FINANCE BRIEFING

Sustainable finance: an evolving landscape for Article 9 products

The Sustainable Finance Disclosure Regulation (*2019/2088/EU*) (the Disclosure Regulation) entered into force on 29 December 2019 and most of the provisions have applied since 10 March 2021.

Commission Delegated Regulation (*2022/1288/EU*) (the Implementing Regulation) sets out details of the content and presentation of the disclosures required under the Disclosure Regulation (*www.practicallaw.com/w-036-6535*).

The Disclosure Regulation was also amended, and is complemented, by the Taxonomy Regulation (*2020/852/EU*) (*see box "The Taxonomy Regulation"*).

The key aim of the Disclosure Regulation is to require manufacturers of certain financial products to report on the integration of sustainability risks and the consideration of adverse sustainability impacts into their investment decision-making processes, at both product and entity levels (*see below and box "What financial products are covered?"*).

Financial product manufacturers are referred to as financial market participants (FMPs). For example, an alternative investment funds (AIF) manager is an FMP in respect of its AIFs.

The objective of the disclosure requirements is to improve investors' access to information on how FMPs integrate relevant sustainability-related considerations, whether material or likely to be material, into their processes, thereby combatting greenwashing (*see News brief "Greenwashing: scrutiny and sustainability", www.practicallaw.com/w-037-7042*).

Disclosures

Information on sustainability risks is information on environmental, social or governance (ESG) events or situations which, if they occurred, could negatively affect the value of the investment.

Information on adverse sustainability impacts is information on the negative consequences of investments on sustainability factors; that is, environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

Product categories

The Disclosure Regulation establishes three broad product categories to determine the extent of the product-level disclosure required:

- Article 6 products. These products do not promote environmental or social characteristics or have sustainable investment as their objective.
- Article 8 products. These products promote, among other characteristics, one or more environmental or social characteristics.
- Article 9 products. These products have sustainable investment as their objective. In particular, under Article 9(3) of the Disclosure Regulation, these products can have a reduction in carbon emissions as its objective.

Despite the insistence of the European Commission (the Commission) and the European Securities and Markets Authority (ESMA) that the Disclosure Regulation is a transparency regime and not a labelling regime, these categories have become a de facto labelling system, with many FMPs seeing value in being able to promote products as qualifying under Article 8 or Article 9. This has prompted ESMA to caution that the misuse of the Disclosure Regulation as a marketing tool could create potential risks to investors, as demand for sustainable products remains strong.

However, with respect to the Article 9 category, in particular, this type of use is not wholly unjustified. Compared to Article 8 products, which may have various degrees of sustainability-related ambition, products that are subject to disclosure under Article 9 should, in general, only make investments that qualify as sustainable investments as defined in Article 2(17) of the Disclosure Regulation (*see "Sustainable investments" below*). This

The Taxonomy Regulation

The Taxonomy Regulation (*2020/852/EU*) and related delegated acts establish technical screening criteria for determining whether an economic activity is environmentally sustainable, by reference to the following environmental objectives:

- Climate change mitigation.
- Climate change adaptation.
- The sustainable use and protection of water and marine resources.
- The transition to a circular economy.
- Pollution prevention and control.
- The protection and restoration of biodiversity and ecosystems.

In addition, the Taxonomy Regulation requires undertakings that are subject to an obligation to publish non-financial information in accordance with Article 19a of the Accounting Directive (*2013/34/EU*) or, where applicable, consolidated non-financial information according to Article 29a of the Accounting Directive, to include in their non-financial statements information on how, and to what extent, their activities are associated with environmentally sustainable economic activities (*Article 8, Taxonomy Regulation*).

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What financial products are covered?

The products that are specified in the Sustainable Finance Disclosure Regulation (*2019/2088/EU*) as financial products include:

- Alternative investment funds.
- Portfolio management products.
- Insurance-based investment products.
- Undertakings for collective investment in transferable securities.
- A range of pension products.

is the position taken in the Implementing Regulation and reiterated by the Commission in its interpretive guidance on the Disclosure Regulation and the Implementing Regulation (the guidance) (*www.esma.europa.eu/sites/default/files/2023-05/JC_2023_18_-_Consolidated_JC_SFDR_QAs.pdf*).

On the other hand, an Article 9 product may invest in economic activities that contribute to an environmental objective but do not qualify as environmentally sustainable economic activities under the Taxonomy Regulation (*see "Taxonomy alignment" below*).

Current landscape

As a result of the Commission's evolving stance with respect to the Disclosure Regulation and, in particular, Article 9, the scope of Article 9 has always been fraught with uncertainty. Many products that were initially qualified by their FMPs as Article 9 products were downgraded to Article 8 products in the weeks before the Implementing Regulation entered into application on 1 January 2023.

However, following the most recent edition of the guidance, some FMPs are now considering relabelling funds that passively track EU Paris-aligned benchmarks (PABs) or EU climate transition benchmarks (CTBs) as Article 9 products.

The goalpost may shift yet again as a result of the consultation on the review of the Implementing Regulation (the review), which ESMA and the other European supervisory authorities (together, the ESAs) published on 12 April 2023 (*see "The review" below*) (*www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation*).

Sustainable investments

As discussed above, Article 9 products are characterised by a requirement to, in general, invest only in sustainable investments (*see "Product categories" above*). This covers both direct and (in the case of funds of funds, for example) indirect investments.

A sustainable investment is an investment in an economic activity that contributes to an environmental or social objective, provided that it does not significantly harm (DNSH) any of those objectives and that investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

An investment's contribution to an environmental objective can be measured, for example, by key resource efficiency indicators on:

- The use of energy, renewable energy, raw materials, water and land.
- The production of waste and greenhouse gas (GHG) emissions.
- Its impact on biodiversity and the circular economy.

An investment that may be considered to contribute to a social objective includes, in particular, an investment:

- That contributes to tackling inequality.
- That fosters social cohesion, social integration and labour relations.
- In human capital, or economically or socially disadvantaged communities.

The Commission has confirmed that FMPs have a degree of flexibility in determining what qualifies as a sustainable investment. Pointing to the fact that the Disclosure Regulation does not set out minimum requirements for concepts such as contribution, it has noted that there is no set approach to determining the contribution of an investment to environmental or social objectives. Instead, FMPs must disclose, in accordance with Article 9 and related provisions of the Disclosure Regulation and the Implementing Regulation, the methodology that they have applied to carry out their assessment of sustainable investments, and must exercise caution in so doing.

Notably, FMPs can invest in funding instruments, such as the ordinary equity or debt of an investee company, that do not specify the use of proceeds.

However, an investment in a company that has a transition plan aimed at mitigating harm to environmental or social objectives in the future may not, in itself, be sufficient to qualify as a sustainable investment (*see feature article "Climate transition plans: charting a greener future", www.practicallaw.com/w-039-1698*).

Investment strategies

Investment strategies that are compatible with Article 9 include, in principle, all of the following, provided that the investments of the product qualify as sustainable investments:

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- Screening strategies.
- Exclusion strategies.
- Best-in-class strategies.
- Best-in-universe strategies.
- Thematic investing strategies.
- Strategies that entail the certain redistribution of profits or fees.

However, the Implementing Regulation singles out exclusion strategies for a note of caution, contesting that some exclusion strategies lead to the exclusion of only a limited number of investments, or are based on exclusions required by law. To prevent mis-selling and greenwashing, and to provide end investors with a better understanding of the effects of the exclusion strategies applied by certain products, FMPs should confirm any commitment in terms of excluded investments, in particular, as binding elements of the investment strategy, in information on asset allocation and in the information on the sustainability indicators that are used to measure the effects of these strategies.

Due diligence

In order to demonstrate that an investment satisfies the DNSH requirement, the FMP must disclose how certain principal adverse impact (PAI) indicators, which are set out in Table 1 of Annex 1 to the Implementing Regulation, and any relevant indicators in Tables 2 and 3 of that Annex, have been taken into account. The Disclosure Regulation does not set any particular threshold for the concept of significant harm, leaving to FMPs the responsibility of ensuring that any adverse impacts that the product's investments may have are adequately prevented or mitigated at all times.

In order to demonstrate that investee companies follow governance practices, the FMP must consider its alignment with the Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises (the OECD guidelines) and the United Nations Guiding Principles on Business and Human Rights (UN principles).

Taxonomy alignment

Under Article 3 of the Taxonomy Regulation, an economic activity qualifies as environmentally sustainable where that economic activity contributes substantially to one or more of the environmental objectives set out in Article 9 of the Taxonomy Regulation according to the criteria set out in the Taxonomy Regulation; does not significantly harm any of those environmental objectives according to the criteria in the Taxonomy Regulation; is carried out in compliance with minimum safeguards relating to alignment with the OECD guidelines and the UN principles; and complies with certain technical screening criteria that have been established by the Commission (*see box "The Taxonomy Regulation"*).

Under Article 5 of the Taxonomy Regulation, where an Article 9 product invests in an economic activity that contributes to an environmental objective, disclosure concerning the environmental objectives set out in Article 9 of the Taxonomy Regulation to which the product's investments contribute is required. Information on how and to what extent the investments are in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation is also required.

Data

The Commission has emphasised that FMPs should have reliable data for the purposes of the required disclosures. Accordingly, where an FMP fails to collect reliable data, disclosures should generally indicate zero taxonomy alignment.

However, in exceptional cases, relating to investee companies that are not themselves subject to taxonomy-alignment disclosure requirements under the Taxonomy Regulation (*see box "The Taxonomy Regulation"*) and only for those economic activities for which complete, reliable and timely information could not be obtained, FMPs are allowed to make complementary assessments and estimates on the basis of other information sources. These assessments and estimates should only compensate for limited and specific parts of the desired data elements and produce a prudent outcome.

Exceptions

The Commission appears to admit certain exceptions to the requirement, in principle, for Article 9 products to make 100% sustainable investments:

- Article 9 products can make other investments where required under sector-specific rules applicable to the financial product. Specifically, an Article 9 product may, in order to meet prudential, product-related, sector-specific requirements, include investments for purposes such as hedging or liquidity. However, such investments must be in line with the sustainable investment objective.
- Products that have an Article 9(3) objective of a reduction in carbon emissions can be products with either a passive or an active investment strategy. There is no need for an Article 9(3) product to track a PAB or a CTB but, in that case, the Disclosure Regulation requires a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the objectives of the Paris Agreement of limiting long-term global warming. However, Article 9(3) products that passively track PABs or CTBs are automatically deemed to have sustainable investments as their objective.

The review

The purpose of the review is to broaden the disclosure framework and address certain technical issues concerning PAI indicators, which would impact the DNSH framework for sustainable investments, and to propose amendments to include GHG emissions reduction targets. The ESAs also propose certain other amendments, including as regards DNSH.

PAIs. Among other things, the review proposes to extend the list of social indicators for PAIs, based on the first set of the draft EU sustainability reporting standards (ESRS) that were recently approved under the EU's wider corporate sustainability reporting framework, but with some additional indicators not covered by the ESRS.

The ESAs also propose to amend the wording of a number of current PAI indicators to align to the data points reported under the ESRS, or to otherwise refine their content and respective definitions, applicable methodologies, metrics and presentation.

Notably, the ESAs propose that the contribution of investee companies' value chains to PAI measurements should be

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considered where the investee company reports impacts in its value chain according to the ESRS. In all other cases, FMPs should include information on the value chains of investee companies only where that information is readily available.

GHG emissions reduction targets. The ESAs propose that products with GHG emissions reduction targets will have to provide information on, among other things, the way that the target will be achieved, the compatibility of the target with limiting global warming to 1.5 degrees (as set under the Paris Agreement), the baseline GHG emissions of the product, and the final and intermediate decarbonisation targets and corresponding timelines.

DNSH. The review expresses concern about the lack of transparency and comparability in the DNSH disclosures that are currently being published by FMPs, noting that a significant share of Article 9 products have exposures to fossil fuels. The ESAs propose several options, including requiring more detailed disclosures, providing an optional safe harbour for taxonomy-aligned investments or shifting to a single taxonomy-based system.

Impact for UK firms

The Disclosure Regulation has direct effect for EU firms so, following the UK's departure from the EU, UK firms are not, in general, directly subject to it. In addition, the Disclosure Regulation was not implemented into UK domestic law at the end of the Brexit transition period. However, there are situations where it could be indirectly relevant to a UK firm, including where:

- There are contractual arrangements under which an EU firm delegates to a UK firm and imposes a requirement on the UK firm to comply with the Disclosure Regulation.

- A UK fund manager is marketing non-EU funds into the EU and therefore becomes subject to the Disclosure Regulation in respect of the marketing of those funds.

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