

Sustainable Finance Consultations May Signal Key Changes

By **Ferdisha Snagg and Andreas Wildner** (November 16, 2023)

On Sept. 14, the European Commission launched its review of the European Union's Sustainable Finance Disclosure Regulation.[1]

The SFDR, one of the core pieces of the EU's sustainable finance framework, imposes on financial market participants transparency requirements relating to the integration of sustainability risks in their decision making and the consideration of adverse sustainability impacts of their investments.

The SFDR entered into force in December 2019 and has applied in earnest from March 2021.

The commission published two consultation documents:

- A public consultation aimed at persons with general knowledge of the SFDR, which focuses on the current requirements of the SFDR and its interaction with other sustainable finance legislation;[2] and
- A targeted consultation aimed at persons who are more familiar with the SFDR and the EU's broader sustainable finance framework, which repeats the questions in the public consultation but also poses a series of more detailed questions on potential changes to the regulation.[3]



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The consultations are open until Dec. 15.

While any potential changes are likely to take some time to materialize, the consultations signal possible important and fundamental changes to the SFDR, notably the potential introduction of a new product categorization regime, that will expressly function as a labeling system, whereas the SFDR's current product categories operate as de facto product labels.

This article seeks to further draw out some of the key points of the consultations, focusing on how they reflect the commission's thinking on how the SFDR regime should develop in the future.

Current Requirements and Interaction With Other Sustainable Finance Legislation

A key concern of the commission is the SFDR's perceived effectiveness. As EU commissioner for financial services, financial stability and capital markets union Mairead McGuinness highlighted recently, the SFDR was one of the first elements of the sustainable finance framework that was introduced following the launch of the EU's first action plan on sustainable finance in 2018.

While it did deliver some of the intended transparency improvements, the commission —

acknowledging that in the relatively new area of sustainable finance it is "literally learning by doing" — is asking itself how the SFDR is viewed by the market and how it can be improved.[4]

Against this background, both consultations raise general questions aimed at understanding market participants' experiences with the regulation, including any shortcomings and the interaction with other parts of the European framework for sustainable finance.

One area of questions relates to how the SFDR has worked in practice. For example, the consultations seek feedback on how effective the SFDR has been in achieving its key objectives, i.e., transparency regarding sustainability risks and impacts, investor protection, and the channeling of capital toward sustainable investment — but also ask whether the overall transparency objective remains relevant.

The commission is also interested in understanding the areas where entities are facing challenges in obtaining good-quality data. A number of the questions also focus on how far the regime allows for the use of estimates to fill data gaps, the clarity of the rules in this area, and the types of estimates that entities use in practice, such as internal or external environmental, social and governance score models.

Another section in both consultations is dedicated to understanding the costs of complying with SFDR requirements, and whether these costs are proportionate to the benefits of the framework. The questions in this section ask respondents to break down compliance costs into various categories and to distinguish between one-off and recurring costs, as well as between product and entity-level disclosure costs.

Importantly, the consultations also seek input on the interaction of the SFDR with other parts of the EU's ever-expanding sustainable finance regime, as well as potential inconsistencies or misalignments — and the extent to which existing guidance clarifies the issues.

Key questions in this respect relate to discrepancies in definitions in the SFDR and the Taxonomy Regulation and consistency of disclosures required under the SFDR and the Corporate Sustainability Reporting Directive respectively.

The potential to streamline the same, or the extent to which product disclosures are required under the SFDR, is sufficiently useful to enable firms to conduct suitability assessments under the Markets in Financial Instruments Directive and the Insurance Distribution Directive.

Categorization System for Financial Products

However, the aspect of the consultations that has captured the greatest amount of interest from market participants is the commission's suggestion to potentially establish a categorization system for financial products.

The commission concedes that the market is effectively using the distinction between Article 6 financial products, Article 8 financial products — light green — and Article 9 financial products — dark green — as a product label regime, something the SFDR was not designed to be.

In particular, noting that the SFDR regime was designed to be of broad scope and flexible in terms of its requirements, the commission acknowledges that it is precisely these qualities

that may give rise to greenwashing risks when used for product labeling purposes.

Moreover, the introduction of separate labeling regimes at member state-level, pending the introduction of a harmonized labeling framework, risks market fragmentation.

Seeking to address these issues, the targeted consultation solicits views on the merits of developing a more precise EU-level product categorization system. The commission also asks for input regarding the governance arrangements that such a system might warrant, for example, third-party verification versus self-declaration.

The consultation puts forward two broad approaches or potential product categorizations.

One approach would build on the existing disclosure categories, by converting Articles 8 and 9 into product categories. The commission recognizes this would require clarifying and specifying criteria for key underlying concepts such as environmental or social characteristics, sustainable investment, contribution to an environmental or social objective, and do no significant harm.

The commission also seeks feedback on what promotion of relevant characteristics means for the purposes of Article 8 of SFDR and what the minimum proportion of investments in taxonomy-aligned activities should be in order to qualify as an Article 8 or Article 9 financial product.

The other contemplated approach would establish a different categorization scheme, for example by focusing on the type of investment strategy. Specifically, the commission seeks input on the usefulness of the following product categories:

- Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability-related problems that affect people or the planet;
- Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme;
- Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets in which they invest; and
- Products that exclude activities or investees involved in activities with negative effects on people or the planet.

Interestingly, the first three of these categories broadly correspond to the labels that the U.K. Financial Conduct Authority proposed in its October 2022 consultation paper on sustainability disclosure requirements and investment labels, namely the "sustainable impact," "sustainable focus" and "sustainable improvers" labels respectively.[5]

The commission also asks whether it might be useful to distinguish between products with a

social and environmental focus, whether the various products should be mutually exclusive, and what the minimum criteria for each product category might look like.

The consultation also contains a section on marketing communications and a potential naming regime. The concerns that underpin these questions seem to be the potential for product names and marketing communications to mislead investors.

This is a reasonable concern since, for example, products that do not qualify for a sustainable product category, could nevertheless, in the absence of appropriate rules, be named or marketed in a way that may suggest they are sustainable.

Accordingly, these questions seek input on a number of pertinent questions in this regard:

- Whether the introduction of product categories should be accompanied by specific rules on how market participants must label and communicate on their products;
- Whether the use of terms such as "sustainable," "ESG," "sustainable development goals," "green," "responsible" and "net zero" should be prohibited for products that do not fall under at least one of the defined product categories; and
- Whether certain terms should be linked to a specific product category and should be reserved for the respective category.

Disclosure Requirements

Perhaps as important for market participants as the possibility for new product categories, the consultation seeks comment on the existing SFDR disclosure requirements for financial market participants. A number of significant potential changes are mooted. Some of the questions draw on the considerations set out in other parts of the consultation. For example, the consultation raises the possibility of removing entity-level disclosures under the SFDR in Articles 3, 4 and 5.

This is on the basis that, considering other EU legislation requiring entity-level disclosures, e.g., the Corporate Sustainability Reporting Directive, there might be room for streamlining sustainability-related entity-level requirements across different pieces of legislation.

In particular, the consultation asks which principal adverse impact, or PAI, indicators are the most and least useful, suggesting that the commission may be considering removing some of the less useful PAIs. The consultation also poses questions regarding the interaction of the potential new product categorization regime with the disclosure requirements.

Another set of questions relates to potential additional disclosure requirements that would apply uniformly to all financial products, regardless of sustainability-related claims. This is underpinned by the concern that, by requiring additional disclosures from products that factor in sustainability considerations, the SFDR places greater burden on such products than on others.

Such uniformly applicable disclosure requirements could include reporting on certain PAI indicators, taxonomy-related disclosures, engagement strategies, and exclusions and information about how ESG-related information is used in the investment process, which would therefore mean that products that do not have any binding sustainability commitments — Article 6 products — would have to provide information on their sustainability features and performance.

The commission also moots an alternative version of this whereby uniform disclosure requirements would apply to some financial products, regardless of their sustainability-related claims but dependent on certain thresholds, e.g., based on assets under management, or target market, e.g., products targeted solely at retail investors.

A further idea suggests that certain information could be taken into account in determining product-level disclosures, such as whether some of the underlying investments are outside the EU, whether some of the underlying investments are in small and medium-sized enterprises and whether the product is a wrapper offering choices between underlying investment options.

Regarding the interaction of entity-level and product-level disclosures, an interesting question posed in the targeted consultation is whether these should be independent.

Currently, the commission appears to take the view that a product could consider PAI indicators or sustainability considerations even where the manufacturer — financial market participant — does not consider PAIs. The commission's question might suggest that it is reconsidering this view.

The consultation also asks whether it would be useful if product-level disclosures were expressed on a scale. The commission does not set out what this scale could be, but this could potentially be similar to the risk scale technique employed by the Packaged Retail Investment and Insurance Products Regulation.

Lastly, motivated by the policy rationale that in order for disclosures to be effective, they need to be accessible and usable to end investors, the consultation contains various questions about the need to improve the accessibility of SFDR information, such as whether the SFDR information should be machine-readable and subject to specific machine-readable format requirements, interactive or available in the upcoming European single access point.

Conclusion

At a time when other jurisdictions, like the U.K., are working to calibrate an appropriate framework for sustainability disclosure requirements, the commission's review, coming relatively soon after the regime's application began, illustrates the difficult and nuanced policy considerations at play: Disclosure regimes seek to deter greenwashing and, at the same time, encourage sustainable investment.

For now, however, market participants will just have to wait and see how the commission's review pans out. Once the commission considers the responses to the consultations, at the end of the consultation period, proposals to amend the regulation may follow.

While it is to be hoped that in future the regime might be less onerous, more integrated with the EU's broader sustainable finance regulatory regime and aligned to some extent to the U.K.'s sustainability disclosure requirements, it is not possible to draw any strong conclusions from the range of ideas put forward by the commission on the likely direction of

travel.

What is more, the appetite of the EU Council and Parliament to redesign the framework, so soon after its implementation, is unknown.

Yet there are clearly issues with the framework. Pending any legislative change, which could take a while to materialize, there will likely be the need for further regulatory guidance, that market participants will have to look out for and react to.

It may be some time yet before the sands cease to shift, in the EU or elsewhere, for sustainable finance regulation.

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[1] Regulation (EU) 2019/2088.

[2] https://finance.ec.europa.eu/system/files/2023-09/2023-sfdr-implementation-consultation-document_en.pdf.

[3] https://finance.ec.europa.eu/system/files/2023-09/2023-sfdr-implementation-targeted-consultation-document_en.pdf.

[4] https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_23_4863.

[5] <https://www.fca.org.uk/publication/consultation/cp22-20.pdf>.