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SFDR: A new regulatory landscape for Sustainable Investing in Europe

Part 1 – Five Things to Know about SFDR in June 2022

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A NEW YORK LIFE INVESTMENTS COMPANY

Breaking Waves

In March 2021, a regulatory wave hit the shores of the European Union, SFDR Level 1. It was the first in a series of rules and regulations aimed at something that can be more deadly than a highly-infectious disease -- climate change and its related environmental and social emergencies.

The EU has voiced a strong and commendable ambition to battle climate change and global warming, formalized in the EU Green Deal, which targets climate neutrality by 2050. Achieving this requires profound changes in our economic structures. Public funding may not be enough to finance these transformations, private assets too must be channeled into activities that contribute to a more sustainable future. Many investors already embrace the benefits of investing more sustainably. To encourage further adoption, the European Commission is developing regulations to provide additional incentives and to harmonize standards and disclosures for sustainable investing.

The *EU Action Plan on Sustainable Finance* has rolled out initiatives such as the *Sustainable Finance Disclosure Regulation (SFDR)*¹ and the *EU Taxonomy*, as well as sustainability-related benchmarks and eco-labels. March 2021 began the progressive entry into force of SFDR. Following this introduction of *SFDR Level 1*, *Regulatory Technical Standards (RTS)* have been published for *SFDR Level 2*, which will be binding in January 2023. Preparations for SFDR Level 2 are in full swing. By autumn 2022, SFDR and the EU Taxonomy will be integrated into *MiFID II*, the *UCITS Directive* and *AIFMD* through *EU Delegated Acts*.

Through this paper series on the evolving regulatory landscape for Sustainable Investing in Europe, we plan to keep you abreast of the latest regulatory developments and their implications, and to offer provide insights on how to manage this uncertain and changing landscape. In this edition, we highlight five things to know about SFDR and the EU Taxonomy. Subsequent publications will provide more detail on each of these five topics.

¹ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector as amended by the "Taxonomy Regulation" (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment.

1. From SFDR Level 1 to SFDR Level 2

SFDR was initially intended to create a common reading grid on the sustainability of financial market participants and financial products. Disclosure and common principles are designed to reduce confusion, heterogeneity, and greenwashing in sustainable investing. The SFDR applies to both the *entity level*, i.e. the Financial Market Participant, and at the *product level*. Importantly, it formalizes the principle of double materiality, integrating the material financial sustainability risks that an entity or product is subject to as well as the impacts that an entity or product has on the Environment and Society.

In line with the usual implementation of EU regulation, the first layer in March 2021 introduced the high-level principles of the framework. Financial market participants must now disclose their Sustainability Risk Policies and describe how they include sustainability in Remuneration Policies. They also require certain disclosures at product level, mostly qualitative, depending on how Participants classify each product. SFDR defines three financial product categories, *Article 6*, *Article 8*, and *Article 9*. Put simply, Article 6 products *do not consider* sustainability except for the management of ESG-related risks, Article 8 products *integrate sustainability* considerations, and Article 9 products have explicit *sustainability objectives*. While the regulatory text is somewhat more detailed, the category definitions are mostly qualitative and open to interpretation.

In April 2022, the European Commission (EC) published the long-awaited Regulatory Technical Standard for SFDR Level 2, to provide further guidance on content, methodologies and presentation of information. For example, it provides templates for both pre-contractual disclosures as well as recurrent periodic disclosures concerning Articles 8 and 9 products (even the website disclosures are put in a canvas). Additional details on some of the key new guidelines introduced via the RTS are provided below.

2. Clearer Definitions for Sustainable Investments . . . Or Are They?

The Standards for SFDR Level 2, scheduled to enter into force on 1 January 2023, clarify the definitions of Articles 9 and 8 products. But, how clear are these amended definitions?

It is now apparent that the Commission expects SFDR Article 9 products to contain sustainable investments almost exclusively. This stipulation has significant consequences, especially as this interpretation was less strict in SFDR Level 1. Some Article 9 product manufacturers may have to adapt or enhance their sustainable investment strategies to meet the new and more specific Article 9 requirements, while some may be required to reclassify Article 9 products as Article 8 products. For example, some Article 9 index-tracking products replicate Paris-aligned or climate transition benchmarks. Since these benchmarks fail to meet this more precise requirement of Article 9, the products which track these indices may have to be reclassified to Article 8.

But is this more specific definition enough to ensure a truly homogenous product category? The RTS specify that Article 9 products must contain sustainable investments almost exclusively, i.e. they must consist of investments in economic activities that contribute to Environmental or Social objectives, must ensure good Governance, and must follow the *Do No Significant Harm* (DNSH) principle², including as it applies to Principal Adverse Impacts (PAIs) and minimum safeguards. However, the exact percentage of sustainable investments and the determination of what it means to 'contribute' to Environmental or Social objectives continues to be defined individually by each Financial Market Participant.

² Including the application of the DNSH principle to now-mandatory Principal Adverse Impacts (PAIs) and minimum safeguards.

3. EU Delegated Acts Integrate SFDR and the EU Taxonomy into MiFID II

Prior to the full SFDR effective date of 2023, in the fall of 2022 we can expect the enactment of the EU Delegated Acts integrating SFDR and the Taxonomy into MiFID II, the UCITS Directive and AIFMD. Notably, the UCITS Directive and AIFMD Delegated Acts clarify the duties of investment fund managers to incorporate the Social and Environmental factors and risks in their own governance, organization, conflict of interest policies, investment due diligence, and risk policies.

One of the most notable requirements³ is for financial product providers to *test investors' sustainability preferences* and to take these preferences into account into their product advice. This assessment should encompass the following criteria:

- A product with a minimum proportion invested in Environmentally-sustainable investments, as defined by the EU Taxonomy (Articles 1-2), or
- A product with a minimum proportion invested in sustainable investments, as defined SFDR (Articles 2-17), or
- A product that considers Principal Adverse Impacts on sustainability factors, where qualitative and/or quantitative elements demonstrating consideration are determined by the client.

The timing creates something of a mismatch, in that the amendments to MiFID take effect in the summer/fall of 2022, while the SFDR disclosures on percentages of sustainable investments become compulsory from 1 January 2023. In theory, the SFDR disclosures should be made ahead of the MiFID amendments to carry out the sustainability preferences assessment. Given this, many product manufacturers should start to voluntarily disclose the sustainability level of their Article 9 and Article 8 products this summer. Stay tuned for Candriam's disclosures in the very near future.

³ Specifically, under MiFID II.

4. Transition and Beyond -- the ESG Template

During the transition period and beyond, the industry-developed *European ESG reporting Template* (EET) should facilitate the communication of key data between product manufacturers and distributors. The template brings together several regulations, including SFDR, MiFID, and the Taxonomy, to capture the sustainability-related information and Environmental, Social and Governance (ESG) data required by the new regulatory landscape at entity and at fund level. For example, the EET should enable distributors and fund selectors to access and filter products based on ESG criteria that are linked to the MiFID sustainability preferences assessment.

Asset managers are encouraged to publish their first EETs in early June 2022. This should be a first litmus test for banks, insurers and other distributors to concretely assess data readiness and how these data are integrated into their investment processes.

5. How Does the EU Taxonomy Fit In?

A certain lack of comparable, consistent, and high-quality data remains the root cause of many of the ESG implementation challenges.

Case in point? The EU Taxonomy on sustainable activities. In the long term, the Taxonomy will encompass two frameworks – an *Environmental Taxonomy* and a *Social Taxonomy*. At present, the Environmental Taxonomy is the most advanced, based on scientific considerations, and having defined six environmental objectives, the first two of which (climate change mitigation and adaptation) are relatively well-framed. It defines sustainable business activities based on physical performance metrics, such as CO₂ emissions per kWh.⁴ The Social Taxonomy is still at draft stage, and will rely to a greater extent on international standards and values.

As these Taxonomy-related criteria are now closely intertwined with SFDR and the resulting amendments to MiFID, the SFDR Level 2 pre-contractual templates and MiFID sustainability assessments include references to levels of Taxonomy alignment. However, it is important to note that it is currently not possible to automatically and accurately measure most companies' Taxonomy alignment due to the lack of reporting standards and relevant

data. This challenge affects all asset managers, and to some extent the entire financial industry. Again, it comes down to a lack of quality data to rigorously assess Taxonomy alignment. This can only be solved when more and better data become available. While the entry into force of the Corporate Sustainability Reporting Directive (CSRD) should provide some support on this front from 2024 onwards, at least for EU issuers, it is important for the financial market participants to continue to use their influence, notably through voting and engagement, to push for greater disclosure of non-financial information.

The data issue also affects the now-mandatory disclosures of Principal Adverse Impacts under SFDR Level 2. For example, PAI 7, which seeks to capture negative effects on biodiversity-sensitive areas, poses particular challenges. The accurate representation of impacts on biodiversity requires detailed information on companies' individual local operating plants and their local biospheres. As an illustration, biodiversity effects, in contrast to CO₂ emissions, cannot be aggregated under one single indicator. We believe investors must remain highly aware of these matters and pay close attention to the data and methodologies behind the indicators and information that is disclosed by product manufacturers.

To Ride the Waves, Know the Waters!

Look for our forthcoming articles in this series, your navigational charts to regulatory waters.

⁴ Under the Environmental Taxonomy, there are specific thresholds and requirements for each economic activity (as opposed to each sector) to be considered as significantly contributing to a sustainability objective.



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