

ROADMAP TO REFORM European Commission Consultation on the Future of the SFDR

This alert discusses the Commission's most recent consultation on the EU Sustainable Finance Disclosure Regulation (SFDR), which:

- provides the market with a roadmap as to how the SFDR regime is likely to evolve;
- considers weaknesses in the current regulatory framework; and
- invites market views on some of the more controversial aspects of the regime.

Given the sweeping reforms that the Commission hints at in its consultation, this topic will be of interest to both EU firms and non-EU firms that have some touchpoint with the EU, whether that is through marketing funds under an NPPR regime, or using EU intermediaries to distribute financial products to end investors.



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Introduction

On 14 September 2023, the European Commission published a consultation on the future shape of the SFDR¹ (the Consultation). This Consultation provides the market with a helpful insight into the future direction of the regime following its rather bumpy implementation period, and outlines a range of amendments that we may see implemented in the future.

The Consultation itself is broad-ranging, with the Commission focusing in particular on:

- a) practical issues that firms have encountered in implementing the SFDR;
- b) how the new regime has been operating in practice; and
- c) whether a disconnect has formed between the SFDR and related pieces of regulation such as the EU Taxonomy.



Likely focus areas for the industry

The Consultation presents an opportunity for market participants to raise some of the frustrations that have emerged in attempting to comply with SFDR disclosure requirements. For example, the Consultation questions raise the issue of data quality and disclosure costs, the clarity of key concepts built into the regime, and the methodology applied to Principal Adverse Impact Disclosures (PAIs). Each of these has presented its own implementation challenges. For example:

- PAI disclosures have been perceived as a key source of regulatory risk, particularly where data relating to individual indicators is lacking or incomplete in some way.
- A perceived lack of clarity around key legal concepts has been an ongoing theme, partly as a result of the SFDR's unusual path to implementation, with the "Level 1" framework Regulation applying in advance of detailed "Level 2" implementing standards. Even following implementation of the Level 2

text, questions remain around fundamental concepts such as the definition of a "sustainable investment", the Do No Significant Harm standard and the treatment of derivatives within asset portfolios. These points are likely to be picked up by respondents to the Consultation.

On the other hand, the Consultation invites views on the efficiency and effectiveness of the SFDR in meeting its objectives. In considering the effectiveness of the new regime, the SFDR has unquestionably had a seismic impact on the European funds industry. For example:

- A recent ESMA research paper² indicates that the number of funds adding "ESG" words to their name peaked in 2021-2022 – this coincides with the period following implementation of the SFDR.
- SFDR-categorised Article 8 and 9 funds now form a significant portion of the market; according to Morningstar data, assets in these funds surpassed EUR 5 trillion for the first time by the end of Q2 of 2023.³
- According to the same data set, during the second quarter of 2023, Article 8 and Article 9 funds accounted for almost half of all fund launches in the EU, and the market share of Article 8 funds in particular was around 53% during this period when measured by AUM.⁴

This all goes to demonstrate that the SFDR has been phenomenally successful at driving product designation across the market, particularly bearing in mind that the regime that has only been in force since 2021. However, the fact that such a high proportion of the market is now classified as Article 8 does not provide a complete picture of how effective the regime has been in achieving its aim of redirecting investment towards sustainable growth to the extent originally envisaged.⁵

Incidentally, the extensive market share of Article 8 funds may also explain the Commission's willingness to explore whether a more nuanced set of categorisations within this bracket may be helpful to aid investor understanding.

¹. Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), available at https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en ². TRV Article - ESG names and claims in the EU fund industry (europa.eu) ³. <https://www.morningstar.co.uk/uk/news/227898/article-8-funds-shed-another-%E2%82%AC287bn.aspx#:~:text=Product%20development%20slowed%20down%20slightly,ones%20are%20reported%20to%20Morningstar> ⁴. <https://www.morningstar.co.uk/uk/news/227898/article-8-funds-shed-another-%E2%82%AC287bn.aspx#:~:text=Product%20development%20slowed%20down%20slightly,ones%20are%20reported%20to%20Morningstar> ⁵. I.e. in the European Green Deal and Sustainable Finance packages

SFDR: Labelling or Disclosure Regime?

During implementation of the SFDR, EU regulators were at pains to point out that the various classifications applying under Articles 6, 8 and 9⁶ were not intended to function as an opt-in “product labelling” regime, but rather should apply automatically based on the manner in which a product is marketed. In other words, where firms “promote” the ESG credentials of a fund or other in-scope product, whether by direct or indirect claims in marketing documents or other disclosures, the product will automatically be drawn within scope of Article 8 (or potentially even Article 9)⁷ on a mandatory basis. This contrasts with the categories proposed under the UK Sustainability Disclosure Requirements (SDR), which are intended to apply on an opt-in basis.

The Commission notes in its Consultation, however, that Articles 8 and 9 of the SFDR are being used as “*de facto* product labels”, leading to “persistent concerns that the current market use of the SFDR as a labelling scheme might lead to risks of greenwashing”. It is therefore considering whether to implement wholesale reforms to the Article 8/9 regime, as described below.

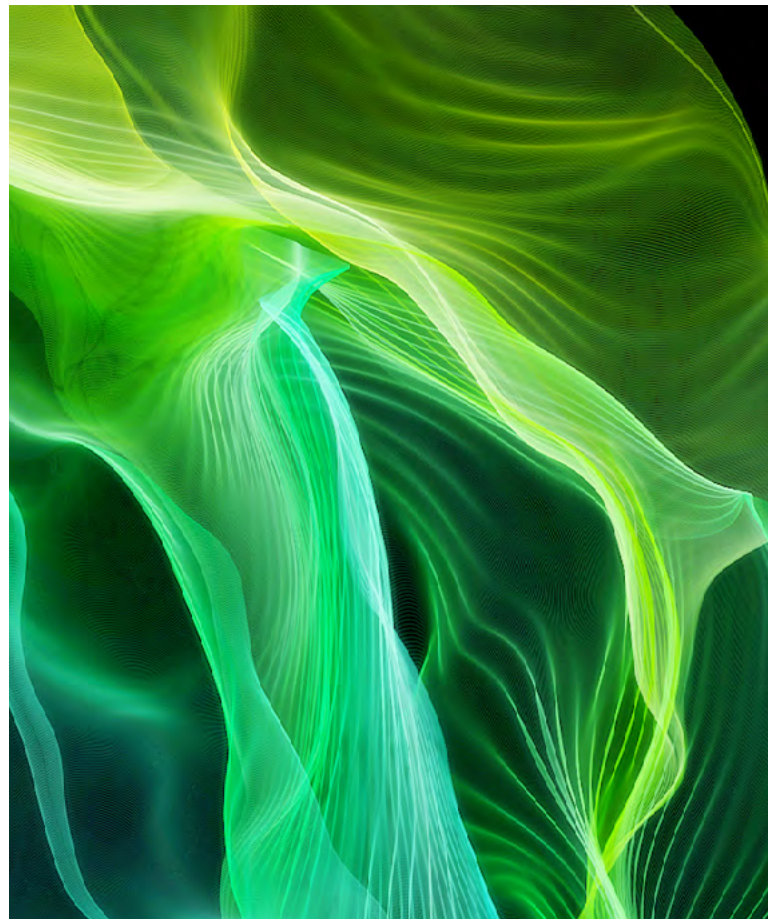


Likely focus areas for the industry

- Some in the market may feel that the line between treating the SFDR as a “labelling” regime and – conversely – as a disclosure regime which incorporates mandatory product designations, is rather more blurry than the Consultation might suggest.
- Certainly, there has been a desire on the part of investment managers and others to bring their products within scope of Articles 8 and 9, given current investor sentiment. However, for some funds marketed partly on the basis of their ESG credentials, the aftermath of the

SFDR’s initial implementation brought with it a mandatory Article 8 classification even where the manager in question may have initially been more comfortable with an Article 6 designation.

- The Commission is, nonetheless, justified in questioning whether – since such a significant portion of the market has now been designated as Article 8 – the regime requires some refinement in order to help investors cut through the noise.
- In any event, moving away from a mandatory Article 8/9 designation to a more optional product labelling regime seems unlikely to reverse the trend towards both domestic and non-EU managers seeking to align their funds with SFDR classifications at this stage.



⁶ Products which make no particular claims with respect to ESG characteristics or objectives (Article 6), products which promote environmental or social characteristics but do not have a specific sustainable investment objective (Article 8), and products which have a “sustainable” investment objective (Article 9) respectively. ⁷ See our summary of the European Commission’s guidance on Article 8 and 9 fund designations: https://insightplus.bakermckenzie.com/bm/banking-finance_1/esg-update-european-commission-sfdr-guidance

What exactly is the Commission proposing?

The Commission's proposals are laid out at only a high level in the Consultation, but comprise two key strategies for developing "a more precise product categorisation system":

- a) Option 1:** The first proposed strategy would involve retaining the existing Article 6 / 8 / 9 product categorisations, while building on and developing the distinction between Articles 8 and 9 in particular. This would involve: (i) refining the existing concepts embedded into each categorisation (such as environmental/social characteristics, sustainable investment or do no significant harm); and (ii) introducing additional minimum criteria applicable to products falling within the scope of each Article.
- b) Option 2:** The second proposed strategy would be to discard the distinction between current Articles 8 and 9 of the SFDR and instead introduce a new product categorisation system based on an entirely different approach. This could, for instance, be focused on the type of investment strategy pursued by a particular fund or product (promise of positive contribution to certain sustainability objectives, transition focus, etc.).

market innovation. For instance, the market is already coalescing around product sub-categories within the Article 8 category in particular, e.g. via differing levels of commitment to sustainable investments.

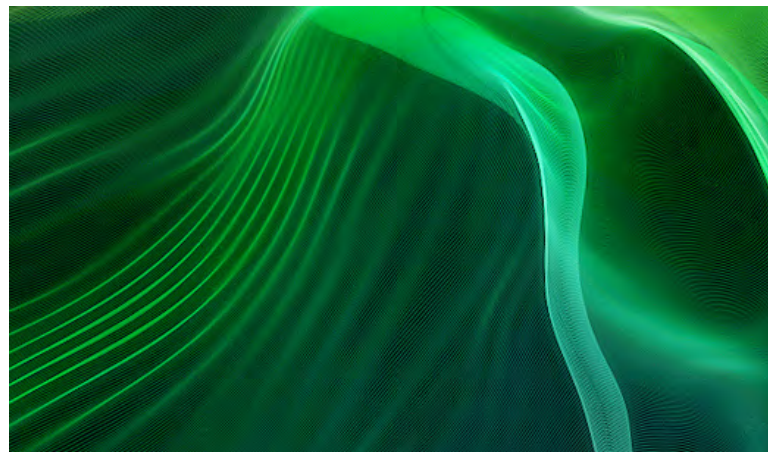
The advantage of Option 1 is that it would preserve a set of categorisations that the market is by now familiar with, and has spent a significant degree of time and resource on implementing. However, it is as yet unclear what "additional minimum criteria" the Commission may potentially impose on existing categorisations; at worst, a host of granular new requirements could lead to a further wave of downgrades like those we saw in the lead-up to implementation of the SFDR Delegated Regulation.

Option 2 might, on the other hand, create a more easily understandable set of product labels, particularly for retail investors, to whom "Article 8" and "Article 9" designations may have little meaning. It would also present an opportunity to better align the EU's product labelling regime with opt-in or mandatory regimes commonly applied in other regions such as Asia and the US. Nonetheless, given the efforts spent on implementation of the current iteration of the SFDR, the idea of entirely scrapping the current set of SFDR designations seems likely to be the less popular route.



Likely focus areas for the industry

This is a potentially significant departure from the manner in which the regime currently operates, and the Commission appears to be taking both options seriously. In some respects, the Commission's willingness to explore whether the SFDR should be fundamentally altered in this way sends a positive signal, but there is a question as to whether wholesale reforms so early on in the life of the Regulation could lead to regulatory fatigue and prematurely curb



A third potential option would be to retain the Article 8 and 9 designations in similar form, but to provide for:

- (i) An additional categorisation aimed specifically at transition funds. One issue with Article 8 is that it covers a range of products from “dark” to “light” green, and at present certain aspects of the SFDR Delegated Regulation are arguably not well suited to transitional strategies; or
- (ii) An additional set of opt-in labels, which could be of particular use in a retail funds context where investors are less likely to be familiar with the “Article 8” and “Article 9” designations, and where clearer / more descriptive terminology could be adopted along the lines of the FCA’s SDR.

Uniform disclosure requirements

In connection with its proposed changes to Articles 8 and 9, the Commission is consulting on whether the EU should “impose uniform disclosure requirements for all financial products offered in the EU, regardless of their sustainability-related claims”. What this effectively means is that even Article 6 funds would, going forward, need to make SFDR-compliant disclosures (albeit that the nature of these disclosures would presumably need to be tailored in some way).

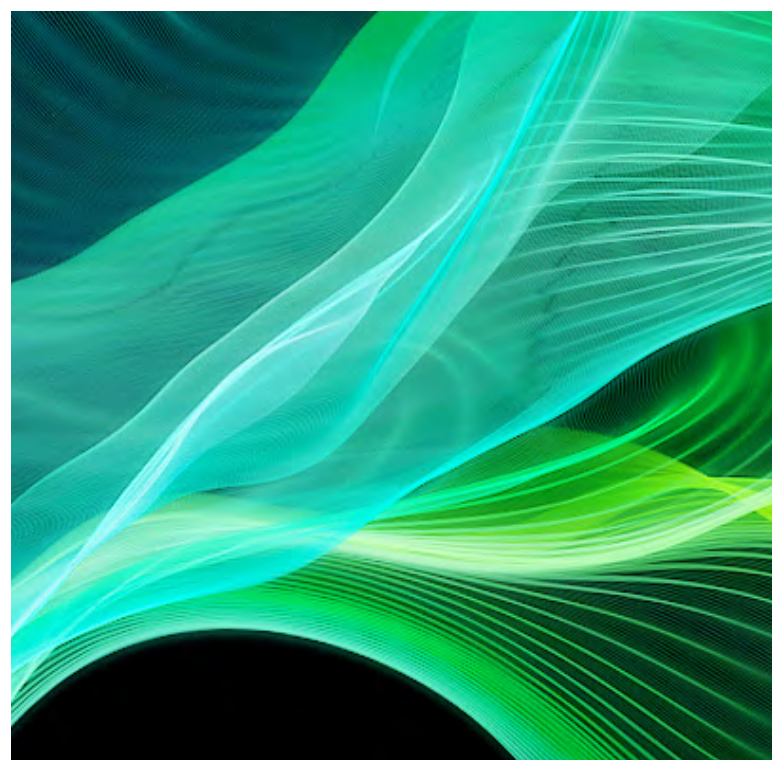


Likely focus areas for the industry

While the Commission has not put forward a detailed policy rationale for this proposal, there is an argument that requiring *all* in-scope products to disclose the proportion of their portfolio that is invested in, say, high-carbon assets, is information that would be helpful to investors looking to distinguish between different investment products or to consider how transition risk may play out over time.

Nonetheless, there is likely to be market pushback on this point, given that:

- A wider roll-out of ESG disclosures would almost certainly increase compliance costs across the industry, and these increased costs would in turn be passed on to investors in some form or another (likely through management fees).
- For products that make no sustainability claims whatsoever, there is also an argument that ESG-focused disclosures could be misleading, particularly to the extent that retail investors are presented with detailed materials on a fund’s sustainability profile. This contrasts with the current approach, which simply makes clear where a fund makes no particular sustainability claims.
- In addition, uniform disclosure requirements may ultimately make the EU a less attractive region to launch or market funds with no particular ESG focus, given that they would be subject to a higher disclosure burden than would be the case in other jurisdictions.



Will Entity-Level Disclosures Survive?

The Commission's Consultation addresses not only SFDR product-level disclosures, but also firm-wide / manager-level disclosures, referred to as "entity-level" disclosures. The Level 1 text of the SFDR makes clear that where in-scope firms "consider principal adverse impacts of investment decisions on sustainability factors", or where they have 500+ employees, they must publish "a statement on due diligence policies with respect to those impacts". In summary, this means publishing the manager's sustainability risk management policy, an indication of how its remuneration policy is consistent with its approach to sustainability risk, and an entity-wide annual PAI statement.

The Commission does not appear to be discarding the entire concept of entity-level disclosures, but is instead querying whether the SFDR is the correct legislative vehicle for imposing such requirements. For instance, the Commission notes that the Corporate Sustainability Reporting Directive (CSRD) already imposes a corporate transparency framework applying to EU-established and EU-listed entities (albeit that the CSRD currently only applies to certain EU regulated firms over a certain size). The Commission queries in particular whether entity-level disclosure requirements should in fact be streamlined across different pieces of EU legislation.



Likely focus areas for the industry

There are questions as to how meaningful entity-level PAI data is in practice, given that it is collated across varying investment strategies that may be applied to individual funds, for example.

Indeed, the entity-level disclosures we have seen published thus far diverge significantly, which makes comparisons challenging. Certain firms have chosen to publish a number of separate entity-level disclosures, while others have gone down the route of publishing a single, consolidated disclosure. In a similar vein, some firms have published disclosures covering all asset classes, whilst others have taken a more selective approach to which asset classes should be covered (e.g. in some cases, the manager has taken the view that no reliable data exists for certain categories of investment, and so has chosen to exclude them).

Nonetheless, it is questionable whether replacing SFDR-style disclosures with a broader application of the CSRD would achieve better levels of reporting and full comparability between entity-level reports. For instance, the application of value chain reporting under the CSRD is particularly unclear with respect to regulated firms such as asset managers.

One advantage of revising the entity-level disclosure framework, however, is that it may provide an opportunity to clarify the circumstances in which the disclosure rules are intended to apply to third country investment managers. This has long been a source of uncertainty for SFDR purposes, albeit that the market now appears to be converging toward a view that application of the disclosures has an extraterritorial impact (i.e. following certain Commission guidance on the point).



Changes to PAI Disclosures

The European Commission directs several questions toward the issue of principal adverse impact indicators or “PAIs”, which are routinely disclosed for Article 8 and 9 funds. PAI disclosures are designed to provide visibility around the extent to which investments within a portfolio could result in some negative effect on sustainability factors, including environmental, social and employee concerns, respect for human rights and anti-corruption. At present, PAIs are divided into 18 “core” indicators that should in theory be reported across all types of portfolio, and 46 “additional” opt-in indicators. The Commission is seeking views on the following points in particular:

- whether the current set of PAIs are appropriate for use in every case, or whether a materiality assessment should be applied (particularly with respect to entity-level disclosures);
- how the concept of PAIs should interact with the “do no significant harm” (DNSH) assessment; and
- how firms are currently filling in data gaps with estimates or modelling.



Likely focus areas for the industry

It seems clear that EU regulators are becoming increasingly concerned about the quality and useability of PAI disclosures. For example, the ESAs’ recent PAI⁸ report encouraged national competent authorities to consider enforcement action after the second annual review of PAI disclosures found that widespread misunderstanding of the regulation remained.

In addition, the ESAs published a detailed consultation touching on PAI disclosures earlier this year,⁹ which likewise focused on their interaction with the principle of DNSH.

This issue, which has also now been picked up by the Commission, may be summarised as follows:

- The DNSH standard aims to ensure that investments promoting sustainability in one area do not cause substantial negative impacts or “significant harm” elsewhere in the environment or society, and acts as a threshold to treating an asset as a “sustainable investment” for SFDR purposes.
- However, one issue that was not made clear in the original text of the SFDR Delegated Regulation was the point at which some undesirable impact of an investment (as assessed by reference to the PAIs) crosses the line into doing “significant harm”.
- It is this point that both the Commission and the ESAs appear to be exploring, with the ESAs previously suggesting either that: (i) managers should be required to set and publish quantitative thresholds related to PAI indicators to determine whether sustainable investments do “significant harm”; or (ii) firms should alternatively move towards reliance on the EU taxonomy screening criteria in applying the DNSH test.

While it may be some time before the Commission’s proposals work their way into a finalised set of reforms, the revisions to the PAI regime proposed by the ESAs could in theory be incorporated into the text of the SFDR Delegated Regulation within a shorter time period. These proposals include a number of new, socially-focused indicators alongside the DNSH point mentioned above, and regulated firms should therefore track their progress closely.

Interaction with Greenwashing and Fund Naming Rules

One central aim of the SFDR was to mitigate greenwashing by imposing a set of standardised disclosure standards on the market. The Commission is interested, however, in exploring whether the new disclosure framework has been successful in this regard. One point that the Consultation picks up in particular is the issue of misrepresentation risk, particularly as a result of marketing communications and product names. The Commission appears to be considering in particular whether to take forward mandatory fund naming rules and stricter requirements on the form and substance of marketing communications.



Likely focus areas for the industry

The Commission's targeted questions follow ESMA's recent progress report¹⁰ on greenwashing, which identified particularly high risk areas as being fund names and other ESG labels or certifications, impact claims and claims around ESG governance.

They also build on ESMA's November 2022 consultation on fund naming rules,¹¹ which proposed linking the ability to use certain fund names to the proportion of SFDR-defined "sustainable investments" within the fund's portfolio. These proposals were not well received by some in the market, given uncertainties around the definition of a "sustainable investment", and whether it applies appropriately to certain types of asset portfolio or geographic focus.

The Commission's new Consultation therefore presents an opportunity to come up with a fresh approach to fund naming. In the year following ESMA's initial consultation on fund names, the market appears to have become more comfortable with making express

commitments to sustainable investment thresholds. For example, according to Morningstar data, half of all Article 8 funds now target a sustainable investment allocation of at least 10%. However, the majority of percentage allocations still err on the lower side (i.e. around 17% of Article 8 funds currently target up to 10% exposure, with a further 13-14% targeting between 20% and 20.9%). As such, ESMA's original proposal – which would have required a sustainable investment allocation of 40% for funds with "sustainable" in their name – may still be too much of a step up for the market as yet.

Regardless, the issue of how and when regulators should intervene in fund naming conventions is unlikely to drop off the EU's list of legislative priorities any time soon; for example, ESMA's own research has demonstrated that demand for funds with ESG-related words in their name has consistently exceeded demand for other funds (a result which holds true even when controlling for asset class and geographical focus).¹² The potential for greenwashing and investor misinformation in this regard is clear, and in-scope firms should expect specific rulemaking on this point in the near to medium term.

Client Sustainability Preferences

When EU firms provide investment advice or portfolio management services, they will generally be required to undertake a "suitability" check on their prospective client. This involves obtaining information on the client's knowledge and experience, financial situation and investment objectives. Based on this information, the firm will assess which products and services are suitable for its client.

Following recent reforms to the MiFID II and IDD frameworks, suitability assessments must also now incorporate a consideration of the client's "sustainability preferences".

¹⁰. <https://www.esma.europa.eu/press-news/esma-news/esas-put-forward-common-understanding-greenwashing-and-warn-risks> ¹¹. <https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related> ¹². https://www.esma.europa.eu/sites/default/files/2023-10/ESMA50-524821-2931_ESG_names_and_claims_in_the_EU_fund_industry.pdf

In other words, EU product distributors are now required to disclose information on the sustainability characteristics of those products, and to explain how the client's sustainability preferences have been taken into account. There is a detailed and specific definition of the end investor's sustainability "preferences" for these purposes, which refers to their preferences around taxonomy alignment, commitment to investing in sustainable investments, and consideration of principal adverse impacts. The European Commission is asking in particular whether these data points are "sufficiently useful and comparable" to allow distributors to make an effective determination of whether a product fits with an end investor's sustainability preferences.



Likely focus areas for the industry

In general, any change to suitability assessments will have far-reaching implications that touch not only EU products but also non-EU products that are distributed through EU intermediaries.

Nonetheless, given that the sustainability profile of products like investment funds and unit-linked life insurance policies is increasingly of interest to investors across the market, incorporating these considerations into investor due diligence seems reasonable.

The question of whether these factors have been effectively dealt with under the current regime is, however, debateable. In particular, requesting the average retail investor's views

on issues such as taxonomy alignment, commitment to sustainable investments (as defined within the SFDR) and consideration of PAIs seems unlikely to be fruitful. Even professional investors find these concepts challenging to pin down.

The Commission's Consultation therefore provides an opportunity to rationalise the current suitability requirements and tailor them more effectively to the retail market in particular, potentially in parallel with a set of new set of opt-in, retail-friendly product labels.

Conclusion

The Commission has requested feedback on the Consultation by 15 December 2023, and there is then likely to be a fairly lengthy lead-in time before we see any concrete regulatory proposals. Certain of the proposals under consideration are so fundamental that they would, for example, require reopening the Level 1 text of the SFDR for negotiation between the European Parliament and Council of the EU. Nonetheless, we have observed previously that EU regulators are ready and willing to push through ESG-related reforms within a relatively short timeframe where they consider this to be necessary. Firms should therefore track the evolving proposals closely and ensure that they avoid any cliff-edge effects similar to downgrade activity occurring in the wake of implementation of the SFDR Delegated Regulation.

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