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asset management group

February 3, 2022

Mr. Alain Deckers, Head of Unit
Mr. Lukas Bortel, Chief Legal Officer
European Commission
DG FISMA, Directorate Financial Markets, Unit C4

Via e-mail

Re: Application of SFDR entity-level rules to Article 42 AIFMs

Dear Mr. Deckers and Mr. Bortel:

The Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**") brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.SIFMA AMG.org/amg.

Our members are active participants in the sustainability journey and have first-hand experience of implementing sustainability related practices and disclosures within the asset management sector – including the EU Sustainable Finance Disclosure Regulation ("**SFDR**") regime.

We are writing to the European Commission (the "**Commission**"), as we understand that the EU authorities are considering publishing guidance that would bring non-EU alternative investment fund managers ("**AIFMs**") marketing their funds in the EU pursuant to Article 42 of EU Directive 2011/61/EU ("**AIFMD**"), in scope of the SFDR entity-level requirements. We note that since the implementation of SFDR on 10 March 2021, the market position has been that non-EU AIFMs should only be subject to the product level SFDR obligations for any alternative investment funds ("**AIFs**") they market in Europe under Article 42 of AIFMD, and not to any SFDR entity level obligations (in particular, the obligation to consider and report against principal adverse sustainability impacts). The Commission's SFDR Q&As (6 July 2021) did not appear to conclusively opine on the matter as while confirming that the SFDR product level obligations apply to non-EU AIFMs, it stated that "*AIFM must ensure compliance with [SFDR], including the financial product related provisions*". No specific mention was made of the entity level SFDR requirements. We understand that the Commission has since had a meeting with an industry group and the European Supervisory Authorities ("**ESAs**"), where it was stated that the Commission's view was that SFDR applied to non-EU AIFMs at both an entity and product level. This view had not previously been communicated to market participants, and we are aware that a number of National Competent Authorities ("**NCAs**") were, like SIFMA AMG members, only made aware of this view upon the distribution of the minutes of the meeting.

As this position will have significant implications for SIFMA AMG members (many of whom have non-EU AIFMs within their group that currently comply with the AIFMD Article 42 regime and SFDR product level requirements for funds marketed in the EU), SIFMA AMG is reaching out to the Commission to put forward our members concerns and perspective on this point.

In summary, our members would strongly encourage the EU authorities to reconsider this position because:

(i) it would mark a significant departure from the broader EU policy approach for regulating non-EU AIFMs under Article 42 of AIFMD – as such managers are only required to comply with specified AIFMD product level requirements rather than any entity level rules[1];

(ii) it would be unduly burdensome for non-EU managers to comply with the SFDR entity level requirements, and in our members' view, the anti-greenwashing aims of SFDR should be adequately met through compliance by non-EU managers with the SFDR product level requirements for any funds marketed in the EU (which is the current status quo);

(iii) in practice, the SFDR entity-level obligations are likely to act as a significant deterrent for non-EU managers when thinking about the EU market - which would then have the undesirable outcome of reducing investor choice within the EU. Our members consider the current Article 42 regime to be one of the key successes of the EU's AIFMD package (as it provides a harmonised and proportionate framework for overseas managers to access EU investors), and are very concerned that this SFDR policy position could lead to additional disproportionate and detailed entity level obligations being introduced for non-EU AIFMs, which would then significantly limit the usefulness of the EU's well functioning Article 42 regime; and

(iv) it could result in confusion and even conflict with local laws that non-EU managers are subject to (e.g. in the US) – noting that other jurisdictions are not as far advanced as the EU in their sustainability journey or may have a very different or even conflicting approach to sustainability and expectations from managers. Given that most of our members have a global presence, with group entities subject to a number of different local ESG regimes, it would become untenable (if not impossible) for asset managers to comply with conflicting extraterritorial regulatory requirements from a myriad of regulators. We welcome the EU's leadership in the context of sustainable finance, but given that climate change and ESG matters broadly represent global issues, there is a strong need for international convergence and consistency here. Again, given the EU's leadership in this space, we consider the EU authorities to be best placed to set

[1] In this regard we note that the Article 24(1) AIFMD obligation on an AIFM to "*regularly report to the competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIFs it manages*" is effectively limited in the case of Article 42 AIFMs, to the funds that they market in the EU under Article 42 of AIFMD.

an example for other international regulators when it comes to designing a proportionate and globally focussed ESG framework – which should prioritise international convergence and consistency, rather than extra-territorial regulation. The extra-territorial reach is also unlikely to be welcomed by non-EU regulators.

This letter will now go on to explore these points in further detail.

1. EU policy approach for regulating non-EU AIFMs

Article 42 of AIFMD provides a mechanism for non-EU AIFMs to market their AIFs in the EU, provided they comply with certain AIFMD product related requirements in Articles 24 – 30 of AIFMD – including pre-contractual disclosures, annual reporting, periodic reporting to the relevant EU regulators (on the activities of AIFs marketed in their jurisdiction) and asset stripping and control requirements with respect to portfolio companies. It is worth emphasising that these are all product level AIFMD requirements – i.e. non-EU AIFMs are not expected to comply with the AIFMD entity level requirements, in recognition of the fact that the relevant non-EU AIFMs will be subject to local capital, organisational and governance requirements in their jurisdiction.

EU Member States have broad flexibility to gold-plate Article 42 in their jurisdictions. Some Member States simply follow the approach mandated by AIFMD, and others impose additional requirements or prohibit access altogether. However, even where Member States have "gold-plated" Article 42, the focus has been on imposing product level obligations rather than any entity level requirements given the impracticability of EU Member States imposing entity level obligations on non-EU managers.

Accordingly, the extension of SFDR entity level obligations to such managers will represent a significant departure from the current, established EU policy approach for regulating non-EU AIFMs under Article 42 of AIFMD. In our members view, this departure will also not be a proportionate response to meeting the EU's policy aims under SFDR – namely preventing greenwashing and improving sustainability practices and risk management within the financial services sector. This is because non-EU AIFMs are already subject to detailed SFDR product level disclosure requirements, that in our members views should sufficiently and proportionately meet these policy aims. At a product / strategy level, each non-EU manager will have to make clear to EU investors its approach towards managing ESG risks (Article 6), considering principal adverse impacts (Article 7) and incorporating ESG/sustainability objectives (Articles 8 -11), and will accordingly be incentivised to incorporate better sustainability practices because of the potential for detailed scrutiny of such disclosures. It is not clear to our members, what additional value, entity level SFDR disclosures (covering funds and activities of the non-EU manager that have no EU nexus) would provide to EU investors.

These additional requirements will also have high implementation costs, and Article 42 AIFMs will have to dedicate significant additional resources to ensure compliance. As a consequence, many smaller non-EU AIFMs may be forced to exit the EU market, which will then reduce competition and impede EU investor choice.

2. Lack of Proportionality

As noted just above, if it were to become formal guidance that non-EU AIFMs should comply with the entity level SFDR obligations, then significant practical obstacles would emerge:

- In relation to Articles 3 (Transparency of sustainability risk policies) and 5 of SFDR (Transparency of remuneration policies in relation to the integration of sustainability risks), it is unclear whether they would apply in relation to the non-EU AIFM's business as a whole (and hence also covering funds that are not marketed in the EU) or just the non-EU AIFM's AIFs that are marketed in the EU under Article 42. If these articles were to apply to non-EU AIFM's business as a whole, it is not clear why there would be any benefit to EU investors for a non-EU AIFM to be required to disclose its approach on ESG risk management etc. for funds that are not marketed in the EU (rather than just funds marketed under Article 42), and hence it is unclear why such disclosure should fall within the remit of EU regulatory obligations. Additionally, regardless of whether these articles apply to the entirety of the non-EU AIFM's business or only to its activities related to AIFs marketed in the EU under Article 42, as noted above, Article 6 of SFDR already requires non-EU AIFMs to disclose their approach to sustainability risks at a product level, and hence it is not clear to us that the entity level disclosures under Articles 3 and 5 would provide additional useful information to EU investors invested in such products.

- The application of Article 4 of SFDR (Transparency of adverse sustainability impacts at entity level) to non-EU AIFMs would also raise significant practical issues:

    - Firstly, it is not clear how the scope of the mandatory application of this requirement under Articles 4(3) - (4) of SFDR would apply to non-EU AIFMs. As above, it is unclear whether the relevant 500 employee thresholds would be calculated by reference to the entity as a whole, or just employees involved in the marketing of AIFs under Article 42 AIFMD. It would seem odd for a non-EU AIFM that only markets one or two funds in the EU to be subject to this obligation by virtue of having a large number of employees servicing non-EU clients or funds that are not marketed in the EU.

    - Secondly, it is not clear how the obligation to collect and publish information on principal adverse sustainability impacts ("**PASIs**") could practically apply to non-EU AIFMs, particularly in light of the Level 2 requirements of the incoming SFDR Regulatory Technical Standards ("**RTS**"). It would be very disproportionate for EU law to require non-EU AIFMs to collect and disclose PASIs data on funds or products that are not even marketed in the EU and in practice would be a significant deterrent for many non-EU managers considering access to the EU markets. It will also

amount to a significant cost burden for non-EU managers, who would have to build complex data capture and reporting systems, in addition to contracting with very expensive data providers to obtain this information. The costs will likely ultimately be passed on to investors and it would seem very inappropriate for these costs to then be suffered by non-EU investors in such funds.

- Thirdly, as the Commission and the ESAs are already well aware, there is significant concern in the industry that reliable data on PASIs is not, and will not be, available in the vast majority of cases - including in the EU (given that there is no obligation on corporates to disclose such data). It will become even harder (and costly) for non-EU AIFMs to obtain PASI information, given their AIFs offered in the EU under Article 42 are more likely than domestic EU AIFs to hold investments in non-EU companies.

- We conducted a survey with some of our members to better understand these data concerns and asked them to provide feedback on how challenging it would be for them to obtain data for the various PASIs, how much of the data would be estimated / based on proxies and how reliable the data would be. We would be happy to discuss the details of our findings further with the Commission, but in summary, the feedback was as follows:

    - mandatory E indicators (investee companies) - this could be a manageable exercise for listed companies if proxies / estimations can be used (but the large majority of the data would be estimated and only partly reliable) and would be a very challenging or impossible exercise in respect of private / unlisted companies;

    - mandatory S indicators (investee companies) – as above but likely to be more challenging overall;

    - mandatory E/S indicators (sovereigns and supranationals) – this could be a manageable exercise if proxies / estimations can be used, but the large majority of the data would be estimated and only partly reliable;

    - mandatory E indicators (real estate) – this would be a very challenging exercise and almost all the data would need to be estimated and would not be reliable;

    - voluntary E indicators (investee companies) - this would be a very challenging or impossible exercise for both listed and private / unlisted companies, and the large majority of the data would need to be estimated and will be marginally reliable only;

    - voluntary S indicators (investee companies) – as above;

- voluntary E indicators (sovereigns and supranationals) – manageable exercise as there are no EU Green Bond standard compliant bonds in the market currently (as the standard still hasn't been finalised);

- voluntary S indicators (sovereigns and supranationals) – this could be a manageable exercise if proxies / estimations can be used, but the large majority of the data would be estimated and only partly reliable; and

- voluntary E indicators (real estate) – this would be a very challenging exercise and almost all the data would need to be estimated and would not be reliable.

- As part of the survey, we also asked members to provide feedback on the costs of obtaining this data, and based on the results, we expect the costs per ESG data provider to be in the range of $100,000 – 150,000 per year. As firms will need to use a number of data providers to cover different asset classes, regions, data gaps etc. and to validate / cross-check figures in certain cases, in practice the overall PASI data costs for each non-EU AIFM (and the sector as a whole) will be very substantial. Our members also expect the costs to increase (rather than decrease) as data quality improves, because firstly they will still invariably need to use multiple data providers to obtain full coverage, and secondly because data providers will very likely increase prices over time (both to pass on any increased internal costs at their end to improve the quality / coverage of data, and in response to the guaranteed high demand for ESG data because of the various mandatory disclosure obligations are members and other market players will be subject to). Additionally, our members wish to emphasise that there will be significant additional compliance costs for non-EU AIFMs beyond the cost of data – e.g. they would need to build in processes and tools to integrate, review and collate the relevant data, and employ additional staff to help ensure and oversee compliance.

- The costs of compliance will therefore likely outweigh any potential benefit as the data available for non-EU companies is likely to be too poor to allow investors (or non-EU managers) to make meaningful interpretations. Additionally and as noted previously, under Article 7 of SFDR, non-EU AIFMs will have to disclose to EU investors how they consider PASIs at a product level – which should provide sufficient information to EU investors on this topic, without the further need to apply Article 4 of SFDR to non-EU AIFMs.

- Finally, we note that the quantitative entity level PASI reporting under the SFDR RTS is due to first be published by in-scope entities in June 2023 with respect to the 2022 calendar year. Since, to date, the market has, based on consistency with AIFMD, taken the legal interpretation that entity level

obligations under SFDR do not apply to non-EU AIFMs, issuing guidance to the contrary at this stage (or in 2022) would make it very challenging for non-EU AIFMs to comply with this deadline.

- We would like to emphasise that even if the application of the entity level SFDR requirements was limited only to a non-EU AIFM's activities related to its AIFs marketed in the EU under Article 42, this will not be a proportionate outcome and will result in the same costs burden, data challenges and proportionality concerns noted above. The costs of compliance will still likely outweigh any potential benefit for investors in our members' view (especially given the detailed product level disclosures non-EU AIFMs will be making).

- Given non-EU AIFMs that market under Article 42 are subject to supervision by NCAs with respect to their marketing in the member state of the NCA, it is also unclear practically which NCA (if indeed any NCA) would have jurisdiction to supervise entity-level disclosures.

- Finally, our members would like to emphasise that the current Article 42 regime has been a great success coming out of the EU's AIFMD reform package – as it strikes an effective balance between investor protection and proportionate supervision, by subjecting Article 42 AIFMs to product level conduct and disclosure obligations, in relation to the funds they market within Europe. Our members are very concerned that the extension of the SFDR entity level requirements to Article 42 AIFMs could lead to additional disproportionate and detailed entity level obligations being introduced for non-EU AIFMs, which would then (i) significantly limit the usefulness of the EU's well established and effectively functioning Article 42 regime; and (ii) have the undesirable outcome of limiting EU investors' access to non-European products and strategies.

3. Conflicts with Local Laws

The SFDR entity level requirements may also conflict with requirements that non-EU AIFMs are subject to in their local jurisdictions. We note that most non-EU jurisdictions are not as far advanced as the EU in their sustainability journey, and in fact some countries even have conflicting rules and expectations on ESG (e.g. the US).

Given that most of our members have a global presence, with group entities subject to a number of different local ESG regimes, it would become untenable (if not impossible) for asset managers to comply with conflicting extraterritorial regulatory requirements from a myriad of regulators. As noted above, we welcome the EU's leadership in the context of sustainable finance, but given that climate change and ESG matters represent global issues, there is a strong need for international convergence and consistency here – which we believe the EU authorities can help achieve through co-ordination and co-operation with overseas regulators, rather than imposing EU rules on an extra-territorial basis. Our concern is also that the extra-territorial reach is unlikely to be welcomed by non-EU regulators.

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Next Steps

We would be very happy to discuss our concerns and reasoning with you further. Once again, our members would like to emphasise that extending the SFDR entity level obligations to non-EU AIFMs will mark a significant departure from current EU supervisory policy for such managers, and does not seem to be a proportionate response to meeting SFDR's policy aims (which our members believe are adequately addressed through the SFDR product level requirements). Further, even if the Commission were to proceed with this position, as noted above, significant interpretive issues would still need to be resolved along with the practical challenges / obstacles to compliance faced by such non-EU AIFMs. Hence, at the very least, we would request that prior to publishing any such feedback, the Commission undertakes a formal consultation process with the industry to gauge their concerns and practical feedback, in order to make an informed assessment on this point.

If you are interested in discussing these comments with us further, please feel free to reach out to me at 202-412-3998 or LKeljo@sifma.org.

Kind regards,

Lindsey Weber Keljo
Asset Management Group – Head
Securities Industry and Financial Markets Association