The SFDR & Non-EU AIFMs, Asset Managers and Financial Advisers

By Dr. Sebastiaan Niels HOOGHIEMSTRA[1]

The deadline for financial market participants and financial advisers to comply with Regulation (EU) 2019/2088, as amended (the "SFDR"), in a "principle-based" manner was on the 10th of March 2021. Nevertheless, there are still uncertainties with respect to, amongst others, the application of the SFDR to AIFMs, asset managers and investment advisers that are located in third countries. This contribution discusses these.

Scope SFDR – Non-EU AIFMs, Asset Managers and Investment advisers

To ensure cross-sectoral consistency throughout European sectoral laws, the SFDR is applicable to a wide range of "financial market participants", including, amongst others, alternative investment fund managers (AIFMs) and investment firms authorized under Directive 2014/65/EU, as amended (MiFID II) which provide portfolio management. The SFDR, however, only applies to certain defined financial products made available by financial market participants. The definition of "financial products" under the SFDR includes, amongst others, portfolios managed by MiFID II investment firms and alternative investment funds (AIFs) managed by AIFMs. Furthermore, certain "financial advisers" including, amongst others, MiFID II investment firms that provide investment advice with respect to "financial products" also fall within the scope of the SFDR.

Authorized (EU) AIFMs and investment firms providing portfolio management are, thus, in relation to financial products as "financial market participants required to comply with the SFDR. The same holds true for MiFID II investment firms that provide investment advice and qualify under the SFDR as "financial advisers" with respect to these products. The question that arises is whether non-EU AIFMs, non-EU MiFID II investment firms providing portfolio management and investment advice also fall within the scope of the SFDR. This question has been raised several times so far, but no clear answer has been given on the EU level yet.

The definition of "financial market participant" under Article 2(1) SFDR includes all AIFMs. Furthermore, the SFDR clarifies that AIFM means "an AIFM as defined in the AIFMD". Reading the AIFMD, an AIFM means "a legal person whose regular business is managing one or more AIFs", regardless of whether the (registered office of the) legal person is located within or outside the EU. In other words, Non-EU AIFMs fall, in principle, within the scope of the SFDR.

Similarly, the definitions of both "financial market participants" under the SFDR includes investments firms, which provide portfolio management and the "financial advisers" definition those that provide investment advice. According to the SFDR, the term "investment firms" means "an investment firm" as defined under MiFID II. Contrary to the AIFM definition under the AIFMD, MiFID II makes a distinction between the term "investment firms", which are established in the EU, and "third-country firms", which are "firms that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office were located within the Union".

Technically speaking, non-EU MiFID II investment firms, which provide investment advice, thus, do not fall within the (personal) scope of the SFDR. The inconsistencies between non-EU AIFMs and investment firms raises the question whether it was the intention of the European legislator to include non-EU financial market participants and financial advisers within the scope of the SFDR.

SFDR Obligations – A brief Overview

The SFDR imposes both obligations on the "entity level", i.e. level of financial market participants and financial advisers, and on the "product level" (e.g. AIFs or managed accounts).

On the "entity level", the SFDR requires financial market participants, amongst others, to:
- integrate sustainability risks in their investment process;
- to consider significant adverse effects of investment decisions on sustainability factors in the due diligence process, or explain why the financial market participant does not comply with this (for financial market participants with less than 500 employees on a group consolidated basis); and
- explain in their remuneration policy how the policy is consistent with the integration of sustainability risks.

Financial market participants are required to publish their efforts in this respect on their website. Similar requirements apply to financial advisers.

On the product level, financial market participants are for every financial product (e.g. AIFs and managed accounts, amongst others, required to include in pre-contractual disclosures (e.g. PPM) how sustainability risks are integrated and their likely effects on the returns, or provide an explanation why sustainability risks are not relevant. Various additional duties apply if the financial products that they offer are labelled as "promoting environmental or social characteristics" (Light Green Product) or as a "sustainable investment" (Dark Green Product) under Article 8 and 9 SFDR. In particular, these additional information obligations relate to not only mandatory disclosure related to this products in pre-contractual disclosures, but also with respect to additional information obligations with publication on the website and in periodic disclosures (e.g. annual reports for AIFs).

Do SFDR Obligations apply to Non-EU AIFMs, Asset Managers & Financial Advisers?

Given the ambiguity of the SFDR's scope with respect to non-EU AIFMs, asset managers and financial advisers, the question remains whether these non-EU entities are required to "materially comply" with obligations under the SFDR.

In this respect, it should be noted that a recent FAQ published by the European Commission and the Technical Expert Group on Sustainable Finance (the "Taxonomy Regulation FAQ") stated that the product disclosure obligations laid down in the SFDR are meant to apply to anyone offering financial products in the EU, regardless of where the manufacturer of such products is based.

This question remains what the implications of this are for (i) non-EU AIFMs, (ii) non-EU asset managers and (iii) financial advisers.

Non-EU AIFMs

The Taxonomy Regulation FAQ seems to confirm that, in any case, non-EU AIFMs that market their AIFs in the EU pursuant to the national private placement regimes under Article 42 AIFMD, have to comply with the disclosure obligations in the SFDR. By absence of further EU level clarifications, it will depend upon the Member State implementations in place with what SFDR obligations such non-EU AIFMs will need to comply with. The Luxembourgish implementation of Article 42 AIFMD seems to suggest that non-EU AIFMs that market AIFs to professional investors in Luxembourg will, at least, need to comply with the SFDR obligations targeting the PPM (Article 23 AIFMD) and the annual report (Article 22 AIFMD).

The regulator may in the coming months clarify whether "entity level" policies/procedures are also required when marketing in Luxembourg. It should be noted, however, that non-EU AIFMs that sell AIFs in Luxembourg in response to reverse enquiry only are not captured by the SFDR. It only needs to comply with the SFDR for those funds which are registered/notified for private placement marketing in the EU.

Non-EU Asset Managers

Depending upon the MiFID II third country regime applicable and its national interpretation thereof, the SFDR might be directly applicable to non-EU asset managers offering managed accounts in the EU. Furthermore, the SFDR might be indirectly applicable to non-EU asset managers where they are a delegate of a European AIFM or other entity that is directly subject to the SFDR. In the latter case, these entities may seek contractual commitments from the non-EU manager to enable the European entity to comply with its own obligations. Such commitments may include, for example:
- the provision of information and data by the non-EU asset manager for the purpose of the European AIFM complying with pre-contractual disclosure requirements; and
- certain duties and responsibilities from the non-EU asset manager as may be required by the EU AIFM's policies and procedures.

Non-EU Financial advisers

At first glance, non-EU financial advisers seem to be excluded from the scope of the SFDR. Furthermore, the Taxonomy Regulation FAQ statement with regards to the SFDR only targets financial market participants offering financial products within the EU and does not include financial advisers. Nevertheless, the MiFID II third country regimes, as implemented by individual Member States, that are applicable to non-EU financial advisers advising EU clients with regard to SFDR financial products may, however, require financial advisers to fully comply with the SFDR "entity level" requirements. When advising "in-scope" SFDR entities, non-EU financial advisers may be indirectly through contractual mechanisms be required to comply with the SFDR.

Conclusion

This contribution highlighted that the obligations arising from a possible (direct) application of the SFDR to non-EU AIFMs and investment firms (asset managers and financial advisers) is not always clear. Hopefully, the (European) legislature and regulators will pick up on this and will make necessary clarifications with respect to the AIFMD (national) private placement regimes and the MiFID II (national) third country regimes.

1) Dr. Sebastiaan Hooghiemstra, LL.M. is an associate in the financial regulatory and investment funds practice of an international law firm in Luxembourg and Senior Fellow/Guest Lecturer of the International Center for Financial Law & Governance at the Erasmus University Rotterdam.