Report on SFDR Categorisations

3 January 2025

The European Commission (the "Commission") is expected to publish a proposal for the review of the Sustainable Finance Disclosure Regulation (together with its delegated acts, "SFDR") in the first half of 2025. The proposal will likely reflect the responses to the Commission's consultation in 2023 (see our update here) and opinions published by the European Securities and Markets Authority ("ESMA") (see our update here) and the European Supervisory Authorities (the "ESAs") (see our update here) in 2024. To address perceived misuse of the Article 8 and Article 9 categories under SFDR and to assist retail investors in selecting sustainable financial products, both sets of opinions favoured the introduction of product categories under SFDR with mandatory minimum criteria for financial products that promote environmental and social characteristics.

The EU Platform on Sustainable Finance (the "Platform"), an advisory body to the Commission, recently published its proposals for a categorisation scheme under SFDR (the "Proposals"). The Proposals are consistent with ESMA's and the ESAs' opinions but are considerably more detailed. The Proposals do not bind the Commission but will have significant influence.

The Proposals are based on investors having three distinct objectives:

- to invest in sustainable assets, which contribute to specific environmental or social objectives;
- to invest in transition investments; and
- more broadly to invest in companies with good ESG performance.

To that end, the Platform proposes three categories of products: **Sustainable**, **Transition** and **ESG Collection**. The Platform envisages that each category includes minimum criteria, including that a predefined proportion of investments fulfil the core sustainability objective. The Platform acknowledges that it may not be possible for a fund to meet these criteria during its fundraising and wind-down phases.

Products which do not adopt one of the categories will be identified as **unclassified products** and may be prohibited from including descriptions of ESG characteristics in their marketing material.

The Proposals are primarily, but not exclusively, directed at retail funds. However, if the Commission adopts the Proposals, institutional investor funds, including non-EU funds being marketed in the EU, will likely need to engage with the proposed categorisations. We discuss this in more detail below.

Sustainable Category

The key criterion for a fund in the "Sustainable" category will be that a minimum proportion of its investments is in sustainable investments and investments aligned with the EU Taxonomy Regulation (the "Taxonomy"). The Platform does not propose the minimum proportion, but notes that products in this category should initially have a lower minimum proportion, with the proportion increasing as the Taxonomy is further developed—for example, to include social objectives. The minimum proportion may eventually be aligned with the 80% threshold specified in ESMA's Guidelines on funds' names (see our update here), which applies to funds with ESG terms in their names. Hedging and liquidity investments are excluded from the minimum proportion.

In line with statements made by the ESAs, the Platform recommends strengthening the definition of "sustainable investment" in a number of ways:

- Where an investment is covered by the Taxonomy, it should only qualify as a "sustainable investment" by alignment with the Taxonomy. Additionally, transition investments may qualify as Taxonomy aligned, where there is a transition plan in place. Hence, as the Taxonomy develops, the Platform's view is that any activity that is covered by the Taxonomy cannot be considered a sustainable investment unless it meets the Taxonomy's technical criteria. This will be a significant change to the current ability of managers either to qualify an investment as Taxonomy aligned, where it meets the strict technical criteria, or to qualify the same investment as a sustainable investment, under criteria developed by the manager, in particular in connection with the "do no significant harm" test.

- Where an investment with an environmental objective is not covered by the Taxonomy, the investment can be qualified as a sustainable investment based on its alignment with science-based targets. Qualifying an investment on the basis of, for instance, an ESG rating, is not likely to be acceptable. The Platform recognises that socially sustainable investments may not be linked to science-based targets but

points to, for instance, the social indicators in the European Sustainability Reporting Standards ("ESRS") under the EU's Corporate Sustainability Reporting Directive ("CSRD") as a helpful resource for assessing its contribution to a social target.

- Strengthening the "do no significant harm" test, where managers will need to set thresholds for environmental and social harm, which are relevant to the investment's sector, asset class and region, with the thresholds used to exclude the "worst performers", unless the manager can demonstrate that it will apply its engagement strategy to poor performers which have a "positive outlook" or can adopt a mechanism to exclude the investment if a targeted threshold is not reached. For these thresholds, managers will use the indicators for principal adverse impacts under SFDR.

In line with ESMA's Guidelines on funds' names, the Platform also proposes the application of a mandatory exclusion list, derived from the exclusion list under the EU Paris-Aligned Benchmarks (the "PAB List"), with some adjustments.

Transition Category

The "Transition" category covers products which invest in companies or specific projects, with environmental transition objectives, either those with a specific transition plan to transform their activities (which may or may not be aligned with the Taxonomy) or those which have more broadly adopted science-based targets. Funds in this category can commit to make environmental improvements at the level of the whole portfolio or for individual companies or projects. Although transition plans have generally focused on climate mitigation and adaptation, the category includes other environmental targets, such as biodiversity and water use. It is worth noting that the EU separately intends to extend the Taxonomy to cover specific transition investments, such as conversion of fossil fuel power plants to reduce their greenhouse gas emissions, with criteria for those investments to meet "intermediate" targets for environmental performance.

Other criteria that the Platform proposes that a product may adopt for this category include: (i) reduction in environmental harm by the whole portfolio in line with an external benchmark; (ii) investing in companies with a climate transition plan which follows the elements detailed in the Corporate Sustainability Due Diligence Directive; and (iii) a portfolio level plan to transition real estate and infrastructure assets. The Platform proposes that, to the extent the fund invests in a limited number of assets that are not covered by a transition plan, the fund will adopt an engagement strategy for those assets, with a decision to divest the assets if necessary.

To measure achievement of these criteria, the Platform suggests that a fund could, among other things, track the extent to which its investments adhere to a transition plan put in place by the investee company under CSRD, or commit to a minimum level of Taxonomy-aligned capital expenditure or revenue linked to transition activities.

The category will allow managers the option to adopt a stewardship strategy, with detailed disclosure required on how the sponsor will use its voting rights or power to engage the investee company and measure the resulting changed behaviour.

For this category, the Climate Transition Benchmark exclusion list (the "CTB List") will apply. Unlike the PAB List, the CTB List does not include exclusions for fossil fuels, recognising that transition strategies may include fossil fuel investments.

ESG Collection

The "ESG Collection" category covers all other funds with material sustainability features. This may involve the fund selecting investments on the basis of negative (excluding worst performers) and positive (including best in class) screening or selecting investments for their potential to improve their sustainability performance, either by comparison to a benchmark or by showing year-on-year improvement. The ESG Collection category will also cover a fund that combines the Sustainable and Transition categories, either by investing in a mixed portfolio which includes investments that are eligible for the Sustainable and Transition categories or by investing (as a fund of funds) in funds in the Sustainable and Transition categories.

According to the Platform, a product in this category will need to make a binding commitment on how it selects investments, such as that the product will achieve significant sustainability performance, compared to a reference benchmark, or that the selection criteria result in reducing the product's investment universe by (for example) at least 20%.

As for the Transition category, the CTB List will apply.

Unclassified Products

According to the Platform, all funds that do not fall into the three categories above will be named "unclassified." This includes funds that do not have sustainability features, funds with sustainability features that do not meet the criteria for the other categories,

and funds which the manager chooses not to qualify because, for instance, all investors are institutional investors with no preference for a category.

Although funds in this category will not be required to fulfil minimum criteria concerning their sustainability features, they will need to describe how they consider sustainability risks under the existing obligation under Article 6 of SFDR. The Platform proposes that these funds will also report data on Taxonomy alignment, greenhouse gas emissions and human rights due diligence. These funds will carry a disclaimer that the fund is unclassified.

The Platform recommends that, for a fund in this category, whilst its "legal documentation" may contain ESG commitments, it may not include references to ESG characteristics in its marketing material. The Platform here is clearly concerned that "unclassified" funds which commit to ESG characteristics or sustainable or transition features need to be distinguished, at the marketing stage, from products which use the Sustainable or Transition categories described above.

Sustainability Preferences and Clients' Needs

The Platform recognises that financial market participants will need to expend considerable time and resources in transforming their existing products—generally categorised under Article 8 or 9—to the categories under the new regime and recognises that some Article 8 or 9 funds will not meet the new criteria. The Platform's proposal that any product which does not use one of these categories should be prohibited from referring to ESG characteristics in its marketing material may require many existing Article 8 funds either to change their ESG characteristics or cease promoting any ESG characteristics—underlining the need for grandfathering and transitional relief for funds no longer in fundraising and for those in fundraising prior to the new rules (if adopted as proposed) taking effect.

Impact Investing

Despite the use of the "impact" term in marketing material, particularly by funds categorised under Article 9 of SFDR, the Platform does not include an "Impact" categorisation. This reflects the Platform's view that there is no common definition or understanding of the term. In discussions on this topic, the Platform points out that, for funds that invest in secondary markets, the fund's contribution to a specific impact might be limited, with difficulties in drawing a causal link between an investor's provision of financing and a change in an investee company's behaviour. The Platform

notes that private equity and venture capital show higher potential to contribute to impact, where the investor itself generates impact, compared to UCITS funds that invest mainly in secondary markets. Finally, the Platform recommends that the Commission develops a common understanding of how impact investing relates to the EU's sustainable finance framework and to the Taxonomy, with a view to integrating it into the categorisation regime.

Links with Article 8 and Article 9 Funds and FCA's Sustainability Disclosure Rules

The Platform makes the broad statement that some existing Article 8 SFDR funds will fit into any of the new categories, whilst existing Article 9 SFDR funds will generally fit into the Sustainable or Transition categories. It is likely that existing Article 8 funds which promote environmental or social characteristics by reference to stewardship, engagement and exclusion screens will not meet either the Sustainable or Transition categories.

The FCA developed its Sustainability Disclosure Rules in 2023, introducing new sustainability labels and related criteria. The FCA intended its labels to be as compatible as possible with SFDR, taking into account the Commission's consultation on SFDR in 2023. The Platform makes limited reference to the FCA's scheme. In fact, the Platform distinguishes its use of Sustainable "Categorisations," which contain minimum criteria for the purpose of grouping products, from Sustainable "Labels," which contain stricter criteria. Despite that, there is some correlation between the Platform's Proposals and the FCA's SDR labels:

SFDR categorisation proposals	FCA SDR labels
Sustainable category	Sustainability Focus—funds that invest in assets that are environmentally or socially sustainable, using robust standards. Sustainability Impact—funds that achieve a measurable impact, showing the contribution by the manager's investment activities.
Transition category	Sustainability Improvers—funds that invest in assets with the potential to improve their environmental or social sustainability, using robust standards.
ESG Collection category	Sustainability Mixed Goals—funds that invest in accordance with two or more of the above objectives.

Impact on Institutional-Only Funds

The scheme is clearly directed at retail investors, with the Platform noting that managers with institutional-only investor funds might decide not to use a categorisation either because investors are not interested in the categorisation or because the managers may wish to form a product with a more specialised strategy.

At this point, it is unclear whether a manager with an institutional-only investor fund which chooses not to use a categorisation will be required to use the "unclassified" products category, which comes with the proviso that the fund's marketing material cannot use ESG characteristics or names. This will be a key point of focus for private fund managers as the Commission's work develops.

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