

SFDR - One year on: Classifications clarified

Classifications and their impact on bringing a fund to market

10 March 2021 seems like a long time ago for many reasons, but the questionmarks that were in many fund's heads at the time are still in some ways present. One of the key questions the fund industry has grappled with since the introduction of SFDR is how a particular fund is to be categorised under the regulation.

Funds are subject to varying levels of rigour on disclosures and reporting, depending on whether they are classified as simply ESG cognisant or have sustainable investment as a clear objective.

Given the associated cost and complexity of extracting, collating, assessing and reporting the information required, ensuring that a fund is positioned to be correctly classified under SFDR is an important step when bringing a new fund to market, as this article explains.

Classifications put simply - Understanding your options

In simple terms, funds will fall into one of three categories under SFDR, namely:

1. Article 6 funds, being all funds which do not fall within Articles 8 or 9;
2. 'Light green' Article 8 funds, being funds which promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that investee companies follow good governance practices; and
3. 'Dark green' Article 9 funds, being funds which have sustainable investment as their objective, which 'do no significant harm' to any of the other sustainable Taxonomy objectives and whose investee companies follow good governance practices.

Article 9 - Sustainable investment is an objective of the

fund

Identifying whether a fund will fall within Article 9 is quite straightforward. If the fund is established to achieve a sustainable objective in addition to generating financial returns (i.e. it is an 'impact fund') then it is more likely than not to be classified as a 'dark green' Article 9 product.

It seems rather unlikely that a fund would inadvertently find itself categorised as an Article 9 product. This is because A) the selection of benchmark indices against which to monitor a fund's impact and B) making the achievement of sustainable goals an integral objective of a fund, are key decisions made at the conceptualisation stage of a fund's lifecycle. This was underlined by the EU Commission which, in its 26 July 2021 Q&A, clarified that even if an Article 6 or 8 fund were to make an investment which qualified as a "sustainable investment" under the Taxonomy, it would not in and of itself cause that fund to be considered an Article 9 product. Put another way, a 'dark green' categorisation generally occurs by design, not by accident.

Article 8 - The fund promotes environment or social characteristics

The EU Commission in its Q&A paper of 26 July 2021 confirmed that the category of funds that could fall within Article 8 is extremely broad, with no prescribed parameters around the composition of fund investments, minimum thresholds or investment strategies. The Commission did, however, clarify that simply taking into account sustainability risks (i.e. environmental, social or governance event or conditions that, if they occur, could cause actual or a potential material negative impacts on investment value) or considering ESG broadly in the context of making investment decisions would not in and of itself cause a fund to be categorised as an Article 8 product.

The Commission went on to focus its analysis on two factors:

1. Whether an environmental or social characteristic has been identified in the promotional materials of the fund; and
2. The extent to which these environmental or social characteristics are 'promoted' as key tenets of the marketing message; in other words, to what extent are such characteristics focussed on as a means of encouraging LPs to invest in a given fund.

The Commission clarified that for these purposes ‘promotion’ is broadly defined, capturing:

“...direct or indirect claims, information, reporting, disclosures as well as an impression that investments pursued by the given financial product...consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition in, but not limited to, pre-contractual and periodic documents or marketing communications, advertisements, product categorisation, description of investment strategies or asset allocation, information on the adherence to sustainability-related financial product standards and labels, use of product names or designations, memoranda or issuing documents, factsheets, specifications about conditions for automatic enrolment or compliance with sectoral exclusions or statutory requirements regardless of the form used, such as on paper, durable media, by means of websites, or electronic data rooms.”

Article 6 - The fund may have regard for ESG factors but fails to meet Article 8 classification

All funds within scope of SFDR must comply with Article 6. It’s clear that the range of funds that fall within Article 6 is extremely broad, ranging from those for whom ESG is a passing consideration at best, to those which are more mindful of ESG matters, through to those which give considerable weight to ESG considerations but yet fall short of Article 8 status.

Key challenges and practical issues

Going green comes at a cost - Is it worth it?

As detail of the disclosure and reporting requirements continues to emerge, it is becoming clear that managing and marketing a ‘dark green’ fund under Article 9 or a ‘light green’ fund under Article 8 of SFDR will not be without its logistical challenges and costs.

Undertaking the data collection, collation and analysis which underpins the required disclosures will be neither straightforward nor inexpensive and many have pointed out the practical issues of even extracting the raw data required from underlying portfolio companies, many of whom will not (until now) have

been asked to compile such data or in perhaps as sophisticated a fashion. There is certainly plenty of work to be done in this regard and the market is moving rapidly to adapt to these challenges with the emergence of specialist software and professional services solutions aimed at simplifying and streamlining these processes.

The final allocation of costs and their impact on fund performance remains to be seen, but it seems logical to us that managers will ultimately bear the costs of their disclosure requirements with investors bearing the costs of compliance with product level obligations.

Check with investors - Is ESG a priority and are they prepared to absorb the cost?

Green funds are currently (and commendably) popular among investors and there are certainly those who will require that a fund be classified as 'light' or 'dark' green as a condition to investing. However, others, while wanting to see a robust ESG policy, will place more weight on traditional investment metrics such as investment returns, the track-record and skillset of the investment team and the proposed sectoral or geographical exposure of the fund.

For managers whose funds are on the borderline between a 'regular' Article 6 product and a 'light green' Article 8 product, an assessment must be made, namely - does the benefit of bringing a 'light green' product to market outweigh the cost (both monetary and in terms of time and human resource) of SFDR / Taxonomy compliance?

If the investors in question are cornerstone investors, or their capital is required to hit fundraising targets, the answer to that assessment may be clear, but if that is not the case then this is a matter which will require careful consideration.

Not an article 9? Market with caution

For managers of 'dark green' (Article 9) funds, compliance with SFDR and the Taxonomy is unavoidable, those who find their funds on the cusp of a 'light green' classification should think carefully about their marketing messages and investment strategies.

Unless managers are actively attempting to bring an Article 8 fund to market,

care must be exercised by all those involved in the marketing effort to avoid inadvertently classifying a fund as an Article 8 product. This would include (for example) those involved in preparing marketing materials, drafting legal documentation and participating in investor roadshows – whether they be staff of the manager itself, professional advisers, placement agents or other intermediaries acting on behalf of the manager.

Questions have also been raised as to whether the environmental or social criteria must be “binding” or merely promoted – i.e. must they be enshrined in the fund’s legal documentation such that their consideration cannot be waived or disapplied at the manager’s discretion. While the Regulatory Technical Standards (RTS) and Q&A do refer to binding criteria, this is in the context of what may be disclosed with regard to investment selection criteria in Private Placement Memorandums (PPMs). The aim of the RTS here is to ensure that managers do not suggest that they will follow certain ‘green’ investment selection criteria at the marketing phase, only to disapply that criteria once investors are closed into the fund and capital deployment begins. However, in our view the fact that the environmental or social characteristics promoted are not binding will not of itself preclude a fund from falling within Article 8 – rather this will only preclude a manager from disclosing its ‘green’ investment criteria in the PPM.

A key question to be addressed by such managers is whether their fund is, purely by virtue of its investment strategy, by default a ‘light green’ product under Article 8 or whether they are making a business decision to position their fund as a ‘light green’ product due to market sentiment. If the former, again the way is clear – compliance must be achieved. If the latter however, managers must ask themselves whether perceived investor appetite for a ‘light green’ product is really applicable to the investors which that manager will target, or whether it is merely a perceived appetite among the LP community generally.

Somewhere between article 8 and 9? Sub-categorisation exists and brings further disclosures

To add a further degree of complexity to the categorisation analysis, the RTS establish a further distinction within Article 8 between funds which do not make a sustainable investment and those which commit to making (or make) at least one sustainable investment (which we will refer to as “Article 8+” funds).

For Article 8+ funds, further disclosures will be required regarding whether its sustainable investments have an environmental or social objective and, for those with an environmental objective, whether those investments are Taxonomy aligned or not. A similar distinction exists under Article 9, save that Article 9 funds will be required to also disclose what percentage of a portfolio comprises investments with environmental objectives and what percentage comprises investments with social objectives.

The creation of sub-categories in this manner is a trend that we anticipate will continue as the SFDR and Taxonomy implementation process progresses, the net result being that investors will be afforded ever greater transparency and granularity in terms of pre-contractual disclosures and on-going reporting which, in turn, will allow LPs to take an ever more sophisticated (and perhaps prescriptive) approach to portfolio building.