GUIDANCE ADVICE:

Application of SFDR Process for Real Estate Funds

October 2024

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The Association of Real Estate Funds

Guidance Advice: Application of SFDR Process for Real Estate Funds

Members must seek advice from their compliance team or legal counsel to ensure that they meet the full SFDR regulations. The information stated in this document has been put together by AREF members who have undertaken the SFDR process, but it is not a fully comprehensive list of requirements, and each manager may interpret the regulations differently or use a different approach. AREF assumes no responsibility or liability for any errors or omissions in the content of this Guidance Advice.

Please note: On 24 July 2024, The European Securities and Markets Authority (ESMA), the EU's financial markets regulator and supervisor, published an Opinion on the Sustainable Finance Regulatory Framework, setting out possible long-term improvements: **https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-its-long-term-vision-functioning-sustainable-finance-framework** .

While this publication does not impact funds reporting as of 23 October 2024, when this guidance was updated, it is important that the recommendations contained within are flagged to readers as they clearly define the long-term vision for the functioning of the Sustainable Finance Framework and were not factored into the original guidance advice.

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Last updated: 23/10/2024

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Important SFDR update:

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While this publication does not impact funds reporting as of 23 October 2024, when this guidance was updated, it is important that the recommendations contained within are flagged to readers as they clearly define the long-term vision for the functioning of the Sustainable Finance Framework and were not factored into the original guidance advice.

Please find ESMA's note below:

ESMA acknowledges that the EU Sustainable Finance Framework is already well developed and includes safeguards against greenwashing. At the same time, ESMA considers that, in the longer-term, the Framework could further evolve to facilitate investors' access to sustainable investments and support the effective functioning of the Sustainable Investment Value Chain.

The main recommendations for the European Commission's consideration:

- The EU Taxonomy should become the sole, common reference point for the assessment of sustainability and should be embedded in all Sustainable Finance legislation;
- The EU Taxonomy should be completed for all activities that can substantially contribute to environmental sustainability and a social taxonomy developed;
- A definition of transition investments should be incorporated into the Framework to provide legal clarity and support the creation of transition-related products;
- All financial products should disclose some minimum basic sustainability information, covering environmental and social characteristics;
- A product categorisation system should be introduced catering to sustainability and transition, based on a set of clear eligibility criteria and binding transparency obligations;
- ESG data products should be brought into the regulatory perimeter, the consistency of ESG metrics continue to be improved, reliability of estimates ensured; and
- Consumer and industry testing should be carried out before implementing policy solutions to ensure their feasibility and appropriateness for retail investors.

This Opinion builds on the findings of the ESMA Progress Report on Greenwashing and the Joint ESAs Opinion on the review of the SFDR. The Opinion also represents the last component of ESMA's reply to the EC Request for input related to greenwashing, next to the Final Report on Greenwashing.

1. Introduction

What is the purpose of this paper?

The purpose of this document is to provide insight and guidance on the Sustainable Finance Disclosure Regulation (SFDR) with regards to the following aspects:

- the evolving terminology of ESG and sustainability and what this means in the context of SFDR and market expectations;
- the wider EU finance terminology and concepts;
- an explanation and interpretation of the different product level disclosure requirements as defined by SFDR Articles 6, 8 and 9; and
- the product level steps for completing the SFDR process in accordance with Articles 6, 8 and 9.

It is important to note that the SFDR regulation is constantly evolving, and this paper will also evolve over time to capture key changes, together with industry interpretations and best practice. There are currently a variety of live SFDR consultations ongoing alongside the timing of the publication of this paper. These consultations have the potential to change key aspects of the regulation.

This document does not provide guidance on entity level compliance.

What is the SFDR?

The SFDR was introduced by the EU on 10 March 2021 with the purpose of helping institutional asset owners and retail clients understand, compare and monitor the sustainability characteristics of investment funds by standardising sustainability disclosures. Its principal purpose was to be a sustainability disclosure regime and not a labelling regime, however it has been interpreted as such by many in the industry.

Effectively, SFDR requires reporting at entity level (company level) and product level through a number of articles within the legislation (Table 1). Within these articles, SFDR distinguishes between three types of product classification and disclosure requirements with regards to the level of sustainability ambition of the underlying investments. These are Articles 6, 8 and 9 highlighted in bold below. Broadly, products that are applicable under SFDR are those that are domiciled and/or marketed within Europe.

While the UK may have its own regulation, such as the upcoming Sustainability Disclosure Requirements (SDR), if a UK firm is providing services into the EU, adherence to SFDR is needed to facilitate access to investor capital domiciled within the region.

Table 1. Overview of SFDR articles and their application at entity or product level

Article	Description	Level	Type of disclosure
Article 3	Disclosure on sustainability risk policies and how this is integrated into the investment process.	Entity	Website disclosure
Article 4	Principal Adverse Impacts (PAI) statement ("comply or explain") aggregated up at entity level.	Entity	Website disclosure
Article 5	Renumeration policies	Entity	Website disclosure
Article 6	**Approach to sustainability risk integration. Article 6 applies to all in scope products.**	**Product**	**Pre-contractual document**
Article 7	Assessment of adverse impact investment decisions on sustainability e.g., the Principle Adverse Impacts (PAIs). The legal text does not require reporting of these however market expectation is beyond the legal text and is to list which PAIs are considered for the product and best practice is that this should be disclosed and reported.	Product	Pre-contractual and periodic reports
Article 8	**Products with binding environmental or social characteristics**	**Product**	**Pre-contractual document**
Article 9	**Products with binding environment or social characteristics and who target a specific sustainability goal**	**Product**	**Pre-contractual document**
Article 10	Transparency of promotion of environmental or social characteristics and sustainable investments	Product	Website disclosure
Article 11	Transparency of promotion of environmental or social characteristics and sustainable investments	Product	Periodic reports

The details of all the entity and product level disclosures are detailed (including PAIs and templates) in the supplementing SFDR regulation.

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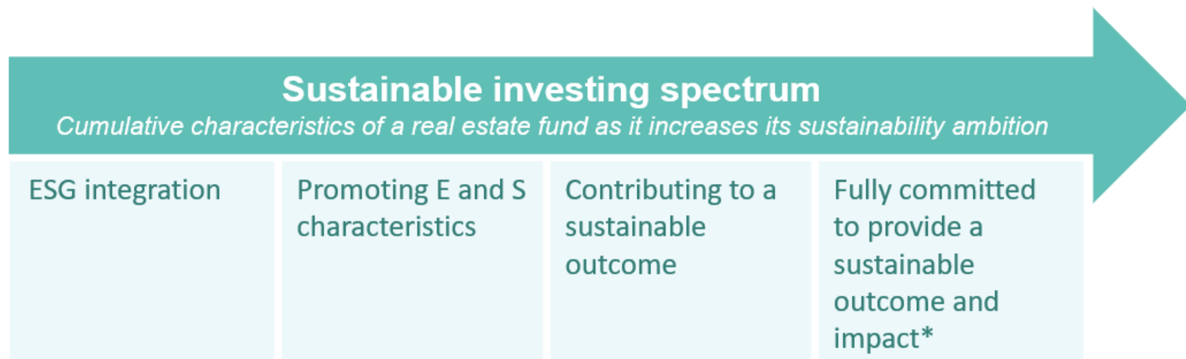
2. The evolution of 'ESG' and 'Sustainability' terms

Historically, the terms ESG, sustainability and responsible investment were largely interchangeable but in recent times there has been growing consensus within the investment management industry, encouraged by the SFDR regulation, on interpreting and defining what these terms mean.

The simplest way to frame this is to consider a sustainable investing spectrum with ESG risk management and integration at one end as the minimum expectation for real estate funds and high impact sustainable investments at the other. Figure 1 outlines this cumulative journey between these two points.

The term 'ESG' was originally created to outline environmental, social and governance factors which could present risks which may potentially harm investment performance. More recently, as focus has expanded to also cover sustainable outcomes, the term 'sustainability' has become more prevalent. It should be noted however that the SFDR regulation refers to sustainability risks rather than ESG risks but does also define E and S characteristics specifically rather than sustainability characteristics.

Figure 1: Sustainable investing spectrum



* The far-right hand box reflects investments that are made with the intent to contribute to measurable positive social, economic, or environmental impact alongside financial returns. Please see 'Operating Principles for Impact Management', https://www.impactprinciples.org/ for further information.

The sustainable investing spectrum can be overlaid with the regulation of SFDR with regards to the product disclosure requirements of Articles of 6, 8 and 9. The disclosure requirements of Articles 6, 8 and 9 are cumulative with all products having to comply with Article 6 as the base case which requires sustainability risks to be robustly integrated within the investment process. For example, if a real estate fund has a higher sustainability ambition than sustainability risk integration, then the investment manager may choose to disclose against the Article 8 requirements. If the sustainability ambition is even higher, and the investment manager wishes to meet the Article 9 requirements, then the fund must also meet the requirements of Articles 6 and 8.

3. EU Sustainable Finance Concepts

This section provides an explanation behind some of the key terms and concepts used within the SFDR regulation to help managers understand how these terms are linked to the overall compliance approach.

3.1 Principal Adverse Impact (PAI) Indicators

The Principal Adverse Impact indicators (PAIs) are a set of indicators defined by the EU to assess adverse sustainability impacts of investment decisions. The PAIs are prescribed and defined in three tables in Annex I of the Sustainable Finance Disclosure Regulation (SFDR: Regulation (EU) 2019/2088) for different asset classes. Across the three tables, there are 64 indicators, with methodologies defined in varying detail in the regulation (Table 2) with currently only seven defined for real estate (Table 3). The seven defined indicators for real estate are environmental and there are currently no real estate social indicators. Note that throughout this document, 'core PAIs' refer to the indicators in Table 1 of Annex I in the Regulation; 'additional PAIs' refer to the indicators in Tables 2 and 3 of Annex I.

The consideration and reporting of PAIs differ for the entity and product level where inconsistency can be found between the requirements at the two levels.

Entity Level:

- All core PAIs and two additional PAIs (one from both Table 2 and Table 3) are mandatory disclosures for entities.

Product level:

- At the product level, the regulator leaves flexibility on how PAIs are applied to investment processes, in contrast to entity level The rules do not prescribe how many or which PAIs must be used or disclosed; it is incumbent on managers to select the appropriate PAIs for their products.
- It is therefore within the SFDR pre-contractual disclosures, where it must be stated whether a product considers PAIs and how they are incorporated into the investment process. This should include descriptions of the PAIs and procedures in place to mitigate the impacts. Within the European ESG Template (EET), PAIs considered in the investment process for each product should be highlighted and PAI data provided to meet investors' expectations and entity requirements.
- The PAIs also form the basis for the 'Do No Significant Harm (DNSH)' criteria within the SFDR sustainable investment (SI) definition, which applies for products which disclose under Articles 8 and 9 where they choose to define and set a percentage threshold of sustainable investments within the fund. DNSH is not defined in detail within the regulation (please see

Section 3.3 for more details); it is incumbent on financial market participants to define and demonstrate how they adhere to this principle, part of which is where the two core real estate PAIs must be considered and be above those thresholds as well as consider any others that are material to the investment.

Table 2: PAI indicators as defined by Annex I of the SFDR

Core PAI indicators (Table 1 of Annex I)	Additional climate and other environmental-related indicators (Table 2 of Annex I)	Additional indicators for social and employee, respect for human rights, anti-corruption and anti-bribery matters (Table 3 of Annex I)
18 indicators: • 14 for company investments • 2 for sovereigns & supranationals • 2 for real estate assets	22 indicators: • 16 for company investments • 1 for sovereigns & supranationals • 5 for real estate assets	24 indicators: • 17 for company investments • 7 for sovereigns & supranationals • (0 for real estate assets)

Table 3: Real estate PAI indicators

Principal adverse Impacts (PAIs) indicators for real estate			
Source	**Topic**	**Reference No.**	**Description**
Table 1 (Core PAI indicators)	Fossil fuels	17. Exposure to fossil fuels through real estate assets	Share of investments in real estate assets involved in the extraction, storage, transport or manufacture of fossil fuels
	Energy efficiency	18. Exposure to energy-inefficient real estate assets	Share of investments in energy-inefficient real estate assets
Table 2 (Additional climate and other environmental-related indicators)	Greenhouse gas emissions	18. GHG emissions	Scope 1 GHG emissions generated by real estate assets Scope 2 GHG emissions generated by real estate assets From 1 January 2023, Scope 3 GHG emissions generated by real estate assets Total GHG emissions generated by real estate assets
	Energy consumption	19. Energy consumption intensity	Energy consumption in GWh of owned real estate assets per square meter
	Waste	20. Waste production in operations	Share of real estate assets not equipped with facilities for waste sorting and not covered by a waste recovery or recycling contract
	Resource consumption	21. Raw Materials consumption for new construction and major renovations	Share of raw building materials (excluding recovered, recycled and biosourced) compared to the total weight of building materials used in new construction and major renovations
	Biodiversity	22. Land artificialisation	Share of non-vegetated surface area (surfaces that have not been vegetated in ground, as well as on roofs, terraces and walls) compared to the total surface area of the plots of all assets

The two core PAI indicators for real estate are challenging to interpret and fully evidence:

17. Exposure to fossil fuels through real estate assets

This relates to the share of investments in real estate assets involved in the extraction, storage, transport or manufacture of fossil fuels. This has been challenging to apply to real estate and general consensus from the industry is that the storage element is the most applicable and has therefore been interpreted by many managers to mean petrol stations. There is inconsistency on how to calculate the percentage share of, either the whole building value or, if the petrol station is located alongside other retail units, then the percentage share may be calculated as the proportion of rental value applied to the fund value to only account for that portion of the underlying asset.

18. Exposure to energy-inefficient real estate assets

This relates to the share of investments in energy-inefficient real estate assets with the following equation to be used to calculate that share:

$$\frac{(\text{Value of real estate assets built before 31/12/2020 with EPC of C or below}) + (\text{Value of real estate assets built after 31/12/2020 with PED below NZEB in Directive 2010/31/EU})}{\text{Value of real estate assets required to abide by EPC and NZEB rules}}$$

The challenge is how to accurately assess whether a building built after 31/12/2020 has complied with Nearly Zero Energy Building (NZEB) standards. One potential method is to use the date the building permit was issued alongside the date that the EU country, in which the building is located, applied the NZEB criteria into its planning criteria.

3.2 E and S Characteristics

‘E and S characteristics’ is a term that describes the environmental or social aspects promoted by a financial product and are environmental and social subtopics.

There is some guidance from regulators on what these E and S characteristics should consist of and whilst the environmental ones can be easily applied to real estate, it is more difficult to apply the full suite of social ones. They are:

- environmental – energy;
- environmental – renewable energy;
- environmental – raw materials;
- environmental – water and land;
- environmental – waste;
- environmental – greenhouse gas emissions;
- environmental – biodiversity;
- environmental – circular economy;
- social – inequality;
- social – social cohesion;

- social – social integration;
- social – labour relations;
- social – investment in human capital; and
- social – economically or socially disadvantaged communities.

3.3 Sustainable investments

Under SFDR, the term 'sustainable investments' refers to the creation of an asset level objective and method that sets the definition and criteria to determine if an underlying investment is sustainable. This is not pre-described by the regulation but is the responsibility of investment managers to determine. Investors can therefore decide to create their own asset objective and method or use that of the EU taxonomy (see Section 3.4 for more details). This is optional for products aligned with Article 8 but mandatory for those aligned with Article 9, as discussed in more detail throughout the document.

For an asset to meet the SFDR Sustainable Investments definition, it must meet all of the below criteria:

1. **Significant contribution to environmental or social objective:** This step defines what 'good' looks like. As described above, this approach is flexible enabling the investment manager to define and include criteria that they believe evidences a good sustainable asset. This does not have to be one holistic definition of sustainable investments but can be aligned with sub-topics of sustainability such as climate mitigation, circular economy, or socially disadvantaged communities.

2. **Do No Significant Harm (DNSH):** There are two steps:

    - Assessment of the Principal Adverse Impacts (PAIs) as outlined in the above section. The PAIs are meant to be considered in the DNSH part of the equation.
    - Adherence of the investee company/or underlying real estate investment to OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights. At the moment, this guidance is primarily focused on public markets and is open to interpretation for the real estate sector.

3. **Good governance:** The term "good governance" typically relates to the consideration of sound management structures, employee relations, remuneration of staff and tax compliance in investee companies. As SFDR is a transparency regulation, it does not prescribe a specific strategy of how good governance practices should be assessed. That being said, the regulation always refers to the good governance practices of the investee companies and while it is hardly applicable prima facie to real estate assets, it seems that the market practice remains to provide some form of disclosure. This allows financial market participants to freely choose the way in which they assess good governance practices (e.g., by assessing the manager, the fund structure, the underlying properties or a combination of those). For the real estate sector, different approaches have been observed in this regard.

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3.4 The EU taxonomy

The EU taxonomy (EUT) is a cornerstone of the EU's sustainable finance framework and an important market transparency tool. It helps direct investments to the economic activities most needed for the transition, in line with the European Green Deal objectives. The taxonomy is a classification system that defines criteria for economic activities that are aligned with a net zero trajectory by 2050 and the broader environmental goals other than climate.

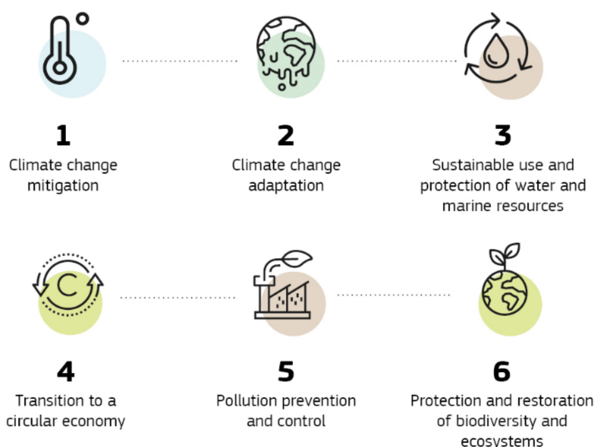
In order to meet the EU's climate and energy targets for 2030 and reach the objectives of the European Green Deal, it is vital that investments are directed towards sustainable projects and activities. To achieve this, a common language and a clear definition of what is 'sustainable' is needed. This is why the action plan on financing sustainable growth called for the creation of a common classification system for sustainable economic activities, or an "EU taxonomy".

The EU taxonomy allows financial and non-financial companies to share a common definition of economic activities that can be considered environmentally sustainable.

In this way, it plays an important role in helping the EU scale up sustainable investment, by creating security for investors, protecting private investors from greenwashing, helping companies become more climate-friendly and mitigating market fragmentation.

The Taxonomy Regulation entered into force on 12 July 2020. It establishes the basis for the EU taxonomy by setting out sets out six climate and environmental objectives and four overarching conditions that an economic activity has to meet in order to qualify as environmentally sustainable.[1]

Figure 2: Climate and Environmental Objectives:[2]



1. *Climate change mitigation*
2. *Climate change adaptation*

[1] From European Commission webpage, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en
[2] From EC Taxonomy Navigator webpage, https://ec.europa.eu/sustainable-finance-*taxonomy/*

3. *Sustainable use and protection of water and marine resources*
4. *Transition to a circular economy*
5. *Pollution prevention and control*
6. *Protection and restoration of biodiversity and ecosystems*

Overarching conditions that an economic activity must meet to qualify as environmentally sustainable:

1. making a substantial contribution to at least one environmental objective;
2. doing no significant harm to any of the other five environmental objectives;
3. complying with minimum safeguards: adherence of the investee company/or underlying real estate investment to OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights which is aligned with the second part of the DNSH of the SFDR; and
4. complying with the technical screening criteria set out in the Taxonomy delegated acts.

It should be noted that the current EU taxonomy criteria released by the European Commission are primarily 'environmental' related. While the current 'environmental taxonomy' does include some requirements around minimum social safeguards, the European Commission has yet to release a 'social taxonomy' with associated social objectives. While the European Economic and Social Committee (EESC) is applying pressure on the European Commission to publish a report on a social taxonomy, there are no clear timelines or certainty over whether one will be published.

How does the EU taxonomy fit in with other legislative frameworks?

There are various legislative frameworks which the EU taxonomy feeds into:

- **SFDR: *The EU taxonomy is a separate framework from SFDR*** but there is an obligation to disclose certain aspects in relation to the EU taxonomy for SFDR funds.
- **Corporate Sustainability Reporting Directive (CSRD):** If a company or subsidiary company is in scope of CSRD, there is a requirement to present a corporate level disclosure of EU taxonomy (for example, how many projects have EU taxonomy alignment) but this is not at the product level. In addition, it should be noted that CSRD requires reporting on a range of sustainability matters. The details are set out in the European Sustainability Reporting Standards (ESRS).

How does the EU taxonomy work fit in with SFDR?

The EU taxonomy sets has developed specific criteria for real estate. It follows a similar framework to the SFDR sustainable investments definition. The main differences between the two frameworks and how the EUT methodology feeds into the SFDR sustainable investments (SI) methodology are outlined in the table below.

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Table 4: A summary and comparison of the SFDR and EUT frameworks for defining sustainable investments

3-step test	SFDR SI methodology	EUT methodology	Comments
Contribution criterion	Contribution of the ***economic activity*** to a social or environmental objective	Substantial contribution of the ***economic activity*** to one of the environmental objectives as defined by the EU taxonomy (by way of technical screening criteria)	Given the EU taxonomy prescribes the screening criteria to assess *substantial* contribution and that both SFDR and EU taxonomy refer to the contribution of the ***economic activity***, the contribution established through EUT assessment can be utilised for SI methodology.
DNSH criterion	DNSH (***of the investment***) Step 1 – Assessment against PAI indicators	DNSH (***of the economic activity***) as defined by the EU taxonomy (by way of technical screening criteria)	There are two main differences between the SFDR DNSH and the EUT DNSH, namely: 1. For EUT DNSH, there are technical screening criteria to assess the economic activity for any harm, whereas the SFDR DNSH requires an assessment against PAI indicators leaving it to firms to determine when there is significant adverse impact of an investment (in which case that investment should not be deemed 'sustainable'). 2. The SFDR DNSH test is applied ***at the level of the investment*** and, in case of the EUT, the DNSH is applied ***at the level of the economic activity***. As a consequence, the regulation requires application of the SFDR PAI test (mandatory PAI indicators and any relevant optional indicators) on top of the taxonomy assessment in order to also label the investment as 'sustainable'. For real estate, that means the two mandatory indicators and any relevant additional indicators (i.e., for real estate any relevant additional environmental indicators – copied below). In addition, other PAIS can be included, if any are deemed relevant.

3-step test	SFDR SI methodology	EUT methodology	Comments
	DNSH (of the investment) Step 2 – Adherence of the ***investee company*** to OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights		SFDR DNSH Step 2 aligns with the EUT minimum safeguards. It is focussed on equity investments so is open to interpretation for real estate.
Minimum safeguards		Apply minimum safeguards, i.e., adherence of the ***investee company*** to OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights	

How does the EU taxonomy work for real estate?

The EU taxonomy includes different criteria against which to assess 'Taxonomy-alignment' for different economic activities ('Taxonomy-eligible activities'), including several activities related to real estate. There are seven real-estate specific activities for which there are available criteria to measure Taxonomy alignment against:

- ***acquisition and ownership of buildings;***
- ***construction of new buildings;***
- installation, maintenance, and repair of charging stations for electric vehicles in buildings;
- installation, maintenance, and repair of energy efficiency equipment;
- installation, maintenance and repair of instruments and devices for measuring, regulation and controlling energy performance of buildings;
- installation, maintenance, and repair of renewable energy technologies; and
- ***renovation of existing buildings.***

For real estate asset managers, core economic activities are typically those highlighted in **bold** above. At this stage, it is not entirely clear if a financial product invests in multiple Taxonomy-eligible activities whether it is appropriate to aggregate Taxonomy alignment up to the Product level from each economic activity. However, to avoid double-counting, it is not possible to report the same economic activity as being aligned to more than one environmental objective (e.g., contribution to climate mitigation plus a biodiversity objective), rather the environmental objective would be chosen that best suits the Product's overall ESG objectives/characteristics.

Where a commitment to measurement or a minimum share of Taxonomy alignment has been made by a real estate fund in any SFDR disclosures (where an investment manager chooses to apply Article 8 and 9 with a percentage threshold of sustainable investments), Taxonomy alignment will need to be assessed both on standing investments and during any pre-acquisition due diligence. An asset can be 'Taxonomy aligned' if it meets one of the below criteria (while also meeting the minimum social safeguards):

- **Contribution to climate mitigation:** the asset must meet the 'substantial contribution' criteria' and 'do no significant harm (DNSH)criteria'. The substantial contribution criteria for climate mitigation typically reflect the energy efficiency of buildings, and the certification, measurement and monitoring of this, while there are other DNSH criteria around climate adaptation, water, waste, pollution prevention and biodiversity.
- **Contribution to climate adaptation:** the asset must meet the 'substantial contribution' criteria' and 'do no significant harm (DNSH) criteria'. The substantial contribution criteria for climate adaptation typically reflect the physical climate risk assessment under suitable climate scenarios, along with specific climate risk vulnerability assessments. The DNSH criteria are typically focused on climate mitigation elements (around energy efficiency, typically similar to the requirements of the climate mitigation pillar), along with water, waste, pollution prevention and biodiversity.

It is considered most appropriate to assess Taxonomy alignment (particularly for ‘acquisition and ownership of buildings’) at the unit/tenancy level, rather than at asset level. This is because different units/tenancies within the same asset may have varying levels of Taxonomy alignment. Therefore, it is most appropriate to aggregate Taxonomy alignment from unit level up to asset level then up to product level, in order to establish a share of Taxonomy aligned or sustainable investments.

4. Application of SFDR at product level

As noted previously, a product domiciled in the EU or marketed to investors from the EU is in scope. Products that are 'open' or were 'open, now closed' since 10 March 2021 are also in scope.

The ESG approach of each product must be clearly communicated within its documentation. This communication must be consistent and there are prescribed statements and templates dependent on various factors as summarised in Table 8. Documentation can be grouped as:

1. Pre-Investment: Depending on the structure of the product, the offering documentation (Prospectus, Offering Memorandum, Investment Memorandum, etc.) must include appropriate statements and templates. The pre-investment requirements are commonly referred to as pre-contractual.

2. Post Investment: Annual reporting, defined as when the audited annual accounts are provided to investors, must include the appropriate statements and templates. The post-investment reporting is commonly referred to as Periodic Reporting. This is not applicable to client-agreed reporting such as quarterly manager reports, although as with marketing materials, this should not contradict or overstate the ESG objectives and activities of the product.

3. Marketing: Materials used for the promotion of the fund either with prospects or existing clients. This must not contradict or overstate the ESG objectives and activities of the product.

4. Website Disclosures: This is challenging for private market products and difficult to understand the merit given how these products are distributed, but nonetheless a requirement. For each product that is Article 8 or above and remains in scope, a website disclosure template must be completed. This must be disclosed on an appropriate website. It can be publicly available, or behind a password, but must be made available to eligible prospects. In addition, the website disclosure must be made available in the local language of each jurisdiction the product is market in.

The requirements and content for the documentation listed above are based on how the investment manager applies Articles 6, 8 and 9 to their real estate funds. The following section outlines:

- the characteristics of real estate funds depending on the level of their sustainability ambition and location on the sustainable investing spectrum with
- an overlay of the SFDR product categories of Article 6, 8 and 9; and
- the practical steps that must be completed to meet compliance.

In addition, examples and qualification suggestions are provided to support investment managers in the assignment of their real estate products, both today and where they might want them to sit in the future.

4.1 Article 6: ESG integration

Definition

The majority of traditional real estate funds sit at the lower end of the sustainable investing spectrum. Their primary objectives relate to investment performance and target returns, but with a strong focus on ESG risk management and integration. It is therefore less likely that a significant outlay on additional ESG services is considered for these funds, with those commissioned focused on environmental due diligence and improving Energy Performance Certificate (EPC) ratings. They will not have ambitious ESG targets.

This is now the base case expectation for all real estate investments. The ESG integration outlined by the Principles for Responsible Investment (PRI) provides best practice guidance on good ESG integration:

- **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4:** We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5:** We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6:** We will each report on our activities and progress towards implementing the Principles.

Practical example

Real estate funds that ensure assets meet a minimum rating level for their EPCs, a low flood risk and a low contaminated land risk.

SFDR application and disclosure requirements

All real estate funds caught by the SFDR regulation need to have good ESG integration. This is the base case.

Table 5: Article 6 Disclosure Summary

Pre-Contractual Documentation	Periodic Reporting	Website Disclosure
A short summary in text format to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs).	Summary in product annual report to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs).	Not applicable.

4.2 Article 8: Promoting E and S characteristics/contributing to a sustainable outcome

There are two options for Article 8 funds that are defined by the depth of ESG/sustainability promotion. They are:

1. promoting E and S characteristics (Article 8); and
2. promoting E and S characteristics alongside contributing to a sustainable outcome (Article 8+).

Definition

Promoting E and S characteristics (Article 8): As you move across the spectrum, the next level up, from good ESG integration, is the further and active promotion of E and S characteristics. This involves going beyond just a risk management approach by promoting the potential opportunities that ESG factors can provide. A real estate fund at this level may have certain E and S targets, KPIs and reporting, which are beyond those material risk aspects. A real estate fund at this point of the spectrum is doing more than the base case of ESG risk management. As a result, it is likely to incur a higher spend on additional ESG services, as it is understood that these will contribute to the quality of a building and yield higher rental premiums, reduce void rates and provide a higher price on disposal. The promotion of E and S characteristics qualifies a real estate fund to be categorised as an Article 8 fund. As with Article 6 funds, investment performance and target returns are still the main priority.

Contributing to a sustainable outcome (Article 8+): At the next level, the promotion of E and S characteristics are still key but in addition the real estate fund also sets a specific sustainability objective, at asset level, which is focused on achieving a specific sustainability outcome. In practical terms, this is the creation of a comprehensive asset level sustainable investments methodology which is focused on meeting key environmental and/or social outcomes. It sets criteria and underlying metrics that an asset must meet to be classified as a sustainable investment. This is where a Fund's investment approach has E and S characteristics as central considerations in the investment process and one of the key drivers of the investment decision. One binding element is

that the real estate fund has set a minimum threshold of the percentage value of sustainable investments that they want to hold in the fund. This essentially sets a 'sustainability' investment restriction. This description reflects an Article 8 real estate fund that has an even higher sustainability ambition.

Practical examples

A fund promoting E and S characteristics (Article 8) may:

- Carry out satisfaction surveys on their tenants to promote occupier satisfaction and wellbeing to improve tenant retention rates; this may create a rental premium.
- Have set a net-zero target, alongside a performance return target which takes precedence; net-zero decisions are therefore made in line with commercial decisions, potentially just ahead of policy requirements.
- Target a higher level of green building certification which can demonstrate that a building is actively promoting E and S characteristics.
- The promotion of environmental and/or social characteristics is demonstrated through: adherence to a set of fixed, pre-defined ESG criteria, e.g. minimum EPCs levels and/or commitment to improving EPC rating profile (both in terms of ratings and coverage) within a pre-defined period; minimum green building certifications ratings or commitment to improving the proportion of assets rated under building certification standards within a pre-defined period; or pursing a decarbonisation strategy with the aim to reduce GHG emissions to net zero by 2050 at the latest.

A fund contributing to a sustainable outcome (Article 8+) may:

- A real estate fund may integrate ESG factors at the core of their business strategy and set a minimum target to have at least 50% of their real estate assets, be EPC A along with other specific targets that are monitored and reported on year on year such as energy consumption, GHG emissions, building certification, and data coverage.
- Use of an ESG scorecard where the promotion of environmental and/or social characteristics can be demonstrated through a commitment to only acquire assets which achieve a minimum score based on a proprietary ESG scorecard either from the outset or within a pre-defined period (to accommodate value-add strategies) alongside transparent reporting of performance against key metrics derived from the scorecard to measure the attainment of the E&S characteristics promoted by the product, e.g. Energy usage intensity (kWh/m2), Carbon intensity (kgCO2e/m2), Water intensity (m3/m2), Building performance certificates ratings and coverage (% sqm) of the assets, Essential local amenities, etc.
- A real estate fund may choose to set a minimum threshold based on assets which meet a certain level of green building certification.

SFDR Application

In summary, at the very least, Article 8 products promote environmental and/or social characteristics, as well as meeting good governance practices. These products can, in addition, set

certain thresholds which align their products with sustainability outcomes. Based on these options, the industry has thus interpreted and applied two levels for Article 8 products as outlined below:

1. All Article 8 products which at the least promote E and S characteristics.
2. Article 8+ for products with a sustainability investments methodology at asset level and set a minimum threshold of assets to meet that methodology. Industry interpretation is that at least 50% should be applied if ESG/Sustainability is in the product name; this is yet to be confirmed by the European Securities and Markets Authority (ESMA).

Table 6: Article 8 Disclosure Summary

Pre-Contractual Documentation	Periodic Reporting	Website Disclosure
Specific text in the main body of the document covering sustainability risk, EUT, PAIs and a description of how ESG is a factor of the investment strategy. Inclusion of the completed formal pre-contractual disclosure template.	A short text summary in product annual accounts/report which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs). It should also include highlights of the SFDR approach and a prominent statement that there is the prescribed periodic report template in the annex.	Completion of the formal disclosure template on the website in the applicable languages.

Investor qualification

To help understand where a real estate product would sit within Article 8, an investment manager must first understand which environmental and social characteristics they believe should be promoted for real estate, then define and create metrics to measure the characteristics.

This would then be applied to a fund to understand if they are indeed promoting these environmental and social characteristics and can be classed as an Article 8 fund. Investment managers should ask themselves the following questions and answer these with respect to the real estate fund in question:

- What environmental and/or social characteristics are promoted by this financial product?
- What sustainability indicators are used to measure the attainment of each of the environmental or social characteristics promoted by this financial product?
- Is there a referenced benchmark that has been designated for the purpose of attaining the environmental or social characteristics promoted by the financial product?

The second part of qualifying the fund to an Article 8 is to decide whether to raise the ambition and, in addition to promoting E and S characteristics, also set a sustainability investments methodology at

asset level focused on sustainability outcomes. Investment managers should ask themselves the following questions and answer these with respect to the real estate fund in question:

- Is there appetite to create an additional investment restriction based on sustainability ambition and outcomes?
- What are the sustainable objectives of the sustainable investments the product partially intends to make?
- How do the sustainable investments that the financial product partially intends to make, not cause significant harm to any environmental or social sustainable investment objective?
- What percentage threshold should be set for the product that is ambitious but also achievable?

It should be noted that all disclosures provided in the pre-contractual template should be considered as binding and exhaustive and the disclosure of indicators, which are purely illustrative, is not appropriate. Regulators have also voiced concern over high-level language, for instance, listing a range of characteristics or sustainable objectives without demonstrating commitment. The regulators expect more detail than what many firms have provided so far.

4.3 Article 9: Full commitment to provide a sustainable outcome

Definition

On the far right of the spectrum, you have sustainability impact funds; the overarching purpose of these funds is to target a specific sustainability outcome and provide a solution to a sustainability issue alongside providing risk-adjusted financial returns. In this category, the real estate fund sets a sustainability objective at both fund and asset level, which means the fund level objective is noted in the fund prospectus and pre-contractual document and is of equal importance as the financial objective. The asset level sustainability objective feeds into and supports the fund level objective with all eligible assets meeting the criteria to be defined as a ‘sustainable investment’. This would be an example of an Article 9 fund.

Practical example

An example is a residential social impact fund which has been created to provide affordable housing where every asset must have at least 50% of units rented at a discount for key workers.

SFDR application

Article 9 products have sustainable investment as their core objective. It is an extension of an Article 8 product, where the real estate fund is additionally setting a sustainability objective at both fund and asset level. The asset level sustainability objective feeds in and supports the fund level objective and almost 100% of eligible assets should meet those objectives.

Table 7: Article 9 Disclosure Summary

Pre-Contractual Documentation	Periodic Reporting	Website Disclosure
Same as Article 8, however prescribed template is different.	Same as Article 8, however prescribed template is different.	Same as Article 8, however prescribed template is different.

Investor qualification

Investment managers should ask themselves the following questions and answer these with respect to the real estate fund in question:

- What sustainability outcome is this financial product targeting?
- Do all investments meet a robust sustainability objective and sustainable investments methodology?
- Do all investments not cause significant harm to enable them to meet the sustainable investment objective and what commitments are being made to ensure those intentions are met?
- How are the indicators for adverse impacts on sustainability factors considered?
- Are sustainable investments aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights?

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4.4 Key steps for product compliance

The table below summarises the section above into key steps to ensure compliance at SFDR product level:

Table 8: Key steps for ensuring product level compliance in accordance with the SFDR

	Article 6	Article 8	Article 9
Step 1: Determine what the sustainability ambition is of product and thus which level of article best describes that product.	ESG risks are well considered and integrated within the fund with no active promotion of E and S characteristics. This applies to all funds caught in the SFDR scope, including those which further prescribe as Article 8 and 9. All funds are required to describe their approach to sustainability risk integration in the prospectus.	All Article 8s need to ensure ESG risks are well considered and integrated within the fund and need to at least promote E and S characteristics. They can in addition set certain thresholds to further increase the sustainability ambition of the fund. The industry has therefore interpreted and applied two levels for Article 8 products as outlined below: 1. Article 8 where the fund promotes E and S characteristics which are reported on over time. 2. Article 8 + where the fund promotes E and S characteristics which are reported on over time. In addition, the fund also has a sustainability investments objective and methodology at asset level and has set a minimum % sustainable investments threshold. (Industry interpretation is that at least 50% should be applied if ESG/Sustainability is in the product	All Article 9s need to ensure ESG risks are well considered and integrated within the fund and promote E and S characteristics. They are also required to have a sustainability objective at fund level, and a sustainability investments objective and a methodology at asset level focused on achieving specific sustainability outcomes. The expectation is that 75-100% of eligible assets must be classed as sustainable.

	Article 6	Article 8	Article 9
		name but yet to be confirmed by ESMA.)	
Step 2: Update Pre-contractual document to align with requirements against the article selected	**Applicable:** The pre-contractual document sets out the ESG ambition for the fund and the specific approach that the manager has developed. For Article 6s, this is a short summary in text format which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs).	**Applicable:** The pre-contractual document sets out the ESG ambition for the fund and the specific approach that the manager has developed. For Article 8s, this includes specific text in the main body of the document which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs). This text also needs to make reference to and inclusion of the completed formal pre-contractual disclosure.	**Applicable:** The pre-contractual document sets out the ESG ambition for the fund and the specific approach that the manager has developed. For Article 9s, this includes specific text in the main body of the document which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs). This text also needs to make reference to and inclusion of the completed formal pre-contractual disclosure.
Step 3: Website Disclosures	n/a	**Applicable:** fund by fund	**Applicable:** fund by fund
Step 4: Periodic disclosures to be completed in the annual accounts/report	**Applicable:** The periodic disclosure must link back to the pre-contractual document to show the fund is reporting against what the pre-contractual document has set out. For Article 6 only funds, this includes a short text summary in product annual accounts/report which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs).	**Applicable:** The periodic disclosure must link back to the pre-contractual document to show the fund is reporting against what the pre-contractual document has set out. For Article 8 funds, this includes a short text summary in product annual accounts/report which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs). It should also include highlights of the SFDR approach and a prominent statement that there is the prescribed periodic report template in the annex.	**Applicable:** The periodic disclosure must link back to the pre-contractual document to show the fund is reporting against what the pre-contractual document has set out. For Article 9 funds, this includes a short text summary in product annual accounts/report which needs to include the prescribed EU taxonomy disclaimer as well as if and how the product considers Principal Adverse Impacts (PAIs). It should also include highlights of the SFDR approach and a prominent statement that there is the prescribed periodic report template in the annex.

5. Summary and Challenges

In summary, it is important to ensure that any real estate fund that falls into SFDR and discloses against Articles 6, 8 and 9 must have a clear outline of its sustainability ambition appropriate to the articles which apply. This should include:

- a clear explanation of what the sustainability criteria the fund intends to assess and target;
- an indication of how the fund is performing against that sustainability criteria with a robust data set and metrics as evidence; and
- assurance that criteria and performance metrics are not only robust in terms of auditability but also from a greenwashing perspective and that they are appropriate for the articles disclosed, standing up to external scrutiny.

SFDR has been welcomed by the industry and has made great progress in pushing forward transparency and accountability of sustainability in the investments industry. However, there are also many challenges, especially in the application of SFDR in a real estate context. The regulators have recognised these challenges and responded in providing various consultations to ensure the regulation can be adapted and evolved to help overcome those challenges.

The challenges experienced by AREF members during the process of complying with SFDR regulation for real estate funds are outlined below.

- **The regulation is equity focused and not asset class specific enough**
  - A lot of the regulation has been written with public markets in mind, so it can be difficult to apply the regulation in a real estate context.
  - One practical example is the application of the Do No Significant Harm criteria especially with regards to adherence of the investee company/or underlying real estate investment to OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.
- **Inflexible templates which can't always accommodate asset class characteristics**
- **Where asset class specific criteria have been developed, there are still difficulties in applying them.**
  - For example, parts of the Do No Significant Harm criteria where prescribed specifically for real estate are still hard to apply especially with regards to PAIs. One of the core PAIs is reliant on energy performance certificates which are not used outside of the UK and Europe and even within the UK and Europe have inconsistent ratings methodologies across countries.
- **Challenging for investors to compare SFDR funds**
  - SFDR allows great flexibility for investment managers to apply sustainability criteria. Whilst flexibility can be good, it does mean in this context that one investment manager's approach which puts their fund into Article 9, may be another investment manager's low Article 8 as they have higher expectations of what 'good' looks like.
  - Investment managers can choose different E and S characteristics and different definitions of a sustainable investment also making it difficult to compare funds.
- **Lack of recognition of transitioning real estate funds**

- A further key challenge / limitation of SFDR in relation to real estate is that 'improver' or 'transitioning' assets cannot (currently) be classified as Sustainable Investments which means that real estate funds dedicated to delivering a brown-to-green strategy are excluded from the Article 8+ and Article 9 universe. This is counter-intuitive given the current condition of the building stock and the disproportionate contribution (both positive and negative) real estate has when it comes to E and S outcomes.

- **Challenge in ensuring real estate funds keep pace alongside the evolution of sustainability ambition over time**
  - Article 8 and 9 funds are those funds that are pushing sustainability ambition faster and higher than (1) the market and (2) policy which may come at the expense of investment performance or may be complimentary. Over time, it is expected that the market will evolve and regulation will tighten, resulting in further evolution of these funds to ensure their sustainability performance and commitments are ahead of both market expectations and regulation. The challenge is to consistently interpret how to position these funds going forward.
- **Cost burden focused on investment managers**
  - To meet the SFDR regulation, it requires cross-coordination both internally and externally for investment managers and a large additional collection of granular ESG data. This cross-coordination includes risk teams, compliance teams, fund team, product teams, ESG teams, external auditors and external consultants. This large stakeholder requirement is beneficial to ensure responsibility and accountability is wider than previously where it has sat within the ESG team, however there is a cost burden to that which also comes along with the data requirements.
  - The cost largely sits with the investment manager but going forwards needs to be distributed more evenly to the appropriate stakeholders.
- **Reporting burden takes away time from delivering performance**
  - With increasing regulatory reporting requirements alongside voluntary requirements, a large amount of time and resource is required resulting in ESG teams spending more time reporting than they are spending on delivering improved performance.
- **Availability of data due to complexity of data sets required and lag time**
  - Data requirements can include tenant level data which is hard to collect at scale and can require tenant buy in.
  - There also tends to be a time lag between when ESG data is available and the timeframe it is required to be reported by.
- **Additional complexity of incorporating EU taxonomy principles into the SFDR legislation**
  - As explained earlier in the paper, various EU taxonomy principles are required to be included as part of complying with SFDR. One of the key challenges is the calculation of assets which are EU taxonomy alignment. The EU taxonomy criteria is currently very difficult to apply for real estate assets and especially at scale.

Glossary of Terms

Principal Adverse Impact (PAI): Negative, material or likely to be material effects on sustainability factors that are caused, compounded by or directly linked to investment decisions and advice performed by the legal entity. The EU has identified 64 adverse impact indicators that must be calculated, of which 18 will be mandatory to report at the entity level, and 46 will be voluntary. Funds can also commit to considering all or some of the PAI indicators in their investment process. They will focus on standard environmental, social and governance (ESG) factors that investors are used to following.

Sustainability indicators: measure how the environment or social characteristics promoted by the financial product are attained.

Sustainable investment: is an investment in an economic activity that contributes to an environment or social objective, provided that the investment does not significantly harm any environmental or social objectives and that the invest companies follow good governance practices.

European ESG Template: The European ESG Template (EET) is a standardised template that harmonises the way ESG-related data on financial products is exchanged and supports compliance with regulatory requirements.

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About the Association of Real Estate Funds (AREF)

AREF is the trade body that represents UK commercial real estate fund managers, those firms that support them and the end customers that invest in commercial real estate funds. Our membership includes over fifty funds spanning the leading commercial real estate fund management houses in the industry, through to smaller specialist boutiques, with a collective net asset value of over £50bn in the UK.

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