

SFDR 2.0 – A time for evolution

On 14 September 2023, the European Commission launched a public and [targeted consultation](#) on the implementation of Sustainable Finance Disclosure Regulation (SFDR) (the Consultation). The Consultation seeks to assess the SFDR framework (identifying any potential shortcomings) whilst also focusing on the usability of the regulation and its ability to play its part in tackling greenwashing.

The Consultation is ambitious and wide ranging, and seeks feedback on the costs, disclosure and data associated with SFDR compliance as well as how SFDR interacts with other sustainable finance legislation. But perhaps what is of most interest is the Consultation's questions in respect of the development of *"a more precise product categorisation system"*.

The European Commission acknowledges in the Consultation that SFDR is already operating as a de facto product labelling regime. Specifically, the Consultation asks for respondents' view on the statement that *"SFDR is not used as a disclosure framework as intended, but as a labelling and marketing tool"*. Rather than seeking to re-focus SFDR as a disclosure regulation, the European Commission has proposed two possible approaches in the Consultation for repurposing SFDR 2.0 as a product regime.

The first approach put forward is to *"build on and develop the distinction between Articles 8 and 9"* and the existing concepts embedded in them (such as environmental/social characteristics, sustainable investments and do no significant harm), complemented by additional minimum sustainability criteria that more clearly define the products falling within the scope of each Article.

The second approach is to establish a new product categorisation system based on the product's investment strategy. The Consultation has proposed four sustainability product categories, namely:

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

Firstly, it must be recognised that publication of the Consultation is timely and represents a positive step by the European Commission.

The challenges presented by the phased implementation of SFDR have been well documented. So the opportunity for industry to provide feedback to the European Commission, particularly so soon after its full implementation, is extremely welcome.



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Looking at the two approaches proposed in the Consultation, we would be supportive of the first approach - to build upon and enhance the existing SFDR framework, as opposed to potentially starting again with entirely new sustainability product categories. We would contend that, rightly or wrongly, the ship has sailed on SFDR being purely a disclosure regulation. In reality, it is being used as a de facto labelling regime. Industry (at both the market participant and investor level) has adopted the three categories of sustainability funds identified within SFDR as product labels. The concept of an Article 6 fund, an Article 8 fund and an Article 9 fund have all now entered into the asset management lexicon. There is growing understanding of the basic distinctions between each of these categories. We would also contend that, in addition to SFDR no longer being a simple disclosure regulation, the way in which it is being implemented by EU regulators (in particular, the oversight role of the depositary) has seen it already transform into a quasi-product regime.



We believe introducing minimum sustainability criteria will be key, not only from distinguishing between Article 8 and Article 9 funds, but also between Article 6 and 8 funds.

SFDR remains in its infancy and is still evolving. However, as we observed in our [SFDR Impact Analysis](#), SFDR has already had a significant positive impact on the European funds space. Assets in European sustainable focused funds have exceeded €5 trillion. Over 40% of all new funds established in the European Union are seeking categorisation as either Article 8 or Article 9 funds. Even at this early stage, all signs suggest that SFDR is indeed contributing towards the objectives of the European Green Deal to reorientate private capital towards the transition to a climate-neutral, green and inclusive European economy. It would perhaps be a step backwards if the categories of Article 8 or Article 9 funds were, as the Consultation phrases it, to “disappear altogether from the transparency framework”. Rather, we believe that the European Commission should embrace how SFDR has developed to date, and focus its efforts on the areas which need enhancement or further clarity.

We would also be supportive of the Commission building on the distinctions between Article 8 and Article 9 funds. We believe that introducing minimum sustainability criteria will be key, not only from distinguishing between Article 8 and Article 9 funds, but also between Article 6 and 8 funds.

SFDR currently does not apply any minimum sustainability criteria or thresholds for what constitutes an Article 8 fund. As a result, the Article 8 category has become quite a broad church. We have seen plenty of what could be described as *strong* Article 6 funds demonstrating more ESG credentials than a *weak* Article 8 fund. The theme of Article 8 funds currently capturing wide-ranging and varying degrees of sustainability is a theme echoed in the feedback and guidance being issued by regulators across Europe in recent months. Regulators have warned that the Article 8 category should not in and of itself be relied upon as reflecting distinct levels of sustainability, and that managers should therefore not be using SFDR categorisations as sustainability labels. Regulators have similarly queried whether such an approach meets the spirit of SFDR.

Introducing minimum sustainability criteria would address these issues. Establishing a baseline of what constitutes an Article 8 fund would also provide investors with more certainty about its ESG credentials, whilst also affording them the reassurance to compare Article 8 funds with greater certainty.

Looking at the second approach proposed, while encouraging the creation of these types of products is laudable, it would be our view that these types of products are already being established as either Article 8 or Article 9 funds in the existing SFDR framework. Removing the existing Article 8 and Article 9 categories entirely, and replacing them with the proposed four new types, would likely lead to another lengthy implementation period for the industry. In turn, this would potentially entail significant new implementation costs being borne by asset managers, the funds and most importantly, investors. The Consultation acknowledges (and is seeking to further examine) the impact that SFDR compliance has had on both initial and recurring annual costs. It would therefore seem at odds with that view if SFDR 2.0 was to be an entirely repurposed regime.

In examining how the existing Article 8 and 9 categories can be enhanced, the Consultation is asking the right questions. Evolving SFDR and the Article 8 and 9 categories would allow managers to build on its success to date, while also embracing its evolution into a product regime through more precise categorisation criteria.

The Consultation remains open until 15 December 2023 but the European Commission has not yet committed to a timeline for subsequent reforms. Managers should take comfort that any substantial changes to SFDR or the introduction of a new categorisation regime will take a number of years before entering into force.

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