ESAs Urge Commission to Introduce Product Classification Regime under SFDR

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The European Supervisory Authorities[1] (the "ESAs") recently published an opinion (the "Opinion") on the European Commission's (the "Commission") review of the Sustainable Finance Disclosure Regulation (the "SFDR").[2] The Opinion is expected to carry significant influence on the Commission's final approach to the SFDR review. For more information on the SFDR review, please refer to our update here.

The Opinion largely addresses issues faced by retail investors on the implementation of the SFDR, with limited reference to the position of private funds offered to professional investors. However, any change in the regime which is directed at retail investors is expected to apply to funds established for professional investors.

The key recommendations made by the ESAs under the SFDR review are:

- introducing a new product classification system, consisting of "sustainable" and "transition" products;
- introducing a new sustainability indicator for ESG-related funds to illustrate the overall sustainability features of the product;
- revising the definition of "sustainable investments";
- revising the documentation for pre-contractual disclosures; and
- making the consideration of principal adverse impacts ("PAIs") on sustainability factors mandatory for certain ESG-linked funds.

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1 Comprising the European Securities and Markets Authority ("ESMA"), the European Banking Authority and the European Insurance and Occupational Pensions Authority.

2 Regulation (EU) 2019/2088.

Introduction of a Product Classification System

The ESAs acknowledge that financial market participants and investors use Articles 8 and 9 of the SFDR, originally established as disclosure requirements for products that: (i) promote environmental and/or social characteristics (Article 8); or (ii) make sustainable investments as their objective (Article 9), as *de facto* sustainability labels. The ESAs support the introduction of more concrete categories, proposing the product categories "sustainable" and "transition", based on the following criteria:

- ***Sustainable*** for products (including funds) that invest in economic activities or assets that are already environmentally and/or socially sustainable and that meet a minimum "sustainability threshold". This includes existing products with a "high proportion" of sustainable investments, so the criteria is based on the existing category of Article 8 or Article 9 funds that make sustainable investments. For environmentally sustainable products, the threshold may be based on investment in a minimum proportion of assets aligned with the EU's Taxonomy Regulation (the "EU Taxonomy"), with the investments that are not EU Taxonomy-aligned at least respecting the existing "do no significant harm" ("DNSH") principle and good governance requirements, provided those concepts are more precisely defined than they are currently. There is a clear parallel between this category and the UK Financial Conduct Authority's "Sustainability focus" label.

- ***Transition*** for products (including funds) that invest in economic activities or assets that are not yet sustainable, but which improve their sustainability over time. The investment strategy for this product could be based on a combination of EU Taxonomy KPIs to show improvement of environmental performance, transition plans, decarbonisation trajectories and mitigation of PAIs (with a minimum level of mitigation specified in the revised SFDR), as well as appropriate exclusions and criteria for a credible transition plan. The ESAs foresee that an "ambitious but realistic" share of the product's investments will be transition investments. The requirement for measurable transition plans means that the DNSH principle would not apply to the investments. There is a parallel between this category and the FCA's "Sustainability improvers" label, although the EU standard will promote the use of the EU Taxonomy and PAIs.

  The ESAs suggest that there could be an "impact" sub-category under the "transition" label for funds that invest in assets that offer solutions to sustainability-related problems that offer a positive measurable impact on an environmental or social objective. There is a parallel between this category and the FCA's "Sustainability impact" label.

- ***Non-Sustainable or Non-Transitional Products***. The ESAs state that products (including funds) that are not categorised as sustainable or transitional products may or may not have other sustainability features. Products that have sustainability features but do not qualify for these categories—in practice, many existing Article 8 funds—will be required to disclose their sustainability features and, importantly, will be subject to restrictions on using "ESG or sustainability-related" terms in their names or marketing materials. The type of disclosure which the ESAs have in mind is not clear, and the extent of the restriction on funds using ESG terms in their marketing materials is unclear, particularly on existing funds. Funds that do not have any sustainability features should be required to include a disclaimer.

  The ESAs expect the current disclosure under Article 6 of the SFDR on the integration of sustainability risks in investment decisions not to change.

Sustainability Indicators

As a separate proposal, the ESAs put forward the inclusion of a standard sustainability indicator for all products that are labelled environmentally and/or socially sustainable. The ESAs make suggestions as to the form of this indicator, such as it being based on the fund's financed emissions and contribution to climate change mitigation, or on "transition and transformational investments where the expected impact on the environment or society is significant", using, for instance, a decarbonisation target or expected social improvement, or other criteria linked to the EU Taxonomy. In addition, a grading scale in the disclosure could refer to letters or colours, where the "most harmful" financial products are red, and where green signals environmentally sustainable products and blue signals socially sustainable products.

The ESAs admit that a single sustainability indicator will be challenging, as it will require aggregating various topics and criteria which may not be comparable. It is also open as to how the sustainability indicator will relate to the product categories described above, with one possibility being that a product may qualify for one of the categories whilst also having a grade in a sustainability indicator. The suggestion for simple standardised sustainability indicators is a significant change to fund sponsors' current flexibility as to how they measure achievement of a fund's promotion of environmental and/or social characteristics and sustainability goals.

“Sustainable Investments” Definition

The ESAs acknowledge the success of the SFDR in creating a sustainable finance framework, but consider that the definition of “sustainable investments” in the SFDR provides too much flexibility. The ESAs also state that consumers find the distinction between EU Taxonomy-aligned and sustainable investments unclear, and therefore recommend a more prescriptive definition of sustainable investments. The ESAs’ recommendations appear to suggest a closer alignment between environmentally sustainable investments under the general SFDR definition and environmentally sustainable investments in the EU Taxonomy. The ESAs also refer to the future development of a social taxonomy, which the European Union has not progressed in recent years.

Changes to Product Disclosures

To address problems of complexity in the pre-contractual disclosures, the ESAs suggest what they consider as more “simplified” or less detailed forms of SFDR disclosures for retail investors (in the form of a Key Information Document), with more complex information included in prospectuses and websites.

Consideration of PAIs

The ESAs consider that further certainty is needed on the meaning of “considering PAIs” for products and firms, in particular whether consideration necessarily requires mitigation and whether there is any time horizon or year-on-year improvement required. In this regard, the ESAs state that whilst “consideration” captures disclosure and mitigation of PAIs, there is merit in funds separately producing “information” on PAIs, which would not include a requirement to mitigate PAIs but still provide useful information on the possible negative consequences of the investments. The ESAs state that “consideration” of PAIs could be mandatory for funds qualifying for the new sustainable product category described above, whilst “information” on PAIs could be mandatory for the transition category.

Other Issues

In a section titled “Other technical issues”, the ESAs raise some helpful observations on other changes to be addressed by the Commission, including relating to: (i) PAI disclosure of unit-linked products at entity level; (ii) overlaps of disclosures under SFDR with reporting under the EU's Corporate Sustainability Reporting Directive (the "CSRD"), particularly under the future CSRD financial sector reporting standards; (iii) requirements for naming and marketing of financial products, (iv) whether SFDR information should be audited and the role of funds' depositaries in checking SFDR disclosures; (v) frequency of the assessment of the PAI disclosures; (vi) SFDR-related information flow to competent authorities; (vii) greater harmonisation of SFDR website disclosure; and (viii) location of financial adviser disclosures.

Conclusion

The ESA's opinion greatly strengthens the case for a more prescriptive disclosure regime. Although much of the private fund industry has supported the move to a stricter labelling regime, fund sponsors which currently promote a broad range of environmental and social characteristics under the general Article 8 category and use ESG terms in the marketing of products will likely be subject to stricter conditions.

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Please do not hesitate to contact us with any questions.

Patricia Volhard
Partner, London, Frankfurt, Paris
+44 20 7786 5505
+49 69 2097 5150
pvolhard@debevoise.com

Jin-Hyuk Jang
International Counsel, Frankfurt
+49 69 2097 5115
jhjang@debevoise.com

John Young
International Counsel, London
+44 20 7786 5459
jyoung@debevoise.com

Harry Just
Associate, Frankfurt
+49 69 2097 5262
hjust@debevoise.com

Eike Björn Weidner
Associate, Frankfurt
+49 69 2097 5220
ebweidner@debevoise.com

Keith Moshe
Corporate Staff Attorney, Frankfurt
+49 69 2097 5123
kmoshe@debevoise.com