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Central Bank of Ireland Outlines Findings from Review of SFDR Filings

December 2023

Following on from the large number of filings made at the end of 2022 under the Central Bank of Ireland's ("**Central Bank**") streamlined filing process relating to updates to fund documentation to comply with the Sustainable Finance Disclosure Regulation ("**SFDR**"), industry has engaged with the regulator to seek feedback from the Central Bank's review of a sample of those filings. This feedback will assist fund management companies in ensuring that their SFDR disclosures meet the regulator's expectations and in turn provide meaningful information to investors.

A number of the Central Bank's key findings from its review were referred to in a speech delivered at the end of September 2023, by Patricia Dunne, Director of Securities and Markets Supervision at the Central Bank. Striking a cautionary note, Ms Dunne stated that the Central Bank has seen interpretations of the SFDR which, while there may be an argument that they comply with the letter of the requirements, they "*certainly do not meet the spirit of the rules*". These and further findings were discussed at a workshop with industry representatives held on 16 November 2023. The Central Bank noted that the discussions at the workshop did not represent final positions and indicated that it will issue a publication in due course setting out its final conclusions and expectations, with a view to guiding best practice with regard to disclosures.

The findings addressed in Ms Dunne's speech and at the workshop are set out in the table below.

1. Article 8 Funds and the Promotion of Environmental and Social Characteristics

Disclosures by funds applying exclusion policies and index-tracking funds classified under Article 8 have drawn particular attention from the Central Bank. The Central Bank's concerns are reflected in both section 1 and 2 of this table.

The Central Bank has found that, in the context of index tracking funds, the disclosures will often outline what the relevant index will exclude, for example tobacco, nuclear weapons, but not what this means in the context of the fund. The disclosures should clearly indicate what environmental and social ("**E / S**") characteristics are promoted by the fund by applying these restrictions. While the European Commission's SFDR Q&A suggests that exclusion strategies are permissible for Article 8 products, the Central Bank expects that funds address the disclosure requirement by positively indicating what characteristics the fund promotes rather than simply listing a limited set of investment exclusions.

2. Index Tracking Funds employing Exclusionary Screening Methodology

The Central Bank has found that a majority of funds that track an index employing an exclusionary screening methodology disclose that the assets of the fund are close to 100% aligned with the E / S characteristics promoted, apparently based on the fact that the relevant index provider has determined that the constituents of the index are not inconsistent with the screening criteria employed. There does not appear to be any additional assessment undertaken of the fund's assets to assess their E / S characteristics.

It was noted at the workshop that the Central Bank's expectation, set out in its Information Note published in November 2022, that fund managers have processes in place to monitor, on an ongoing basis, the relevant index provider or delegate investment manager, has not been widely adopted. The Central Bank queried how industry can be confident that disclosures are accurate when there is no additional due diligence carried out by the manager on the resulting fund portfolio. It is not clear what form this additional due diligence would take and it was agreed at the workshop that further engagement on this matter is required.

3. Minimum Proportion of Investments

The Central Bank has identified a number of issues with the disclosure of the minimum proportion of sustainable investments with an E / S objective or the minimum proportion of investments used to attain the E / S characteristics promoted by the fund. The issues include:

- the disclosure provides that the minimum proportion provided may be subject to change and such updates can be found on a website. The Central Bank expects that the minimum proportions disclosed in the pre-contractual disclosures be accurate and not subject to change (unless by way of amendment to the prospectus or supplement);
- the disclosure of a range for both the minimum proportion of sustainable investment with an environmental objective and a minimum proportion of sustainable investments with a social objective. In some instances, the ranges included were between 0% to 100%. The Central Bank's view is that this is not meaningful information for an investor;
- with respect to Article 9 funds, the disclosure of a low minimum proportion of sustainable investments with an environmental objective and sustainable investments with a social objective when compared to the disclosure of the overall minimum proportion of sustainable investments. The Central Bank's understanding is that the minimum proportion of sustainable investments with an environmental objective and the minimum proportion of sustainable investments with a social objective disclosed in the asset allocation chart in Annex II disclosures should equal the minimum proportion of sustainable investments disclosed on page 1 of the Annex; and
- some Article 8 funds disclosed a minimum proportion of investments aligned with E / S characteristics as low or zero. This raises questions as to the appropriateness of the fund being subject to Article 8 SFDR.

Industry attendees at the Central Bank workshop noted that, due to the fact that depositaries are treating the minimum proportions disclosed under SFDR as the same as an investment restriction, with ensuing consequences where breaches occur, managers may be erring on the side of caution due to concerns about breaching those minimum commitments. It was noted that, particularly with respect to impact funds, there is potentially a wide range of sustainability themes that may be pursued in the investment strategy, making it difficult to disclose a minimum proportion of social investments, Taxonomy-aligned environmental investments and Taxonomy unaligned investments that will reconcile with the overall sustainable investment commitment disclosed on page 1 of the Annex.

4. Binding Elements of the Investment Strategy

The Central Bank expects that there be clear and detailed disclosure as to what are the binding elements of the investment strategy and the disclosures should not provide for an option to dis-apply the binding element. It was noted that, where aspects of the binding elements can be dis-applied, this raises questions as to the appropriateness of the Article 8 / Article 9 classification of the fund.

The Central Bank noted at the workshop that disclosures should detail in full the binding elements used to select investments and that it was not sufficient to disclose that the fund tracks the performance of an index as the binding element.

In relation to examples of where more detailed disclosures would be desirable, these include information as to what constitutes "involvement" or what thresholds are applied where a fund excludes companies based on their involvement in controversial business activities, or what ESG score or degree of controversy would result in the exclusion of a company from a portfolio. The Central Bank also referred to the practice of disclosing that the fund will not invest in companies as per the investment manager's exclusion policy, available through a website link. The Central Bank is concerned that cross-references to exclusions listed on a website are unsatisfactory, as those lists can be changed by the investment manager without the investor being made aware that an exclusion may have been removed.

5. DNSH Disclosures

The Central Bank requires complete and detailed disclosure as to how the sustainable investments do no significant harm to any E / S objectives. References to indicators for harm being under "proprietary thresholds", with no further detail being provided on those thresholds, is not satisfactory. Examples of good practice included where detailed information was provided as to the steps taken prior to and after the investment to ensure the sustainable investments do no significant harm, or where detailed information was provide as to the principal adverse impact indicators ("**PAIs**") applied.

Other Observations

The September speech outlined that, while the vast majority (72% as at 30 June 2023) of Irish authorised funds are classified as Article 6 SFDR funds, in terms of new funds being authorised, there is more balance between the classifications, with 131 new Article 6 funds being approved over the past 12 months compared with 134 Article 8 or Article 9 funds.

In another speech delivered on 9 November 2023, Ms Dunne noted the Central Bank's intention to examine whether funds that engage in securities lending are in a position to meet their environmental or social characteristics if they have lent shares and those loaned shares lead to positions which would not qualify as sustainable investments. At the workshop, it was stated that the Central Bank has not reached any specific view on this issue as yet.

The Central Bank also confirmed that the fast track process for SFDR filings is still open and will remain open for the rest of the year. Industry will receive advance notice of the closing of the fast-track process.

The common supervisory action ("**CSA**") on the SFDR, announced by the European Securities and Markets Authority ("**ESMA**") in July 2023, will be split into two phases:

- Phase 1 (due to conclude by 31 January 2024) will specifically address greenwashing risks and includes desk based reviews (ongoing) and inspection calls and onsite visits in Q2 2024;
- Phase 2 (due to finish by 30 September 2024) will focus more generally on sustainability risks and disclosures; and
- Phase 3 will involve an impact survey, the findings of which are to be shared with ESMA by December 2024.

Next Steps

The Central Bank acknowledges challenges with SFDR implementation and that more clarity around the legislation is needed. While some of the issues relating to SFDR implementation may be addressed at EU level, the Central Bank will look to publish additional clarifications in terms of how funds should meet their disclosure obligations, but there is no specific timeframe for this guidance yet. It was suggested at the work shop that, if the Central Bank could provide case studies outlining clearly its expectations, this would be very helpful.

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