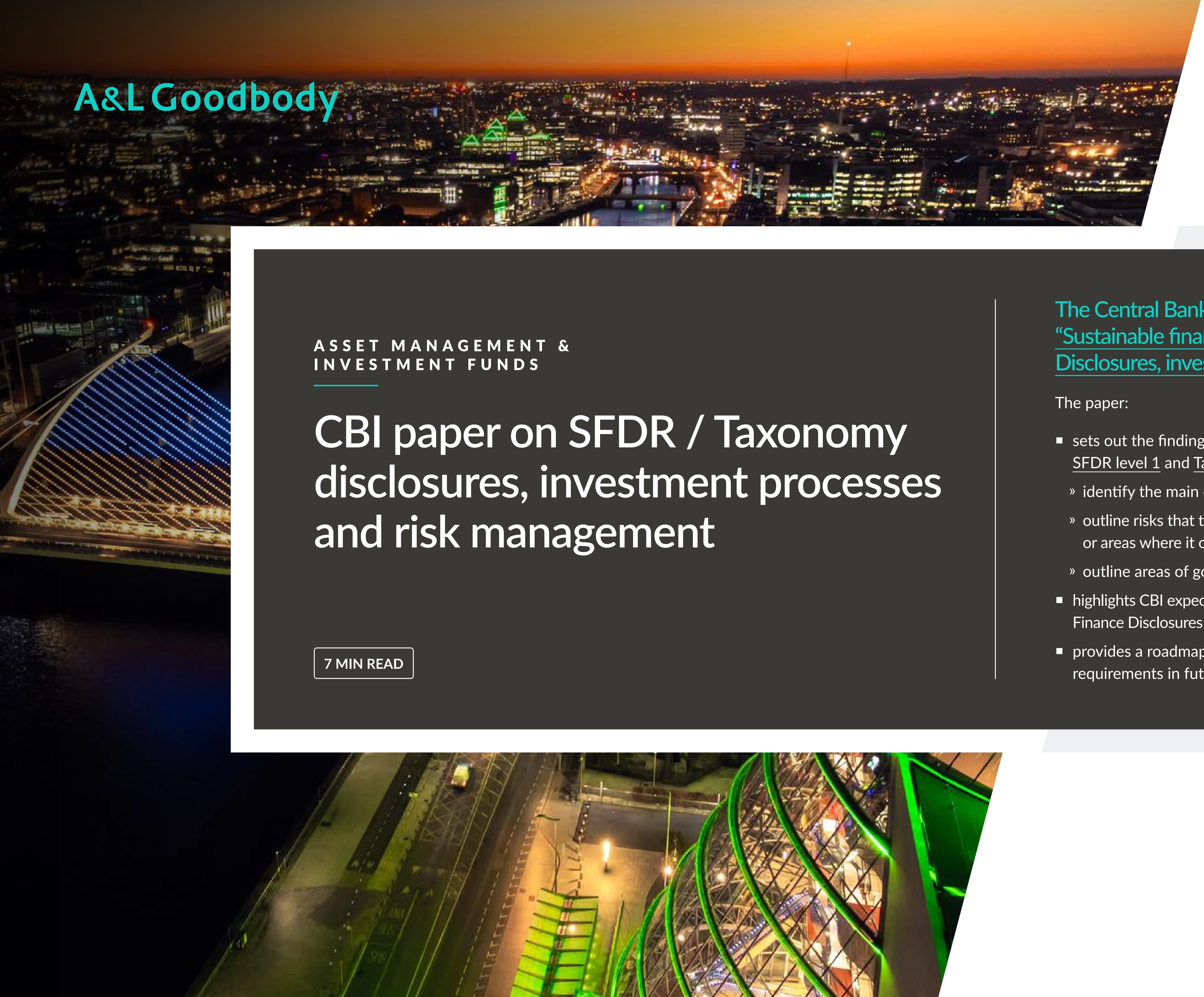


A&L Goodbody

ASSET MANAGEMENT & INVESTMENT FUNDS

CBI paper on SFDR / Taxonomy disclosures, investment processes and risk management

7 MIN READ

The Central Bank of Ireland (CBI) published a paper "Sustainable finance and the asset management sector: Disclosures, investment processes & risk management."

The paper:

- sets out the findings of the CBI's gatekeeper review of investment fund SFDR level 1 and Taxonomy Regulation disclosures so as to:
  - identify the main disclosure issues encountered
  - outline risks that the CBI observed in terms of potential greenwashing or areas where it observed a lack of transparency or clarity
  - outline areas of good practice identified
- highlights CBI expectations around the implementation of the Sustainable Finance Disclosures Regulation (SFDR) and the Taxonomy Regulation
- provides a roadmap as to how the CBI will supervise these requirements in future.

"Fund Managers must continuously review fund documentation to ensure disclosure remains specific to the fund and that all SFDR and related requirements are complied with. In this regard, Fund Managers should provide clear and complete details on the ESG characteristics of a fund's portfolio."

Patricia Dunne,
CBI Director of Securities and Markets Supervision

Supervisory roadmap

In addition to the SFDR / Taxonomy related disclosure matters (discussed below under Gatekeeper Review) the CBI listed other topics which may form part of a supervisory roadmap in the future.

Adaptation of risk management frameworks

The CBI will consider how Irish fund management companies have adapted their:

- investment due diligence processes to take account of sustainability risks and factors
- organisational procedures, resources, the management of conflicts of interest and risk management policies frameworks to take sustainability risks into account.

CBI references updates to the UCITS and AIFMD frameworks (discussed here) and the CBI Governor's letter of 3 November 2021 setting out CBI expectations of all regulated firms regarding climate and other ESG issues.

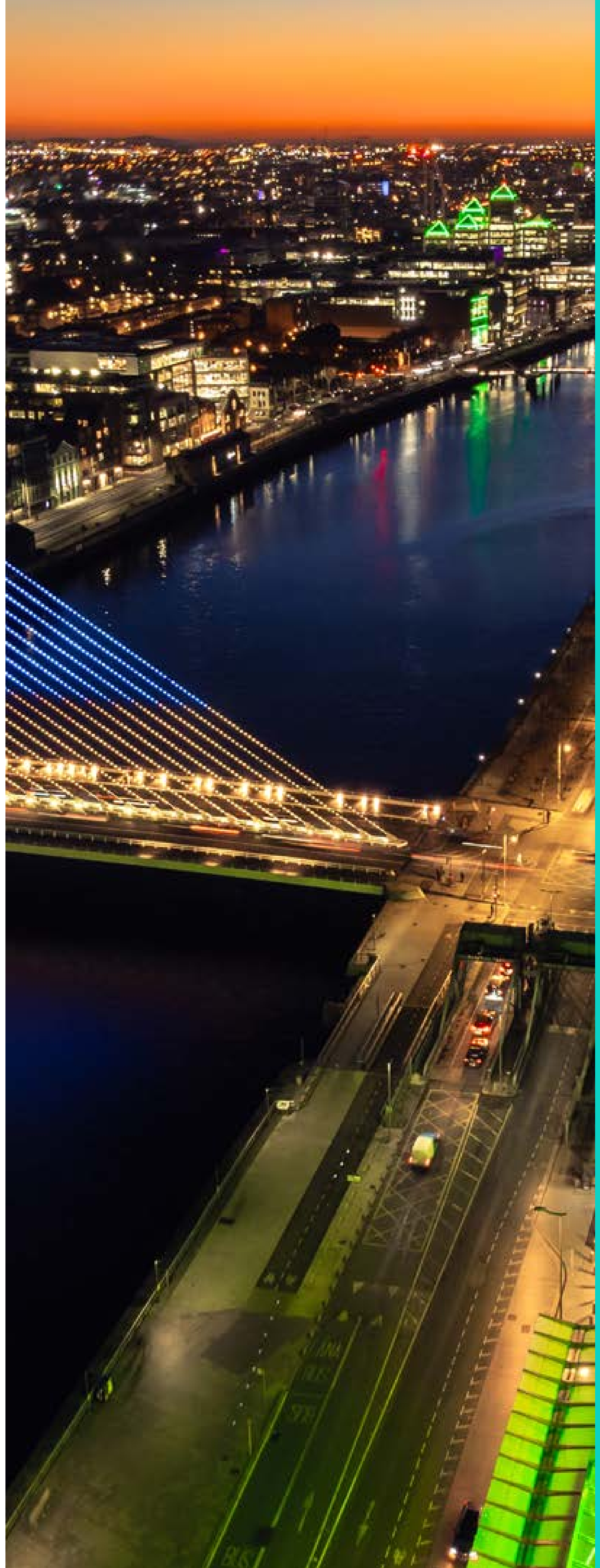
Article 8 'Guardrails'

- the CBI's supervisory engagement will focus on funds disclosing under Article 8 which have a low proportion of their portfolio aligned with the promotion of relevant environmental and/or social characteristics
- the CBI may also examine funds which have changed their "classification under the SFDR" and consider further the rationale provided at the time of the change
- fund managers need to carefully consider the relevant fund's classification under the SFDR to ensure that it is aligned with both the letter and the intention of the legislative requirements.

The CBI notes that funds disclosing under Article 8 SFDR are not subject to minimum investment thresholds or any prescribed composition of investments. Moreover, the definition of 'promotion' provided for is very broad. The CBI supports additional work at a European level, including looking at minimum sustainability criteria for financial products that promote environmental or social characteristics.

Marketing materials

Assessing the consistency of information in documentation (such as the prospectus/fund rules/constitution) with the information in marketing materials (including all marketing communications addressed to investors or potential investors).



"Market participants should pay particular attention to these matters as they progress their implementation of the requirements. These areas of interest are in addition to other initiatives which are planned, including the ESMA Common Supervisory Action (CSA) on sustainability risks and disclosures which is planned for 2023."

Fees and costs

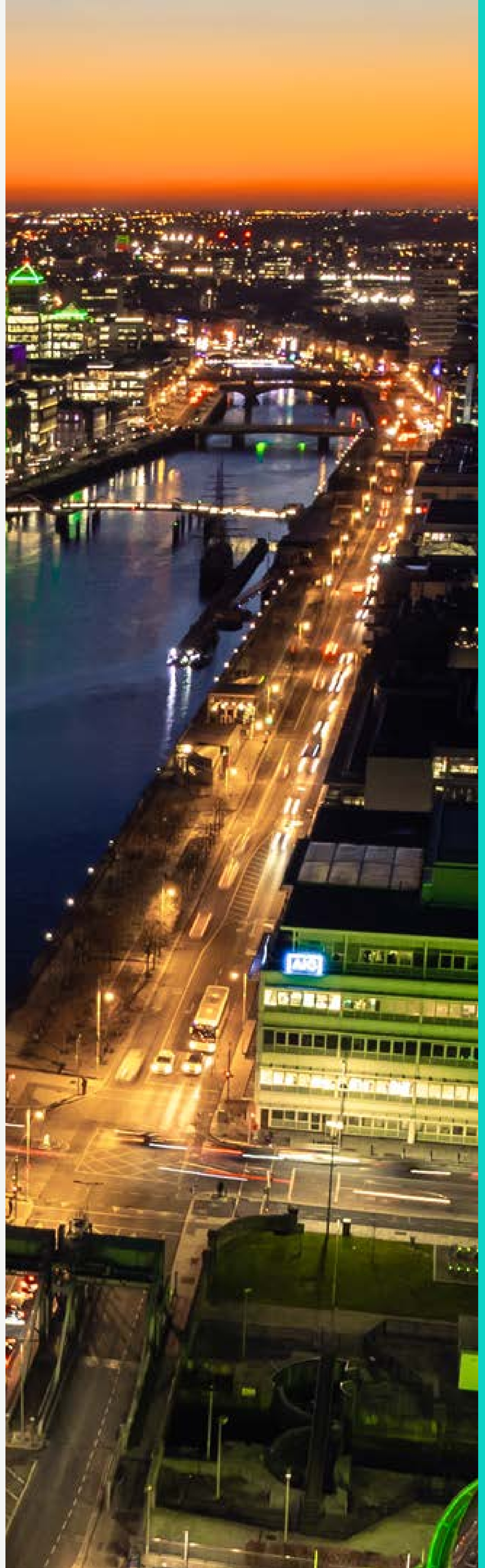
Ensuring that fees and costs of funds disclosing under Article 8 and Article 9 SFDR are not disproportionately higher than funds disclosing under Article 6 SFDR, without a legitimate rationale for such higher costs. Fund managers should be mindful of the types of third party service providers which such funds utilise and whether/how such services are overseen by the fund/fund manager and what 'value add' such services provide to the fund. The fees and costs associated with 'green' investment products should be transparent and proportionate and investors should not be subject to undue costs.

Securities lending

Assessing funds that engage in securities lending whilst also promoting environmental and/or social characteristics and/or having sustainable investments as their objective. In particular, whether these funds are in a position to meet their environmental and/or social characteristics if they have lent out shares and those shares end up taking contradictory positions (such as by the exercising of associated voting rights or because the shares were lent to short sellers which take an opposing view).

Fund service providers

The CBI will also consider the role played by certain fund service providers, such as depositaries. This could, for example, include whether depositaries include ESG-related investment restrictions in the monitoring of the instructions from the fund manager (or the investment manager as its delegate). CBI may also consider how a depositary would categorise a breach of an ESG-related investment restriction and the circumstances in which they would report such breaches to the CBI or, for example, in financial statements.



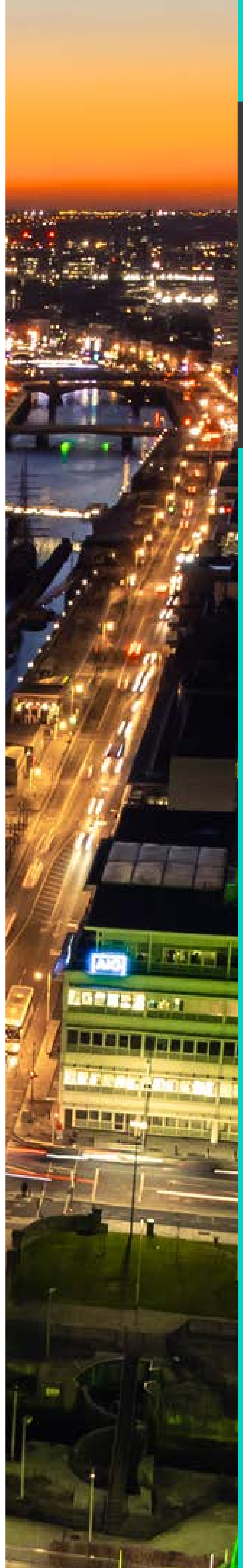
Gatekeeper review

The CBI's gatekeeper review was based on a sample of submissions which included a range of UCITS management companies and AIFMs and covered funds disclosing under Articles 6, 8 and 9 of SFDR. It found that:

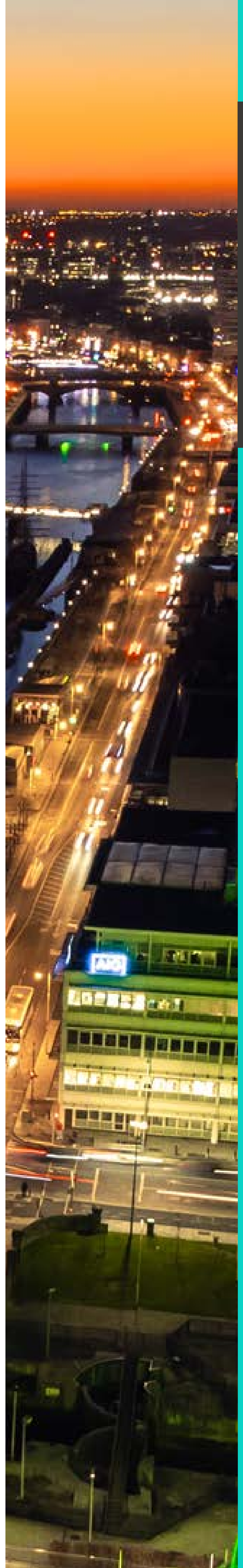
- the extent of compliance with SFDR level 1 and the Taxonomy Regulation disclosures varied significantly
- a significant challenge observed related to the lack of granularity and high-level nature of the disclosure obligations under the SFDR level 1 and Taxonomy Regulation. The CBI points out that this issue will be addressed when the SFDR level 2 disclosure requirements become applicable (1 January 2023) as these are more prescriptive in nature.

"It is imperative that disclosures to investors are clear, accurate and not misleading."

Nature of finding	Relevant Requirement	Finding
SFDR classification	Paragraph 28, ESMA supervisory briefing	Fund documentation should clearly disclose the relevant SFDR classification (6, 8 or 9) without giving the impression of a “label” to investors. Where an existing investment fund proposes a change to its SFDR classification, the post authorisation submission should include a detailed rationale and justification explaining the basis for the proposed change. **CBI expectations:** *Adequate consideration must be given to what this change in classification may mean for existing investors in the fund (and what communication to investors may be appropriate as a result). Fund managers should keep such classifications under regular review to ensure their ongoing accuracy. Although changes to SFDR classifications may take place, fund managers should be able to stand over the classification applied to their funds and so the CBI would not expect numerous changes to a fund’s SFDR classification to take place.*
Generic sustainability risk and/or Taxonomy alignment disclosures	Article 6 of the SFDR and Article 5 and Article 6 of the Taxonomy Regulation	Some of the funds assessed only included generic sustainability risk and/or Taxonomy alignment disclosure. The primary rationale given was that such disclosure avoids repetition and duplication across all fund documentation and is consistent with other general disclosures that were included throughout that fund’s documentation. **CBI expectations:** *Disclosures must be specific to the investment fund in question. Fund managers should keep such disclosures under regular review to ensure their accuracy.*
Quantification of Taxonomy-alignment	Article 5 and Article 6 of the Taxonomy Regulation	Only a small number of funds provided a percentage proportion of investments in environmentally sustainable economic activities. In these cases, detailed information on the economic activities that qualify as environmentally sustainable was provided in support of the allocated proportion. It was clear that in these cases significant consideration had gone into the proportion to apply and detailed supporting information was provided which outlined the assessment of particular investments in this regard as well as how the investment would meet the sustainability characteristics to qualify as Taxonomy-aligned. A large proportion of the assessed funds indicated that they were not in a position to describe the proportion of a fund’s investments that are in Taxonomy-aligned. Since the Commission’s SFDR Q&A response of 25 May 2022, there has been a significant improvement in the level of SFDR and Taxonomy-related disclosure. However, some applicants persist in including negative justifications and / or ambiguity, notwithstanding that the Commission has clarified that these are not permissible. **CBI expectations:** *Disclosures around the quantification of Taxonomy-alignment must improve. Fund managers should keep such disclosures under regular review to ensure their accuracy.*



Nature of finding	Relevant Requirement	Finding
Integration of sustainability risks	Article 6 (1) of SFDR	Funds generally provided a detailed outline of the reasons why sustainability risks were not relevant thereby fully addressing these requirements. In some cases, this requirement appears to have been addressed by including statements that sustainability risks are integrated rather than providing any specific information to outline how this is achieved. In addition, in a number of cases, funds included statements that returns may be impacted by investment in certain products and that this will be factored into the investment decision-making process. However the disclosure did not provide specific information on how the impact on returns has been assessed. **CBI expectations:** Where applicable, funds should provide a detailed outline of the reasons why sustainability risks are not relevant or provide an outline of how such risks are integrated into the investment decision making process. Funds should also include information on how the approach taken will impact returns. Such disclosures must be specific to the investment fund in question. Fund managers should keep such disclosures under regular review to ensure their accuracy.
Pre-contractual product disclosures – Benchmark Indices	Article 8 (1)(b) of SFDR	In a number of funds, the disclosure provided lacked the expected detail in terms of how the designated index was consistent with the environmental and/or social characteristics the fund promotes. In certain instances, this requirement was further undermined by the insertion of statements to the effect that neither the fund manager nor the investment manager would monitor the composition of the Benchmark Index against the screening criteria applied on the basis that the index provider is responsible for screening investments in the index. In some cases, it appears that UCITS management companies/AIFMs do not intend to carry out monitoring of an investment manager's ESG approach on an ongoing basis but rather will rely on an annual assessment of the application of the ESG strategy. **CBI expectations:** *Such practices are not considered appropriate and instead the fund manager should have processes in place to monitor, on an ongoing basis, the relevant index provider or delegate investment manager.*
Naming convention for funds	Paragraph 19, ESMA Supervisory Briefing	Of the funds assessed, the naming conventions were consistent with the fund disclosure outlined in its investment objective and strategy. However, it is nevertheless important to note that funds' names should not be misleading. In this regard, the use of terms such as "ESG", "green", "sustainable", "social", "ethical", "impact" or any other ESG-related terms should be used only when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the fund's investment objectives and policy and its strategy as described in the relevant fund documentation. The use of the word "impact" or "impact investing" or any other impact related term should be used only by funds whose investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return. ESMA has issued a consultation on guidelines for fund names using ESG or sustainability - related terms. **CBI expectations:** *Fund managers should ensure that fund names are not misleading. Fund managers should keep their funds' naming conventions under regular review to ensure their continued appropriateness.*



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Resources

- CBI paper "Sustainable finance and the asset management sector: Disclosures, investment processes & risk management" — READ MORE
- SFDR Level 1 — READ MORE
- SFDR Level 2 (in the process of being amended) — READ MORE
- Taxonomy Regulation — READ MORE
- CBI letter of 3 November 2021 to regulated firms setting out supervisory expectations related to climate, environment and ESG issues — READ MORE
- European Supervisory Authorities (ESAs) statement of 24 March 2022 — READ MORE
- European Securities and Markets Authority (ESMA) supervisory briefing of 31 May 2022 — READ MORE
- ESAs clarifications on the draft SFDR RTS of 2 June 2022 — READ MORE
- European Commission SFDR Q&A of 25 May 2022 discussed here — READ MORE
- ESMA Consultation Paper on funds' names using ESG or sustainability-related terms — READ MORE