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Standard Brief

# Sustainable Finance Disclosure Regulation (SFDR)

Sustainable Finance Disclosure Regulation (SFDR) is a disclosure framework designed to introduce transparency into sustainable investments, assets, and products and combat financial greenwashing. SFDR classifies all funds into one of three categories, each subject to a set of disclosure requirements defined: Article 6 (integration of sustainability risks), Article 8 (promoting environmental or social characteristics), and Article 9 (sustainable investment objectives). This framework is being implemented currently through two phases. SFDR is required for EU-based investors and investments and thus is influencing global disclosure framework implementation.

https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en

## THE BASICS

**Seeks to improve transparency and comparability of sustainability claims in investment products based in the EU or sold to EU investors.** The Sustainable Finance Disclosure Regulation (SFDR) was first introduced as part of the 2018 Sustainable Finance Action Plan and has become a pillar of the EU Sustainable Finance agenda.[1] "[SFDR] is a European regulation introduced to improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants."[2] With this regulation applying to all investment products based in the EU or sold to EU investors, the impacts are far-reaching across financial markets.

**SFDR requires financial institutions to self-classify products into one of three categories, based on product claims.** Products that **do not take sustainability into consideration** in the investment process are often referred to as in the category of "grey" funds. Products that **promote explicit environmental or social characteristics** are known as "light green" funds. Products with **explicit sustainable investment objectives** are known as "dark green" funds. Importantly, this means *all* investments based in the EU or sold to EU investors are categorized and subject to some level of disclosure about sustainability issues.

**Based on category, products are subject to one of three classifications of disclosure guidance, termed Article 6, Article 8, and Article 9.** Grey funds have to comply with **Article 6: Transparency of the integration of sustainability risks**. This means that firms must state the ways in which sustainability risks are integrated into their investment decisions and the likely impacts of those risks on returns. Where they claim sustainability is not relevant in the product, they must disclose why that is. **Article 8: Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures** applies to "light green" funds and requires

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stricter disclosures than Article 6. **Article 9: Transparency of sustainable investments in pre-contractual disclosures** applies to dark green funds.


Source: Finding ESG Funds Just Got Easier, Morningstar. Accessed 11/10/2022.

## USEFUL FOR

**Required for financial market participants operating in the European Union or marketing products to European clients.** This includes asset managers, institutional investors, insurance companies, and pension providers. Financial products may include investment and mutual funds, insurance-based investment products, pensions, and investment advising.[3]

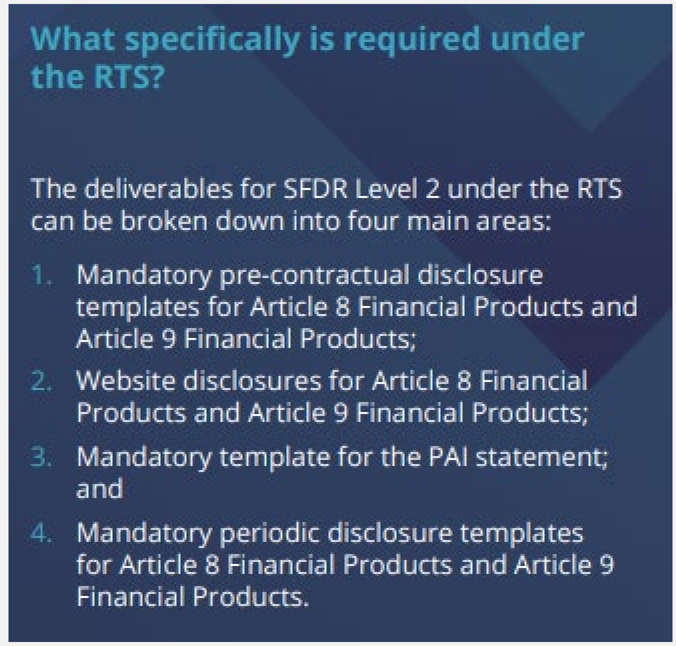
**Disclosing information on principal adverse impacts.** Principal adverse impact is a central concept in SFDR, referring to the negative sustainable impacts of investment decisions. SFDR requires and provides a template for an entity-level Principal Adverse Sustainability Impacts Statement with the expectation that companies publish this information on their website.

**Providing disclosures about the objectives of funds claiming positive social or environmental characteristics or impacts.** SFDR makes distinctions between products that claim to promote environmental or social characteristics and products that claim a specific impact objective – and have different disclosure requirements for each.

## IMPLEMENTATION & IMPACT

**SFDR is being implemented through Level 1 and Level 2 requirements, with different effective dates for each.** **SFDR Level 1 requirements went into effect in March 2021.** They require financial market participants to publish the entity-level policies they apply to identify and prioritize principal adverse impacts (PAI).[4] Level 1 did not include the technical detail of disclosure requirements, but mandated that draft SFDR Regulatory Technical Standards (RTS) be defined for the specific disclosures required in each product category. The draft RTS is currently published for review and use.

**SFDR Level 2 requirements are set to come into effect in January 2023.** At that point, the specifications detailed in the Regulatory Technical Standards for entity- and product-level disclosures will become required. In addition to detailing the template for the entity-level principal adverse impact statement, the RTS will make Article 8 and Article 9 products subject to mandatory pre-contractual disclosures and periodic disclosures. The graphic at right from a guide published by Maples Group and AIMA breaks the RTS into four main areas, showing the higher level of scrutiny for ESG and impact investment products categorized under Article 8 and Article 9.




Source: Guide to the EU Sustainable Finance Disclosure Regulation – Regulatory Technical Standards, Maples Group and AIMA. Accessed 11/11/2022.

**"Comply or explain" philosophy.** After SFDR Level 1 was enacted in March 2021, the framework for reporting at the entity-level on principle adverse impacts took the form of "comply or explain," and moved to "comply" in June 2021 for entities with more than 500 employees.[5] The "comply or explain" policy means that firms must explain how they consider the principal adverse impacts on sustainability of their investment decisions, including references to their related due diligence policies. Firms that do not consider PAIs must explain why they do not.[6]

**Mandatory and optional principal adverse impact indicators in product-level disclosures.** Article 8 and Article 9 product-level disclosures include 18 mandatory and 46 optional indicators. Examples of mandatory indicators include information on carbon emissions, fossil fuel exposure, waste levels, gender diversity, human rights, and exposure to corruption or bribery.[7]

## CURRENT GAPS

**Delays in implementation indicate the complexity of disclosure requirements.** Despite a few years of lead time, many financial market participants continue to track fewer than the necessary required metrics.[8] SFDR requires data from multiple sources and vendors, including non-financial data.[9] Confusion around what is required, clarification on definitions and articles, and the complexities involved on accurate metric reporting have contributed to the delay of Level 2 implementation.[10]

**Some criticize SFDR's lack of clarity on product definitions for Article 6, 8, or 9.** Although SFDR does not set out to define ESG or Impact Investment products, some financial market participants are using the Article categories as proxy definitions. However, the boundaries between categories are blurry and firms are responsible for self-classifying products.[11]

**SFDR is geographically limited, but financial investments know very few geographic boundaries.** Firms outside of the EU are concerned about the reporting requirements of their company if they have a subsidiary in the EU, for example. In the United States, an estimated market capitalization of parent companies worth $2.5 trillion with a presence in the EU will likely be subject to SFDR.[12]

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[1] https://assets.kpmg/content/dam/kpmg/ie/pdf/2021/03/ie-sustainable-finance-disclosure-reg-sfdr.pdf
[2] https://www.eurosif.org/policies/sfdr/
[3] https://www.bloomberg.com/professional/blog/demystifying-the-sustainable-finance-disclosure-regulation/
[4] https://assets.kpmg/content/dam/kpmg/ie/pdf/2021/03/ie-sustainable-finance-disclosure-reg-sfdr.pdf
[5] https://www.bloomberg.com/professional/blog/demystifying-the-sustainable-finance-disclosure-regulation/
[6] https://greenomy.io/blog/sfdr-principal-adverse-impact
[7] https://www.robeco.com/en/key-strengths/sustainable-investing/glossary/eu-sustainable-finance-disclosure-regulation.html
[8] https://www.apexgroup.com/insights/the-three-major-challenges-of-esg-under-sfdr/
[9] https://www.biqh.com/blog/sustainable-finance-disclosure-regulation-sfdr-market-data-challenges/
[10] https://maples.com/en/knowledge-centre/2021/7/european-commission-replies-on-sfdr-priority-issues
[11] https://capitalmonitor.ai/regions/europe/explainer-what-are-the-sfdr-regulations/
[12] https://www.spglobal.com/esg/insights/more-than-3t-of-companies-outside-the-eu-could-be-on-the-hook-for-europe-s-sustainable-finance-disclosure-regulation