SFDR Consultation: Paving the way to formalise EU fund labeling?*

***An unnecessary overhaul, or much needed reform?**

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In a targeted consultation, the EU Commission has proposed overhauling product categories established under SFDR. Regulators will consider establishing "precise criteria" and formal product categories for Article 8 "light green" and Article 9 "dark green" funds to mitigate greenwashing. The changes are being made after a wave of funds were downgraded from Article 9 to Article 8 status, while Article 6 funds upgraded to Article 8 status.

Market participants have raised concerns about the disclosure regime which defines Article 8 funds quite broadly, not prescribing any thresholds while providing little flexibility in the interpretation of Article 9 requirements. The Commission has proposed, as an alternative, completely revising the EU's categorization system and examining the relevance of concepts embedded within the SFDR framework.

On September 14, 2023, the European Commission (Commission) released a public consultation and targeted consultation on the EU Sustainable Finance Disclosures Regulation (SFDR). Here are the key points:

1. Investigating SFDR Implementation Issues:

- The Commission is examining how the SFDR has been functioning and identifying challenges faced by stakeholders in its implementation.
- Areas of focus include the efficiency of SFDR in meeting objectives, methodology of adverse impact indicators, disclosure costs, data quality, and legal concepts clarity.

2. Potential Product Categorization System:

- The Commission is considering a new product categorization system due to SFDR being used as a labeling regime.
- Questions revolve around the advantages, workings, usefulness, and governance of such a system, suggesting two potential pathways: building on existing concepts or developing new approaches.

3. Entity-Level Disclosures Under Scrutiny:

- The Commission is questioning the inclusion of entity-level disclosures in SFDR, considering whether these should be streamlined across different EU legislations.
- Challenges include difficulties in meaningful comparisons between different entities' disclosures and concerns about the specificity of the information provided.

4. Uniform Product-Level Disclosures:

- The Commission is seeking feedback on whether uniform disclosure requirements should apply to all financial products in the EU, irrespective of their sustainability claims.
- The focus is on determining useful and necessary transparency requirements, including Taxonomy-related disclosures and engagement strategies.

5. Addressing Greenwashing:

- The Commission is evaluating marketing communications and product names to mitigate the risks of misleading investors, indicating a potential need for naming and marketing rules.
- Article 13 of the SFDR empowers European Supervisory Authorities to develop standards on marketing communications' presentation.

The benefits and drawbacks of proposed reforms are summarised below:

Pros

Clearer criteria for Article 8 and Article 9, such as thresholds, would streamline the disclosure process and help differentiate between fund-level strategies (exclusions, normative screening) within these categories.

Refining Article 8 and Article 9 definitions to align with market practices ensures that this reflects real-world sustainability efforts. This would address the issue of mislabeling and incentivize market participants to transparently disclose and communicate sustainability information.

The newly proposed disclosure requirements would require sustainability information from Article 6 funds (those not integrating sustainability into their investment approaches) which may be a means for investors to accurately identify the most unsustainable assets across European markets.

Under the new SFDR category proposals, the regulation would align with the UK Financial Conduct Authority (FCA) by introducing new types of investment categories, including those with quantifiable targets, measurable sustainable solutions and thematic investments.

These proposed changes reflect the complexities and burdens of implementing the general principles of the SFDR framework. A more robust categorization system will help investors who are looking to accurately identify sustainable finance products to effectively channel capital towards sustainable activities.

Cons

Overhauling the fund classification system may be complex and time-consuming. Asset managers and financial institutions will need to adapt to the new criteria, which could result in transitional challenges and additional regulatory uncertainty.

The introduction of new categories may lead to fragmentation, especially if national fund labeling regimes reference SFDR.

Asset managers and financial institutions may face increased compliance costs associated with adjusting their products to fit the new categories and meeting additional reporting requirements. These costs could impact investment returns or impact the profitability of sustainable products.

The regulation cracks down on greenwashing as one of SFDR's unintended consequences was to become a fund labeling regime, rather than a purely transparency-focused instrument. As the structure of the framework undergoes changes to prevent greenwashing, asset managers may become overly conservative in their sustainability claims to avoid misclassification, which could stifle innovation and limit the availability of sustainable investment products.

The success of the new categorization system relies on the availability and quality of sustainability data. Ensuring that accurate and comprehensive data is readily accessible can be a significant challenge, particularly for smaller asset managers.

The burden of additional disclosures may disproportionately affect products that make sustainability claims, potentially creating an uneven playing field. This could counteract the original goal of attracting private investment to support the transition to a sustainable economy.

Conclusion

The consultation period is open until December 15, 2023.

Investment managers, particularly those impacted by SFDR, should engage with the consultation, as potential changes, including a new labeling regime, are under consideration. However, any significant alterations would take time before implementation, providing managers with a window to adapt their practices.

	EU – SFDR	UK – SDR	US – SEC	India – SEBI
Product ***categories***	***No but distinction between Article 6, 8 &9 funds based on Principle Adverse Impact indicators (PAIs), Sustainable investments and EU Taxonomy-alignment (current state-of-play)***	***Proposed categories include: (a)Not promoted as sustainable; (b) Responsible; (c) Sustainable-Transitioning; (d) Sustainable; Aligned; (e) Sustainable-Impact***	***Three disclosure categories specified: (a) ESG Integration Fund; (b) ESG-Focused Fund; (c) Impact Fund***	***Proposed categories of mutual fund schemes: (a) ESG exclusion; (b) ESG integration scheme; (c)ESG best-in-class & positive screening scheme; (d) ESG impact investing scheme; (f) ESG sustainable objective scheme***
Category name equivalence	Category C - Products that exclude activities and/or investee companies involved in activities with adverse impacts This aligns with the existing Article 6 category requirements	No sustainable label	ESG Integration Fund	ESG Exclusions
	Category B - Products follow recognised sustainability standards or themes Category D - Products with a transition focus This aligns with the existing Article 8 category requirements	Sustainable Focus Sustainable Improvers	ESG-Focused	ESG Integration ESG Sustainable Objectives Scheme ESG Best-in-class & positive screening
	Category A - Product focus on investments that provide measurable sustainability solutions This aligns with the existing Article 9 category requirements	Sustainable Impact	Impact Funds	ESG Impact Investing Scheme ESG Best-in-class & positive screening

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