

ESMA Opinion on SFDR

30 August 2024

The European Securities and Markets Authority (“ESMA”) has recently published an opinion on the future shape of the European Union’s Sustainable Finance Disclosure Regulation (the “SFDR”), building on the opinion published jointly by the European Supervisory Authorities (the “ESAs”) in June 2024 (see our Debevoise In Depth [here](#)). The view presented by ESMA is not binding, nor does it impact current rules, but it is of interest as it may have a considerable influence on the EU Commission’s final approach to the review of SFDR.

EU Taxonomy Regulation and Sustainable Investments. The SFDR contains a definition of “sustainable investments”, investments that contribute to a specific and measurable environmental or social objective on the condition that they do no significant harm to any other environmental or social objective, and the investee company follows good governance practices. Firms set their own parameters for “contribution” and “do no significant harm” under the SFDR’s sustainable investment definition. On the contrary, the EU Taxonomy Regulation (the “EU Taxonomy”) provides detailed and science-based technical screening criteria for activities which can be classified as environmentally sustainable. Any fund that invests for environmental or social impact, either broadly or in specific fields such as renewable energy or social housing, must engage with the sustainable investment definition, and, to the extent relevant to its strategy, the EU Taxonomy.

In the opinion, ESMA promotes the EU Taxonomy as the sole basis for qualifying investments as sustainable investments, with the view that the broader SFDR definition of sustainable investments should be phased out over time. This is based on ESMA’s view that “[firms] may currently apply weak ‘do no significant harm’ tests to portfolio holdings or use an overly generic sustainable objective at fund level” and, as a consequence, provides a high level of flexibility.

ESMA acknowledges that the EU Taxonomy becoming the sole reference point would require a separate social taxonomy. The European Union has discussed the possibility of an equivalent taxonomy for socially sustainable activities, although that project has not progressed in recent years. ESMA also acknowledges that extension of the

environmental EU Taxonomy to transition investments will require a legal definition of transition investments. By transition investments, ESMA is referring to investments which are currently harmful but which can either be decommissioned (as “always significantly harmful”) or for which the technology exists to improve their performance and which are in need of urgent transition to avoid significant harm to environmental objectives (as “significantly harmful”). In either case, the concept seems to be limited to investments contributing to climate change transition and not other environmental objectives. ESMA states that the metrics for measuring a transition investment can either be aligned with the EU Taxonomy (which measures the share of revenue or CapEx associated with harmful activities that are transitioning or being decommissioned) or with metrics on environment- or climate-related impacts (such as the reduction in GHG emissions). Clearly, the do-no-significant-harm criteria would need to be reduced for transitioning investments.

It is currently clear that investments covered by transition plans are not sustainable investments within the meaning of the SFDR—at least where transition is the thesis for qualifying the whole investment as a sustainable investment. This is covered in the EU Commission’s answers to the ESAs’ questions in 2023 (see the consolidated SFDR Q&As [here](#)). In addition, the EU Taxonomy for climate change mitigation does not generally cover transition-type activities, such as “brown to green” infrastructure, except for building renovation. However, the EU Taxonomy does allow CapEx to be counted as EU Taxonomy-aligned if it is part of a plan to expand EU Taxonomy-aligned activities by a company (with various conditions, such as that the plan is executed in at least five years).

Merging the concept of sustainable investment and EU Taxonomy-aligned investment may be workable in the very long term, once the EU Taxonomy’s scope has been extended to cover, for instance, “low impact” environmental activities, and once existing questions on the workability of the technical screening are resolved. The European Union has found it challenging to obtain consensus on any extension of the EU Taxonomy to date, and a new social taxonomy to cover socially beneficial activities such as social housing will be subject to extensive debate. Funds disclosing under Article 9 of the SFDR must commit to making only sustainable investments, whilst funds under Article 8 of the SFDR may commit to making a proportion of sustainable investments (and hence qualify as Article 8 “dark”). If, in the future, the only condition for an investment to qualify as a sustainable investment is that it is aligned with the environmental EU Taxonomy (and a future social taxonomy), it is open to question whether most existing Article 8 “dark” and Article 9 funds will be able to retain that qualification. There is also continuing uncertainty about how firms should qualify activities under the EU Taxonomy for non-EU investments—the position is ambiguous under the EU Taxonomy, which sometimes specifies non-EU equivalent standards in

the “do-no-significant-harm” criteria but leaves open the general question of whether funds generally can apply an equivalence test for non-EU investments.

Clearer Sustainability Disclosures. ESMA has raised concerns several times on the comprehensibility of SFDR disclosures for retail investors. In that regard, in the opinion, ESMA advises the following:

- All financial products within scope of the SFDR should include minimum sustainability information, regardless of the product’s actual sustainability ambitions. This could comprise a small number of basic sustainability KPIs, such as GHG emissions, impact on biodiversity and EU Taxonomy-alignment. Whilst this proposal will allow an investor to make a like-for-like comparison between products, including those that do not promote environmental or social characteristics, it is not easy to see how some strategies, such as investments in securitisations, can report on a set of basic sustainability KPIs.
- Referring to “layering” of information to meet different investor needs, ESMA envisages products publishing a set of “vital” sustainability information for less sophisticated investors in a short separate document (similar to the PRIIPs KID), with the full disclosure contained in the prospectus.
- Establishing a voluntary product categorisation system for products offered to retail investors, ESMA proposes the introduction of “sustainable” investments (aligned with the EU Taxonomy) and “transition” investments categories. ESMA here largely repeats the proposal already expressed in the ESAs’ joint opinion, with the qualification that the “sustainable” label should only be available for funds investing in EU Taxonomy-aligned products. ESMA only refers to a product categorisation system for retail investors—if the EU Commission adopts this proposal, it is open as to whether it will adopt it for professional investor-only products.
- ESMA also supports a “grading” system for sustainable products. Under the ESAs’ opinion, a grading scale 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. ESMA acknowledges that as sustainability matters are “multidimensional”, a single grading system is challenging.
- ESMA also points out that product categories would be a simple basis on which to discuss investors’ sustainability preferences, which EU investment advisers are required to obtain under separate regulation.

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Please do not hesitate to contact us with any questions.



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