

Sustainable finance: to be or not to be an article 8 or 9 fund?

Pre-contractual Disclosure Obligations

10 March 2020 has passed and the Sustainable Finance Disclosure Regulation (EU) 2019/2088 (SFDR) has now entered into force. SFDR disclosures are applicable both to financial products (e.g., alternative investment funds (AIFs), undertakings for collective investments in transferable securities (UCITS), etc.) (the Products) and financial market participants (e.g., alternative investment fund managers, UCITS management companies and MiFID investment firms) (the FMP).

On 4 February 2021, the European Supervisory Authority (ESA) published its final report on draft regulatory technical standards (the RTS). Except for certain provisions, the proposed application date set in the RTS is 1 January 2022. The European Commission should adopt the RTS in the coming weeks but may still request amendments to the RTS or their application date.

In light of pre-contractual disclosure obligations under SFDR applicable to the Products, all Products are subject to article 6 of SFDR. The RTS will apply to Products falling under (a) article 8 of SFDR and promoting environmental or social characteristics, provided that the investee companies follow good governance practices (so-called «light green products») or (b) article 9 and having sustainable investment (or reduction in carbon emission) as their objective (so-called «dark green products»). The RTS provide valuable guidance on whether a Product classifies as an article 8 or 9 Product.

1. Article 8 Products

Product documents, such as UCITS prospectuses or article 23 AIFMD pre-contractual disclosures for AIFs (collectively referred as the Product Documents) of article 8 Products should make disclosures on environmental or social characteristics without misleading investors. The Product Documents must among others describe the investment strategy of the Products as well as the binding elements and criteria to select the investments to attain the environmental or social characteristics promoted by the Product (article 15(a) of the RTS). Therefore, the FMP should not disclose selection criteria in the Product Documents which are non-binding, (i.e., which it may disapply or override at its discretion (preamble (20) of the RTS)). Article 6 Products over-emphasising for instance on ESG factors may need to re-



view their investment policies disclosed in their Product Documents. The RTS will affect the transparency of investment policies and investment strategies of Products in general and, in particular asset allocation of article 8 Products described in Product Documents.

The RTS clarify that article 8 Products may invest in underlying assets, some of which may themselves not contribute to the promoted environmental or social characteristics (e.g., hedging instruments or cash held as ancillary liquidity, etc.). The planned asset allocation should be disclosed in the Product Documents.

Specific rules on asset allocation are also foreseen in the RTS. The Product Documents must explain (a) the minimum proportion of the investments of the Product used to attain the environmental or social characteristics promoted by it in accordance with the binding elements of the investment strategy and (b) the amount and purpose of the remaining proportion of the investments, including a description of any minimum environmental or social safeguards (Article 16(2)(a) and (b) of the RTS). Such safeguards may be the minimum safeguards referred to under article 18 of the Taxonomy Regulation (EU) 2020/852 (e.g., OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, etc.).

Article 8 Products must include an express statement in their Product Documents that they do not have sustainable investment as an objective. This however does not preclude article 8 Products from making investments considered as sustainable investments, provided that the proportion of such investments is disclosed in the Product Documents. Where the article 8 Product commits to making sustainable investments, its Product Documents need



to provide information on the «do no harm principle» (DNSH). DNSH are linked to disclosures of principal adverse impacts (PAI) and will hence also need to be disclosed in the Product Documents.

Article 8 Products may set up their investment portfolios by designating an index as reference benchmark. By doing so, specific information on the index will need to be included in the Product Document. Article 8 Product Documents need to disclose to investors (a) the continuous alignment between each of the promoted environmental or social characteristics, the investment strategy and the index, (b) where calculation methodology of the index may be found as well as (c) how the designated index differs from the relevant broad market index. Article 8 Products should clarify whether they invest directly or indirectly in investments such as in fund-of-funds or derivatives. How the use of derivatives attains (a) the environmental or social characteristics promoted by the Product or (b) the sustainable investment objective must be disclosed in the Product Documents.

Finally, Article 8 (and 9) Products must disclose their policy to assess good governance practices, including requirements on sound management structures, employee relations, remuneration of staff and tax compliance of investee companies.

2. Article 9 Products

Renewable and clean energy funds, social impact funds or development funds will typically qualify as Article 9 Products. These Products exclusively pursue a sustainable investment (or reduction in carbon emissions) objective in the sense that they invest directly or indirectly in an economic activity that satisfies the following criteria: (a) it contributes to an environmental or social objective; (b) DNSH any other environmental or social objectives



and (c) the investee companies follow good governance practices.

Articles 20 to 27 and Annex III of the RTS require Article 9 Products to describe the relevant sustainable investment objective (e.g., renewable energy, reduction of CO2 emissions) and the sustainability indicators used to attain such objective in the Product Documents (i.e., in a dedicated Annex). Certain sustainability indicators are common to those described above for Article 8 Products such as the investment strategy description, including binding selection criteria, the asset allocation between sustainable and non-sustainable assets (being noted that the later shall represent a minority of investments or be made in support of sustainable investments, e.g. use of derivatives) and good governance principles applied at the level of the investee companies.

Other sustainability indicators are specific to Article 9 Products as being the most ambitious products in the sustainability hierarchy. As part of their DNSH assessment, Article 9 Products must consider adverse impact indicators pursuant to Annex 1 – Tables 1, 2 and 3 of the RTS and/or common indicators used by the EU Climate Transition Benchmarks and the EU Paris-aligned benchmark as set out in Regulation (EU) 2016/1011.

Article 9 Products as well as Article 8 Products making sustainable investments shall include a statement on whether PAI on sustainability factors are taken into account. To determine PAI, an analysis at the level of the Product should be performed on (a) the principal adverse sustainability indicators (PASI) listed in Table 1 (e.g., greenhouse gas emissions, unadjusted gender pay gap, etc.); (b) at least 1 additional adverse impact indicator on climate under Table 2 (e.g., emissions of air pollutants, land degradation, etc.); and (c) at

least 1 additional adverse impact indicator on social matters under Table 3 (e.g., lack of human rights and anti-corruption policies). The number of additional indicators should be determined pursuant to the proportionality principle.

In other words, the DNSH principle applies and an assessment on what is the PAI of the investments on other sustainability factors using PASI should be performed. This effect should obviously be minimal otherwise we would arrive to counterproductive results whereby for instance renewable energy installations have a PAI on surrounding flora and fauna.

If an index is used and is designated as a reference sustainable benchmark by an Article 8 or 9 Product, the Product Documents should demonstrate continuous alignment between the investment objective, on one hand, and the index and its methodology, on the other hand, as well as how the designated index differs from a relevant broad market index. If the objective of the Article 9 Product consists in a reduction of CO2 emissions, then the index should be a Union-climate related benchmark (i.e. EU Climate Transition Benchmarks and the EU Paris-aligned benchmark as set-out in Regulation (EU) 2016/1011) or, where such benchmark is not available, the Product Documents should explain (i) how the reduction of CO2 emissions will be achieved and (ii) how the methodologies applicable to Union-climate related benchmarks are pursued.

Article 8 Products and Article 9 Products will be under scrutiny going forward considering that the main challenges of SFDR and the RTS are to avoid greenwashing and mis-selling. FMPs wishing to market such Products are encouraged to analyse in detail the RTS requirements and provide a clear and comprehensive description in the Product Documents. While the RTS are still in draft form, it may be useful for FMPs to incorporate or at least consider the provisions of RTS prior to launching new Products or amending the Product Documents of existing Products. RTS developments should be followed closely going forward. In the meantime, stay tuned and invest green!

For further details on the relevant RTS provisions, please access A&O Great Fund Insights here: <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/new-rts-for-sustainable-finance-disclosure-regulation-sfdr-key-points-for-fund-and-asset-managers>

Yannick ARBAUT, Partner
Codrina CONSTANTINESCU, Senior associate
Lisa KLEMANN, Senior associate

Allen & Overly, société en commandite spéciale

SDG 7 and Hydrogen : a new investment thematic?

By Christophe BOGAERT, Senior Portfolio Manager & Charles LAMOULEN, Head Portfolio Management at FIA Asset Management

As the world struggles to control climate change and CO2 emissions, the search for alternative sources of energy is accelerating. Renewables (solar, wind and hydro power) have made good progress in terms of both capacity and efficiency, driving down costs. However, one of the biggest challenges is how to store the power generated from those renewable sources.

Hydrogen could be a key part of the answer, creating a boom in innovation around this technology. Hydrogen has the chemical properties to store energy for later use. Hence, the “decoupling” of power generation and consumption is one of the big challenges facing green energy.

On the face of it, hydrogen seems like the holy grail of energy. It is easy to make, as you simply pass an electrical current through water to split it into hydrogen and oxygen – a technique known as electrolysis. If the electricity comes from renewable sources, then this process is essentially emissions-free. When the hydrogen is burned or passed through a fuel cell, the only by-product is water. So, why hasn't this wonder fuel taken off? There are practical issues relating to storage and transportation, but the number one hurdle is cost. Electrolysis is energy intensive, meaning that ‘green’ hydrogen is not yet commercially

competitive with fossil fuels. At the moment, the cost of ‘green’ hydrogen production can be 3-5x greater than ‘grey’ alternatives. While it is possible that companies and consumers will pay more for ‘green’ hydrogen given its environmental benefits, it is unlikely that ‘green’ hydrogen can reach its full potential unless costs continue to fall and become economically competitive. As the cost of renewable energy comes down and installed capacity increases, hydrogen could become more financially viable.

To ensure development and eventual adoption of hydrogen-producing technology and hydrogen-supporting infrastructure, support from the public sector will be critical. We are seeing increasing signs that such support will be forthcoming. The European Commission's European Green Deal stated that it aims to deploy some 1%-2% of annual GDP (around €270bn per year) to support the bloc's energy transition. This initiative will lead to increased investment across all low-carbon technologies, including clean hydrogen production and fuel cells. The new US president Joe Biden also name-checked the sector as an area that will be part of his clean energy plans for the country.

So the real question is: Is now the time to invest in hydrogen?

Over the past few years, there has been an enormous shift toward increased public and political awareness of environmental sustainability, as well as rising pressure on institutions such as pension funds or assets managers to include “green companies” in their investment portfolios. These sustainability and ESG

issues will help drive interest in low-carbon options and financing of green projects, including hydrogen. However, there is debate over the depth of this sector, as there are only a handful of small companies operating in this field. Those that exist tend to be early-stage businesses with a high degree of uncertainty about future profitability. Furthermore, hydrogen-related stocks have exploded over the past year, trading at very high multiples, but the reality has yet to match up to expectation. This reminds of the solar sector in 2007 when we had a bubble and many pure plays were small in size, and now 15 years later, many of them do not exist anymore. There is no true visibility yet when it comes to barriers to entry and competitiveness of these companies.

The more mature opportunities currently available tend not to have pure exposure, but on the other hand we can more straightforwardly assess how they will yield high returns from their hydrogen-related operations. Looking further down the value chain, companies closer to hydrogen applications, such as electrolyser developers and fuel cells catalyst manufacturers, could also be compelling investments as their costs fall and demand grows for low- or zero-emission technology in the transport and industrial sectors.

Investing in hydrogen remains thus highly speculative and it is unclear how significant hydrogen will ultimately be to the global energy picture.

At FIA Asset Management, ESG investments lie in our DNA. For years, we have been investing in finan-

cial instruments striving to make an impact on environmental and social issues. As investor in among others clean energy and solar energy instruments, we are also looking at investments in hydrogen. By investing in Hydrogen, we would target various United Nations Sustainable Development Goals, such as obviously SDG 7, but also SDGs 12 and 13.



As explained earlier, financial instruments available today on Green Hydrogen are scarce, as the topic is still at a very early stage. For example, the only ETF investable today is L&G (Legal & General) Hydrogen Economy ETF, which seeks to gain exposure to the full hydrogen value chain. Launched in January 2021, it looks at companies with a minimum market cap of \$200 million, including electrolyser manufacturers, hydrogen producers, fuel-cell manufacturers, specialist mobility providers, fuel-cell component suppliers, key industrial and utility companies. FIA AM may consider this ETF a potential future investment, but as of today, it has a very short track record and a Due Diligence still needs to be performed before any other consideration.

Globally, the question remains pending: even if the topic looks attractive as an ESG Investor, it is still very immature. The market is currently tiny, and there is a lack of viable attractive financial instruments today.