SFDR: what you need to know for 2023

The EU's Sustainable Finance Disclosure Regulation (SFDR) is evolving. In this article, *Katrina Magsino* and *James Gow* unpick the latest regulatory changes in the ESG space, and summarise what you need to do when it comes to ESG disclosure and reporting in 2023.

Since March 2021, SFDR has changed to include EU Taxonomy Regulation, which establishes specific environmental criteria relating to economic activities for investment purposes. These enhanced disclosure obligations are required under SFDR, effective from January 2022. There's an ever-growing need for disclosure and transparency when it comes to ESG, and this is expected to grow further over time.

Let's have a quick refresher on what SFDR is, who it effects and what you need to do:

WHAT? The Sustainable Finance Disclosure Regulation (SFDR) is the European Union's attempt to harmonise ESG disclosure standards across the continent. It provides a comprehensive sustainability disclosure requirement covering a wide range of environmental, social and governance metrics and criteria.

SFDR's main goal is to integrate sustainability risks into firms' investment processes, and report on such integration both at a company and product level.

WHY? SFDR is part of the EU Action Plan on Financing Sustainable Growth, with an overarching goal of providing a link between finance and sustainability. It was introduced to encourage and improve transparency in the sustainable investment markets and to prevent greenwashing.

WHO? The regulation applies to financial market participants (FMPs) and financial advisors. Any company that offers and develops financial products needs to report SFDR in addition to existing disclosure obligations of the financial undertaking of their products. Although it applies mainly to companies operating in the EU, non-EU companies will be indirectly affected through its EU subsidiaries, the provision of services in the EU and market pressures.

WHEN? Following the introduction of SFDR Level 1, the Regulatory Technical Standards (RTS) for SFDR Level 2 were published and are mandatory from January 2023. SFDR Level 2 is still being developed but approval is expected in the medium term, with implementation expected this year.

HOW?

Under SFDR, investment products are classified as one of the following:

- **Article 8** (Light Green) funds integrating ESG factors, considered to be more focused on financial materiality
- **Article 9** (Dark Green) funds focusing on sustainable economic activities or impact, and/or aiming to reduce carbon emissions in line with the Paris Agreement.
- **Article 6** (All other funds) with no specific ESG considerations integrated into the investment process.

REPORTING: SFDR requires companies to disclose any ESG factors that are being adopted in their decision-making processes.

SFDR applies different disclosure requirements and implementation timeframes depending on the type of content information is being expressed in:

	Websites	**Pre-contractual disclosures & Marketing Materials (and if not relevant, why)**	**Periodic Reports**
FMPs (Entity Level)	**Sustainability Risk Policy** – Information on the integration of sustainability risks in their investment decision-making process. (And if not relevant, why). When "principal adverse sustainability impacts" are being considered, statements with their due diligence policies. (And if not relevant, why). Principal adverse impacts statement.	Way in which sustainability risks are integrated into their investment decisions and the results of that assessment. Must publish a clear and concise reason why sustainability risks on the returns of the financial products are not relevant.	**Sustainability Risk Policy** – Information on the integration of sustainability risks in their investment decision-making process. (And if not relevant, why). When "principal adverse sustainability impacts" are being considered, statements with their due diligence policies. (And if not relevant, why). Principal adverse impacts statement.

FMPs (Product Level)	Information on products pursuing sustainable objectives or promoting E&S characteristics.		Information on how sustainable objectives or E&S characteristics are met.
Financial advisors (Entity Level)	Information on integration of sustainability risks (including principal adverse sustainability impacts) in their investment advice or insurance advice on their websites. (And if not relevant, why).	How sustainability risks are integrated into their investment or financial advice. The result of the assessment of the likely impacts of sustainability risks on the returns of the insurance products.	

Disclosures also need to be made when it comes to an entity's Sustainability Risk and Principal Adverse Impacts (PAI):

	FMPs	**Financial Advisors**	**Products**
Sustainability Risk	Sustainability Risk Policy integration in the investment decision-making.	Sustainability Risk Policy integration in the investment or insurance advice.	Disclose the manner in which Sustainability Risks are integrated into their decision-making and assessment of the likely result of it on the returns of the product.
PAI (Principal Adverse Impacts) ** minimum of 16 indicators consisting of 14 mandatory (nine environmental and five social) and two additional.*	Considerations of PAIs investment decisions on different sustainability factors. Due Diligence policy statement. Mandatory for large companies (more than 500 employees) and comply and explain for smaller ones.	Considerations of PAIs investments and insurance advise on different sustainability factors. Comply and explain.	Disclose how each financial product considers the adverse impact on sustainability factors.

Sustainability Finance Disclosure Regulations (SFDR), Taxonomy Regulations (EU Taxonomy) & Corporate Sustainability Reporting Directives (CSRD)

These regulations require FMPs and asset managers to be transparent on sustainability and impose mandatory ESG disclosure. Taxonomy Regulation on the other hand sets out criteria for identifying if an activity is environmentally sustainable, including whether the activity contributes to, or does significant harm to, one or more of the below environmental objectives:

- Climate change mitigation
- Climate change adaptation
- Sustainable use and protection of water and marine resources
- Transition to a circular economy (including waste prevention and recycling)
- Pollution prevention and control

- Protection of health ecosystems

In October 2021 the EU published a draft RTS which provides guidance and templates relating to pre-contractual and periodic disclosure for Article 8 and Article 9 products.

Although the Taxonomy's **'Do No Significant Harm' (DNSH)** statement relates to harm on other environmental objectives not pursued, Disclosure Regulations' DNSH is more in line with the minimum precautions of the Taxonomy. As per the European Securities and Markets Authority's (ESMA's) Final Report on the draft RTS, DNSH reporting must show whether investments are aligned with the OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Rights, Declaration of the International Labour Organization on Fundamental Principles and Rights at Work, and the International Bill of Human Rights. In addition to having good governance practice.

In September 2022, ESMA duly delivered its first report, with amendments for financial products exposed to investment in nuclear and gas activities now aligned with the Taxonomy regulation (TR).

All product disclosure templates (per RTS Annexes II, III, IV, V) have been revised to include:

- New indicators of financial products investing in **fossil gas and/or nuclear energy**.
- Updated graphs depicting these investments (aligned with the Taxonomy, including key performance indicators).
- Additional information must also be included in financial product website disclosures (per RTS Chapter IV).

Furthermore, Article 8 of the Taxonomy Regulation requires companies covered by the current Non-Financial Reporting Directive (as well as any new companies covered by the CSRD) to report on the sustainability of their operations. Companies will be required to submit these metrics in addition to other ESG/sustainability data required by the CSRD.

These three regulations are directly linked to each other. Corporations subject to CSRD are required to make Taxonomy-related disclosures; their reporting is directed via financial market participants, who are subject to SFDR reporting obligations which also includes Taxonomy-related disclosures.

ESG Related Fund Names

In November 2022, ESMA, the EU's financial markets regulator and supervisor, announced a consultation and draft guidelines on the use of ESG/Sustainability-related terms in a fund's name, to avoid confusion or deceptive fund names.

The draft included elements of guidelines where:

- Fund names which contain ESG-related words should have a minimum threshold of 80% of its investments meeting a specific goal or objective.
- An additional threshold (minimum of 50% investment) as defined in SFDR, for the use of "sustainable" or any sustainability-related term only, as part of the 80% threshold.
- Funds that are using an index as a reference are allowed, only if they use the same benchmarks and criteria met by the fund (or exclusion criteria provided in the name).
- When a Fund is using the word 'impact' or the term 'impact investing', it should meet the proposed benchmark, and make investments with the intention on generating measurable socially and environmentally positive results alongside the financials.

This consultation ends in February 2023 with final guidance provided by Q2-3 2023, before becoming applicable three months later. A six month transitional period will then be given for funds in scope.

One of the main positive impacts of upcoming mandatory disclosure reporting is that every company will need to be accountable and transparent when it comes to ESG and sustainability. And this greater scrutiny has led to fund managers across the globe to re-evaluate the classifications of their funds, from Article 9 to Article 8 for example – an activity which has become known as 'The Great Reclassification'.

As of November 2022, more than 130 funds have been downgraded to Article 8 as they either failed to meet the necessary criteria, or are not able to provide the necessary statistics to verify their success in this area.

With the final date to report on SFDR (30 June 2023) fast approaching, please contact us if you’d like to discuss how Aztec can support you with your ESG data and reporting needs. We can help you identify the most relevant ESG factors for your business.