Impact of SFDR on U.S. Fund Managers

8 May 2024

The Sustainable Finance Disclosure Regulation[1] (the "SFDR") has been in place since 10 March 2021. It is primarily directed at fund managers and financial advisers based in the EU but also applies to non-EU, including US, fund managers marketing their funds to investors in the EU under national private placement regimes.

The SFDR sets out categories for funds and template disclosures and reports, depending on the level of sustainability-related ambitions of the fund sponsor. All funds must describe, under Article 6, in general terms how they integrate sustainability risks into investment decisions, whilst funds that disclose under either Articles 8 or 9 must: (i) show an ambition to promote specific environmental and/or social characteristics (Article 8) or (ii) have a sustainable investment objective (Article 9).

Articles 8 and 9 of the SFDR—What Do They Mean?

Article 8 of the SFDR. Article 8 applies if a fund promotes specific environmental and/or social characteristics, leaving open the type of "promotion" required, and the degree to which, in promoting environmental and/or social characteristics, the fund should qualify its investment policy. A fund under Article 8 also needs to assess and promote "good governance" in relation to its investments. Even though it was not the intention of the legislator, Article 8 of SFDR is now understood by many investors as a "label," raising important questions as to whether minimum criteria are required for a sponsor to engage with Article 8 of SFDR. The market has generally settled on the view of the European Commission (the "Commission") that, in principle, there are no minimum requirements for a fund to meet under Article 8, with the exception of the good governance principle (although clarifying that this is also subject to determination by the fund sponsor), and the Commission has provided non-exhaustive examples of the term "promotion" to include direct or indirect claims, information, reporting, disclosures and impression that the fund's investments also consider environmental and social characteristics. In principle, an ESG "tilt"—in which the sponsor commits to

[1] Regulation (EU) 2019/2088.

pursue particular environmental or social characteristics, such as climate change mitigation, across the portfolio, but without selecting investments for particular environmental or social characteristics—or even an ESG-related exclusion screen is sufficient. That said, from an investor perspective, and in light of ongoing green-washing risk, funds are well advised that the promoted characteristics should be credible, reportable and measurable.

Reflecting the flexibility of the concept, it is fair to say that a large portion of private equity funds offered to EU investors have categorized themselves under Article 8. Credit funds and funds of funds, which have fewer opportunities to promote environmental or social characteristics by engagement and by reference to their terms of investment, have also increasingly opted to make disclosures under Article 8 of the SFDR. US-managed funds that make direct or indirect environmental or social claims that raise funds in the EU should always consider the suitability and implications of the Article 8 categorization.

Article 9 of the SFDR. Funds making disclosures under Article 9 must exclusively make "sustainable investments" (as defined in the SFDR), with the only permitted exception being investments for hedging or liquidity purposes. This is a high threshold and few US fund sponsors have gone that path.

Sustainable investments are investments in economic activities that:

i. contribute to an environmental objective and are measured by key resource efficiency indicators that track, *inter alia*, energy usage, renewable energy, greenhouse gas (GHG) emissions, waste generation; or

ii. assess an investment's impact on biodiversity and the circular economy; or

iii. contribute to a social objective, specifically, tackling inequality or fostering social cohesion, integration and labor relations, investments in human capital or economically or socially disadvantaged communities.

The investment must also ensure that it does not significantly harm ("DNSH") any of the objectives listed above and must ensure that investee companies follow good governance practices, particularly by reference to sound management structures, employee relations, remuneration of staff and tax compliance. A fund manager must perform the DNSH and good governance assessments at the time of investment and on an ongoing basis.

The sustainable investment concept is designed for funds that make investments that, in each case, contribute to specific and measurable environmental or social objectives.

The Commission has confirmed that, as the SFDR does not prescribe any minimum requirements for sustainable investments, the sponsor itself should define the key parameters, namely the contribution test, DNSH and good governance. US sponsors that are active in investing for environmental purposes—such as in renewable energy—or for clearly defined social objectives—such as social housing, or in the developing world—will likely be able to adapt their existing due diligence and monitoring processes to determine that each such investment meets the definition of sustainable investment.

What Is Next?

Delegated regulation under SFDR. The regulatory technical standards ("RTS") are meant to provide further guidance and templates to be used for purposes of disclosure and reporting under the SFDR, as well as the list of "principal adverse impact" ("PAI") indicators. In December 2023, the European Supervisory Authorities proposed amendments to the RTS, with the key changes being: (i) new mandatory and opt-in (voluntary) social PAIs; (ii) changes to the overall PAI reporting framework, such as reporting on the use of estimates; (iii) changes to the way in which fund managers report on the outcome of the DNSH test; (iv) a new set of disclosures for funds with greenhouse gas ("GHG") emission reduction targets; and (v) simplifications and new lay-out for the disclosure and reporting templates.

We expect the EU to publish the revised RTS in Q2 of 2024 and to apply them by January 2026.

SFDR 2.0. Meanwhile, in a separate exercise, the Commission conducted in September 2023 a consultation on a more general revision of the SFDR. This in part arises from the SFDR having become a labelling regime and the proliferation of national labels for ESG or sustainable products. In particular, the Commission suggests a new categorization system for sustainable products based on four sustainable investment strategy categories, including "products aiming to meet credible sustainability standards" and "products with a transition focus." Any such system could be directed at retail and/or professional investors. The criteria for such categories may be based on matters such as degree of Taxonomy alignment, engagement strategies, exclusions or pre-defined and measurable environmental or social outcomes, such as minimum year-on-year improvement of chosen KPIs. The Commission may be influenced in this respect by the UK FCA's forthcoming sustainability disclosure regime, which includes specific criteria for funds to adopt various ESG labels, although that is purely for retail funds. The Commission's work is ongoing and it is unlikely that such new regime will come into force before 2026.

ESMA Guidelines on ESG and sustainability-related terms in fund names. On a related note, ESMA published an update on its consultation regarding the use of ESG and sustainability-related terms in fund names. Where funds use certain restricted terms in their fund names, these funds must meet minimum requirements, ensuring that a certain portion of their investments meet the disclosure requirements set forth under Article 8 or Article 9 of the SFDR, i.e., promoting environmental and/or social characteristics or having sustainable investment objectives.

The scope and applicability of the guidelines to non-EU fund managers are somewhat unclear, pending publication of the final guidelines. We expect the guidelines to apply to US sponsors to the same extent as SFDR, so US sponsors intending to market in the EU should have regard to the guidelines, if the fund uses ESG or sustainability-related terms in its name. We expect ESMA to publish the full guidelines near the end of Q2 of 2024.

The Bigger Picture: The EU's Green Deal

Taxonomy Regulation. The Taxonomy Regulation,[2] the EU's detailed classification system of environmentally sustainable activities, is a significant piece of work, which the EU intends will have a long-lasting impact on investment into environmentally sustainable companies and projects in the EU. It is now mandatory for EU-listed companies to report under the Taxonomy, and the scope of reporting will considerably widen over the next few years as large EU unlisted companies are required to report. Despite the technical detail, there have been numerous uncertainties under the Taxonomy Regulation, as companies consider, for instance, the position of non-EU activities, and the scope of the separate "minimum safeguards" test, which requires companies separately to consider human rights issues when performing due diligence.

Sponsors that commit to make sustainable investments under SFDR will need to consider the relevance of the Taxonomy Regulation. To date, sponsors that adopt a broad impact investing strategy have shown limited engagement with the Taxonomy, whilst investors in types of renewable energy or infrastructure have generally committed to at least a small proportion of their portfolio as Taxonomy aligned. In that regard, it is worth bearing in mind that the Commission has stated that, when funds publish their annual periodic disclosures, any fund that has promoted environmental characteristics, regardless of any prior commitment to make Taxonomy-aligned investments, must report on the Taxonomy alignment of their portfolio, to the extent the fund can obtain reliable data. This underlines the importance of data on Taxonomy alignment to investors and the EU economy but leaves open the question as to the

[2] Regulation (EU) 2020/852.

sources of reliable data—most sponsors treat this as primarily information on Taxonomy alignment published by a company under the Corporate Sustainability Reporting Directive ("CSRD").

The EU has not progressed the separate Social Taxonomy since its Final Report of February 2022, and it is unclear whether it will restart the project. It may be that the EU feels that companies are thoroughly engaged with social impacts through the separate CSRD and the forthcoming Corporate Sustainability Due Diligence Directive. Equally, the EU may well accept that it is very challenging (and political) to define strict classifications in areas such as trade union representation and social housing, given the differences in approaches in member states.

CSRD. The EU has expended a great deal of resources on the CSRD, its ambitious framework for corporate sustainability reporting by EU-listed and large private companies, which has been in force since 5 January 2023. Under CSRD, large EU-listed companies must prepare reports for reporting periods starting on or after 1 January 2024, and large private companies come into scope for reporting periods starting on or after 1 January 2025.[3] The EU completed in 2023 the detailed set of European Sustainability Reporting Standards. Notably, funds are exempt from the scope of CSRD—placing investors in the reporting framework as recipients of the information provided by their investee companies. The volume, quality and consistency of information reported under CSRD will increase over the years, greatly reducing the amount of ad hoc and voluntary ESG reporting provided by companies, and greatly increasing the availability of ESG data available for investors. The external "assurance" required for the data under CSRD will also increase the reliability of the information reported.

Outlook and Challenge for US Sponsors

US sponsors have a particular challenge in potentially being subject to multiple, often conflicting regulations related to ESG, including at the US state level. For example, a number of states, including Texas, Florida, Oklahoma and West Virginia, have passed so-called "anti-ESG" laws. Some or these laws may prohibit state pension funds from

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[3] **Large undertakings**: Exceeding two out of three criteria: *(i) 250 employees; (ii) €50 million net turnover (revenue); (iii) €25 million balance sheet total.*
Medium-sized undertakings: Not exceeding two out of three criteria: *(i) 250 employees; (ii) €50 million net turnover (revenue); (iii) €25 million balance sheet total.*
Small undertakings: Not exceeding two out of three criteria: *(i) 50 employees; (ii) €10 million net turnover (revenue); (iii) €5 million balance sheet total.*
Non-EU parent company: Meets both criteria: *(i) €150 million net turnover (revenue generated in the EU) and (ii) €40 million net turnover (revenue) or in-scope EU subsidiary.*

investing with firms that "boycott" the oil and gas, coal or firearms industries. The common practice among sponsors of maintaining an exclusion list, which could prohibit fund investments into fossil fuels or firearms companies, for example, and are often favored by European investors, could run afoul of such anti-boycott laws, creating a tension for sponsors in balancing the conflicting requirements of investors. These apparent conflicts often can be addressed by a careful reading of the laws themselves, many of which have carve-outs that could be applicable in certain circumstances, or through inclusion of excuse rights in side letter agreements. Nevertheless, these issues need to be considered carefully when defining the sustainability characteristics for a fund intending to disclose under Article 8 or 9 if the fund also markets to US state investors.

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