Navigating SFDR Compliance

IN COLLABORATION WITH:

What Is the Sustainable Finance Disclosure Regulation (SFDR)?

The Sustainable Finance Disclosure Regulation (SFDR) imposes mandatory ESG disclosure obligations on asset managers and financial markets participants (FMPs) in the European Union (EU) or those that fundraise in Europe, effective March 10th, 2021.[1] The SFDR was introduced by the European Commission alongside the EU Taxonomy Regulation and the Low Carbon Benchmarks Regulation as part of a package of legislative measures from the European Commission's Action Plan on Sustainable Finance. Taxonomy sustainability disclosure requirements came into effect as of January 1st, 2023.[2]

The SFDR aims to prevent greenwashing and ensure comparability of funds by standardizing transparent information on sustainability within EU financial markets. Applicable financial products include investment and mutual funds, insurance-based investment products, private and occupational pensions, and insurance and investment advice. In-scope advisors and FMPs must disclose required information both at the firm and product level.

KEY TAKEAWAYS

- The SFDR establishes mandatory ESG disclosure obligations for EU fund managers and all managers that fundraise in the EU, including many asset owners with 500+ employees
- The SFDR requires funds with an ESG, sustainability, or impact focus to be designated under Articles 6, 8, or 9, with additional PAI reporting requirements for Articles 8 and 9
- European asset owners must gather fund-level data to fulfill their SFDR reporting requirements, even if such obligations are not specifically required of fund managers
- Fundraising is becoming increasingly challenging for GPs, motivating them to expand fundraising to the EU and thus introducing SFDR stipulations for their future funds

[1] European Commission, Sustainability-related disclosure in the financial services sector

[2] EUR-Lex, Corrigendum to Commission Delegated Regulation (EU) 2022/1288

Applicability of the SFDR

The SFDR applies to FMPs and advisors in the EU as well as those that are marketing products in the EU or have some other EU nexus (e.g., fundraising in Europe).

- FMPs with less than 500 employees can disregard disclosure of sustainability risks and principal adverse impacts (PAIs), a condition of the SFDR. Instead, they can simply provide an explanation of why sustainability risks and PAIs are not considered in investment decisions.
- Many General Partners (GPs) have fewer than 500 employees and can therefore choose to opt out of the reporting regime through a pre-contractual disclosure explanation and a negative PAI statement. Those that collect ESG data relevant to their portfolios but do not align with the PAIs can explain that they maintain ESG programs separate from PAI disclosure requirements.

However, many institutional asset owners employ more than 500 employees and will be required to report on PAIs to demonstrate the extent to which their direct and indirect investments in the EU incorporate ESG and sustainability into investment decisions.[3] In-scope asset owners must therefore make good faith efforts to collect fund-level PAI data from GPs, even if the GPs are not required under the SFDR to comply with disclosure requirements.

GPs that are not required to report under SFDR may thus face pressure from asset owners to do so for their reporting needs. Some GPs may also be incentivized to report under SFDR to verify the strength of their ESG programs to prospective asset owners.

[3] Deloitte, How the SFDR is changing the dynamics in Private Equity

SFDR Disclosure Requirements

The SFDR contains several articles with which in-scope financial institutions must comply.

- Articles 3, 4, 5, and 7 require in-scope institutions to explain existing policies on integration of sustainability and ESG risks in investment decisions.
- Articles 6, 8, and 9 introduce specific classifications for financial products, depending on the extent to which sustainability considerations—namely, sustainability risks and PAIs—are implemented in their investment processes.[4] Managers designating their products according to Articles 6, 8, or 9 are considered "in-scope" must comply with additional disclosure obligations, as seen below.

ARTICLE	DISCLOSURE DESCRIPTION	OBLIGATION	SCOPE	WHERE TO DISCLOSE
3	Policies on the integration of sustainability risks in investment decisions or advice	Mandatory	Asset managers, pension providers, financial advisors	Website
4	Considerations of adverse sustainability impact at entity level: PAI indicators/actions Engagement policies Adherence to standards on due diligence, alignment with Paris Agreement (where relevant)	Comply or explain (firms >500 headcount must comply)	Asset managers, pension providers, financial advisors	Website (Annual PAI statement)
5	Consistency between remuneration policies and sustainability risks	Mandatory	Asset managers, pension providers, financial advisors	Website
6	Products that either integrate sustainability risks in investment decisions, or that consider advice and impacts of sustainability risks on the returns of financial products, or explain why sustainability risks are not considered or are irrelevant	Comply or explain for in-scope products	Asset managers, pension providers, financial advisors	Pre-contractual documents
7	Consideration of adverse sustainability impacts at product level (methodology integrating adverse impact into investment decisions)	Comply or explain (by 2023, all financial products must comply unless < 3 employees)	Asset managers, pension providers	Pre-contractual documents
8	Products with strategies to promote social or environmental characteristics that may have sustainable investments, but that do not have a core sustainability objective (i.e., ESG investing)	Mandatory for in-scope products	Asset managers, pension providers	Pre-contractual documents, website, periodic reports
9	Products with strategies that have sustainable investment as a core objective (i.e., impact investing)	Mandatory for in-scope products	Asset managers, pension providers	Pre-contractual documents, website, periodic reports

[4] Morgan Stanley, Sustainable Finance Disclosure Regulation

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ARTICLE	DISCLOSURE DESCRIPTION	OBLIGATION	SCOPE	WHERE TO DISCLOSE
10	Published information maintained on products classified under Articles 8 and 9	Mandatory	Asset managers, pension providers	Pre-contractual documents
11	Additional detail for products classified under Articles 8 and 9 regarding extent to which social or environmental characteristics are met, or extent to which sustainability impact is achieved	Mandatory	Asset managers, pension providers	Pre-contractual documents, website, periodic reports

Sustainability Risks and PAIs

The SFDR encompasses sustainability risks and PAIs, which are two key factors that standardize how fund managers and FMPs disclose sustainability information.

- Sustainability risks refer to ESG events or conditions that could cause a material negative impact on the value of an investment.
- PAIs refer to negative effects that investment decisions may have on sustainability.[5]

They reflect the 'double materiality' principal: products must report on not only the impacts of the external environment on financial performance of funds, but also their sustainability impacts on external stakeholders.

For firms with more than 500 employees, there are 14 mandatory PAIs that must be reported on across environmental and social factors, listed below. Sovereign wealth funds and real estate asset classes must also report on four supplemental PAIs, listed below. Finally, there are 46 other voluntary key indicators for PAIs across environmental and social factors, from which firms must select at least two (one environmental and one social) for use in disclosing product sustainability considerations.

In-scope asset owners and GPs must publish an annual PAI statement on their websites that includes both qualitative and quantitative disclosures.

- The qualitative disclosure should include a description of principal adverse sustainability impacts during the relevant reference period, a description of planned or taken actions to identify and prioritize PAIs, information on engagement policies to reduce PAIs, and any reference to adhered international standards (e.g., alignment with Paris Agreement).
- The quantitative disclosure will require numeric reporting on PAI indicators. Given that asset owners must take best efforts to collect fund-level PAI data from GPs, asset owners may require their GPs—even those not directly required to comply—to align with PAI disclosure requirements as well.

[5] EIOPA, Principal adverse impact and product templates for the Sustainable Finance Disclosure

Mandatory PAIs

ESG CATEGORY	INDICATOR #	INDICATOR DESCRIPTION
Environmental	1	Scope 1 GHG emissions
	1	Scope 2 GHG emissions
	1	Scope 3 GHG emissions
	1	Total GHG emissions
	2	Carbon footprint
	3	GHG intensity of investee companies
	4	Companies active in fossil fuel sector
	5	Share of non-renewable energy consumption and production
	6	Energy consumption intensity per high impact climate sector
	7	Activities negatively affecting biodiversity-sensitive areas
	8	Emissions to water
Social	9	Hazardous waste ratio
	10	Violations of UN Global Compact principles and OECD guidelines for multinational enterprises
	11	Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD guidelines
	12	Unadjusted gender pay gap
	13	Board gender diversity
	14	Exposure to controversial weapons

Asset-Specific Supplemental PAIs

ASSET CATEGORY	INDICATOR #	INDICATOR DESCRIPTION
Sovereign	15	GHG intensity
	16	Investee countries subject to social violations
Real Estate	17	Exposure to fossil fuels through real estate assets
	18	Exposure to energy inefficient real estate assets

How Does the EU Taxonomy Regulation Interact with the SFDR?

The EU Taxonomy Regulation from January 2022 introduced standard environmental criteria to define as well as which economic activities can be considered environmentally sustainable.[6] For economic activities to qualify as sustainable, they must align with at least one of the below environmental objectives and cannot result in significant harm to the other objectives—a principal known as 'do no significant harm' (DNSH).[7] An EU Taxonomy specific to social objectives is currently in development and may interact with future SFDR disclosure requirements around social PAIs.[8]

The Taxonomy Regulation establishes six environmental objectives, including:

- Climate change mitigation
- Climate change adaptation
- Sustainable use and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

The EU Taxonomy Regulation is integrated into the SFDR's disclosure obligations. Specifically, Article 8 and Article 9 funds must justify their fund categorizations using environmental PAI disclosures, aligned with the EU Taxonomy (a higher bar than for Article 6, wherein Taxonomy alignment is preferred but not a requirement). Taxonomy alignment is optional for Article 6.

[6] European Commission, EU taxonomy for sustainable activities
[7] S&P Global, A Short Guide to the EU's Taxonomy Regulation
[8] Platform on Sustainable Finance, Final Report on Social Taxonomy

What Level of Participation Is Required from Asset Owners?

SFDR has two levels of disclosures: Level 1 and Level 2 reporting requirements. All in-scope asset owners and GPs need to determine product categorizations (i.e., Article 6, 8, or 9 designations) under Level 1 requirements, while Article 8 and 9 funds also need to comply with Level 2 reporting requirements on PAIs. The Level 2 Regulatory Technical Standards (RTS) were published in January 2023, and asset owners will need to supply detailed disclosures and complete reporting templates. These will include pre-contractual and periodic disclosure templates designed to solicit information for investors on PAIs and Taxonomy alignment.[9]

Level 1 Requirements

Level 1 requirements provide a legal framework that defines disclosures on firm-level policies for identifying and prioritizing PAI. Per Level 1 requirements, EU funds must be sorted between Articles 6, 8, and 9 categorizations, and comply with mandatory elements contained in Articles 1 through 5. These funds must produce statements that report how and why PAIs are incorporated or excluded from investment decision-making processes. These statements should be included in pre-contractual fund documentation, website pages, and any annual fund reports.

Institutional asset owners and GPs with over 500 employees are subject to Level 1 requirements and will need to classify their funds accordingly. Level 1 requirements are also designed to signal to asset owners what they can and cannot expect from funds managed by GPs who opt into a specific Article 6, 8, or 9 classification, allowing for comparing investment products for sustainability considerations.

Level 2 Requirements

Level 2 formalizes reporting on PAIs. In-scope asset owners and GPs must comply with annual website and pre-contractual reporting disclosures, as well as publish disclosures in mandatory templates. Specifically, managers with Articles 8 and 9 funds will need to report on the 14 mandatory PAIs (as well as one additional environmental and one social indicator from the voluntary PAIs), with four supplemental PAIs for specific investment types (sovereign and real estate). Article 8 and 9 funds must disclose how their funds align with the EU Taxonomy Regulation's list of environmental activities. These disclosures are still required for in-scope asset owners and GPs with less than 500 employees if they choose to classify their funds under Articles 8 or 9.

[9] European Supervisory Authorities, Final Report on Draft Regulatory Technical Standards

Given the level of information needed to fulfill PAI reporting requirements, in-scope asset owners will need request information from fund-level managers, even if these managers choose to publish a negative explanation of why they are not reporting on PAIs specifically. Asset owners seeking or already maintaining Article 8 and 9 product designations should request that GPs provide fund-level information regarding Level 2 disclosure requirements, preferably on a formal SFDR compliance basis, and then report that information publicly. Asset owners can expect to require GPs to provide compliance data for their needs, even if GPs themselves have not made explicit commitments under SFDR.

In pre-contractual disclosures, Article 8 funds must disclose whether they have investments with sustainability objectives aligned to the Taxonomy, and if so, calculate the degree to which investments promote and avoid harm to the objectives. Article 9 funds, which have sustainable investments as an objective by designation, need to disclose their minimum share of sustainable investments and how their sustainable investments' activities align with the Taxonomy Regulation.

Article 9 funds face higher standards for PAI disclosure requirements than Article 8 funds, as they must invest in products with core sustainability objectives. Level 2 will also require fund managers to detail investment decisions that do not consider PAIs, such as by explaining why they do not align with the EU Taxonomy. In website disclosures, sustainability information must be clearly published in a separate section of managers' websites alongside other information relating to the product, including marketing communications.

Many managers have faced confusion in determining correct fund designations. These challenges have subsided following additional guidance from the European Commission. For instance, it has proposed that funds with ESG names invest at least 80% of their assets toward achieving their ESG strategies, as well as for sustainability funds to invest at least 50% of assets toward sustainability outcomes.[10] Rigorous reporting on PAIs will also be expected to cover ESG and sustainability investments in funds under Articles 8 and 9. Many managers are not prepared to verify these percentage allocations in their funds and report fulsomely on PAIs, which has led them to downgrade their registered fund designations (e.g., from Article 9 to 8, from Article 8 to 6).[11]

[10] Responsible Investor, ESMA floats 40% SFDR requirement for funds with 'sustainable' in title

[10] Responsible Investor, SFDR credibility 'at stake' as trickle of article 9 downgrades grows to a flood

[11] Bloomberg, Asset Managers Are Facing Hundreds of ESG Fund Downgrades

How Is the SFDR Affecting In-Scope Asset Owners?

SFDR's Level 2 sets a high standard for reporting on sustainability risks and ESG factors in investment processes – as a result, many FMPs with ESG programs are not equipped to immediately comply with Article 9 or 8 requirements. For instance, FMPs may not be prepared to verify percentage allocations in funds, report on PAIs, or demonstrate that their funds are achieving core ESG or sustainability objectives.

Article 8, which most FMPs are interested in achieving for their funds, requires robust ESG diligence, data monitoring, portfolio company initiatives, and reporting to key investment stakeholders to prove out compliance. FMPs interested in achieving a classification under SFDR can consider either repurposing their existing ESG programs to align to these stringent expectations or building a program from the ground up that can satisfy them.

How Does the SFDR Compare to the SDR (UK)?

The Sustainable Disclosure Regime (SDR) is a framework proposed by the UK's Financial Conduct Authority (FCA). It introduces labelling and disclosure rules for funds that are marketed as having sustainable characteristics.[12] Disclosure rules are expected to be finalized by Q3 2023, applicable from 2024 onward. The SDR addresses similar topics for UK-based financial institutions and products as the SFDR does for the EU, though there are several differences.

Like the SFDR, the SDR is designed to address greenwashing concerns, increase transparency, and standardize reporting of firm and product-level sustainability information. The proposal includes an anti-greenwashing rule stating that all fund sustainability claims must be fair and accurate. The anti-greenwashing rule will apply to all FCA-regulated firms, with the remaining applying to UK wealth, fund, and asset managers. Foreign funds are not yet in scope, though may be in the future.

The proposed rule establishes sustainable investment labels (SILs) for in-scope firms and financial products:

- "Sustainable focus" funds: at least 70% invested in assets with high standards of sustainability.
- "Sustainable improvers" funds: not currently sustainable but have an objective to deliver measurable improvements over time.
- "Sustainable impact" funds: an explicit goal to achieve positive, measurable contributions to sustainable outcomes.

[12] Financial Conduct Authority, CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels

The FCA is still defining the exact stipulations of these labels. These categories also closely mirror the SEC's proposed ESG disclosure categories of "ESG focused", "integration", and "impact" funds (see Understanding the SEC's Proposed ESG and Climate Disclosures). Products that do not have any of these labels will be restricted from using sustainability marketing terms (e.g., 'ESG' and 'green'). While these labels may improve compatibility with the SFDR, they are not interchangeable with Article 8 or 9 designations under SFDR. For example, no PAI disclosures are required under the SDR. Funds with over £5 billion AUM will need to publish annual sustainability reports describing governance processes surrounding ESG risks and opportunities. However, unlike SFDR regulations, no mandated reporting template currently exists to fulfill SDR requirements.

If implemented, UK asset owners and other asset owners with UK investments could leverage the SDR's fund categorizations and greenwashing rule to compare UK funds and GPs, according to the strength of their ESG programming. That said, these comparisons would likely not be as robust as those under the SFDR, as the requirements for SDR compliance are less stringent.

How Does the EU SFDR Compare to the SEC's Proposed Rules for ESG and Climate Disclosures?

The US SEC's disclosure rules around ESG and climate change have similar goals to the SFDR. Both regimes will increase the availability of sustainable information available to asset owners in the market and signal public market demands for such data, thereby increasing the value of investments that disclose on sustainability. Both regulatory frameworks also aim to prevent greenwashing and standardize ESG information available to investors, which ultimately enables asset owners to make more informed decisions about fund allocations. However, when compared to the SFDR, the SEC's disclosure rules are smaller in scope, less robust, and still in the proposal stage (see *Understanding the SEC's Proposed ESG and Climate Disclosures*). Thus, the SFDR represents a leading framework for ESG disclosure and regulatory compliance in action, whereas the SEC's disclosure requirements are currently theoretical.