Review of Sustainable Finance Disclosure Regulation—Commission Proposal Published

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The European Commission (the "Commission") has published the text of its proposed changes to the Sustainable Finance Disclosure Regulation ("SFDR" or the "Regulation"). The review of SFDR has been long anticipated, with the Commission's draft proposing three new categories for funds with sustainable characteristics, replacement of the existing framework of products disclosing under Articles 8 and 9 of SFDR, which the Commission notes have been used as *de facto* sustainability labels. The review also introduces important simplifications to the regime, including replacement of the existing disclosure and reporting templates.

Under the changes, all funds that are offered to EU retail and professional investors will either need to select a category, and comply with the relevant criteria, if they wish to claim the types of sustainable characteristics covered by each category or otherwise significantly limit the amount of sustainability information included in their fund marketing materials.

It is unclear when the changes to the SFDR regime will come into force. The Commission's proposal will need to be adopted through the ordinary legislative procedure, which entails a review (and possible amendments) by the European Parliament and the Council of the European Union. This process typically takes 12 to 24 months, depending on the points to be negotiated and how quickly the Commission proposes compromises, before the final regulation is published in the Official Journal and in force, normally 20 days following publication. According to the draft, the Regulation will then apply 18 months after entering into force. It is also unclear when the Commission will adopt the Delegated Act setting out the rules and details of the disclosure.

As anticipated, the Regulation has removed the existing Article 8 (that applies to funds that promote environmental and social characteristics) and Article 9 (that applies to funds that have sustainable investment as their objective) in favour of new product categories. Funds that promote the types of characteristics that are covered by the categories must adhere to the criteria in each category. The obligation for firms to disclose for each fund the manager's approach to the integration of "sustainability risks"

(ESG events that could cause a material negative impact on the value of an investment) when making investment decisions remains the same as in the original SFDR. The new product categories are fairly closely aligned to the FCA's Sustainability Disclosure Regime—see Annex 1 for a comparison. The MiFID "suitability" rules will change to require retail distributors to ask about investors' preferences for a particular category. Funds must make a minimum of 70% of investments in each category in accordance with the sustainability-related claim. Accounting for the period when the fund builds its portfolio, the text requires the fund to meet this threshold at the latest at the expiry of the phase-in period, but it does not specify the length of this period.

At a further stage, there will be a Delegated Act with new rules and details on the contents of the required disclosures. This will include additional conditions about the criteria and will replace the existing six-to-seven-page templates with a list of items to be disclosed, with the disclosure not exceeding two pages.

Grandfathering Relief

The Regulation provides grandfathering relief (an optional exemption to scope out of the new rules) for closed funds. This is expressed as applying to closed-ended funds that were created and distributed before the date the Regulation applies. Hence, private closed-ended funds that published disclosures under the original SFDR that are no longer fundraising may opt not to be in scope of the amended SFDR ("SFDR 2"). It seems likely that these funds will continue to provide their investors with periodic reporting under the original SFDR reporting template to reflect their original commitments to investors.

Funds falling within fundraising at the date of application of SFDR 2 will be subject to the new regime. As a result, they will need to decide if they can map across their existing SFDR disclosure to one of the new SFDR 2 categories, with changes to their disclosures in accordance with the new Delegated Act, and consider the investor relations impact of a decision to transition, or not to transition, to SFDR 2. Similar questions arise for successor funds which are established after SFDR 2 applies. In light of SFDR 2, sponsors that are currently forming open-ended funds, in particular those with a retail component, should carefully consider now the implications of adopting an SFDR category or ceasing to adopt a new category under SFDR 2.

The exemption for professional investor-only funds included in the leaked draft from early November 2024 has not made it to the formal proposal.

New Categories

We set out the criteria for each new category below. Note that the Delegated Act will introduce further conditions, particularly in light of the breadth of some of the criteria in the draft.

Article 7—Transition Category

Funds that invest in transition investments, generally meaning the transformation of assets that are not currently environmentally sustainable, are not clearly accommodated in the current SFDR concept of "sustainable investment". To address this, the Commission has introduced Article 7, which includes criteria for promoting a fund that has an environmental or social transition related objective. Transition is broadly defined to include investments with a credible transition plan (in respect of the whole company or an activity), and, more broadly, investments with credible science-based targets; funds which set a transition target, such as emissions reduction, for the portfolio as a whole; or investments to which the sponsor applies a credible sustainability-related engagement strategy, with specific targets and milestones, such as for de-carbonisation. Any climate-related transition plan or target, or associated engagement strategy, must be compatible with the Paris Agreement global warming objective and EU 2050 climate neutrality objective.

Article 8—ESG Basics Category

The new Article 8 applies to funds that claim to integrate sustainability factors with credible sustainability-related indicators—meaning funds that integrate sustainability factors beyond the consideration of sustainability risks. As such, it includes selecting investments with a high ESG rating, investments that outperform the average investment universe or reference benchmark on a specific sustainability indicator or investments selected with a proven positive track record for sustainability. Article 8 also includes selecting other types of investments to integrate sustainability factors beyond the consideration of sustainability risks, provided proper justification is included in the disclosures. The "new" Article 8 remains relatively broad, allowing a range of strategies that integrate ESG in asset management decisions, such as by selecting investments which perform strongly in particular environmental or social areas. Funds in this category will need to report on sustainability KPIs to demonstrate how they have integrated sustainability on an ongoing basis. An active ESG engagement strategy for each portfolio company, combined with ongoing reporting of relevant KPIs, of the type adopted by some private equity sponsors, may well fit in this category, or under Article 7, as a type of transition strategy which is a "credible sustainability related engagement strategy", provided that there are defined milestones and escalation actions in case the expected changes do not happen. Article 8 also includes products with investments which combine investments under Article 7, 8 and 9 categories.

Article 9—Sustainable Category

The new Article 9 applies to funds that claim to invest in sustainable undertakings, activities or other assets. This is clearly directed at current Article 8 or 9 funds that invest in environmentally or socially sustainable investments, including Taxonomy-aligned investments or "green bonds" issued under the EU Green Bonds Regulation.

Referring to inconsistencies in the interpretation of the current definition of "sustainable investment", the Regulation proposes to remove the definition and include its underlying concepts in the further rules for the product categories to be contained in the separate Delegated Act. The extent to which the definition of sustainable investment will change is not yet clear. A recital to the rules states that the underlying concepts of "contribution to an environmental and social objective", "do no significant harm" and "good governance practices" should continue to be reflected in the criteria of the relevant categories, and the rules themselves refer to a type of investment in this category as "investments in comparable assets to [Taxonomy aligned investments or Green Bonds]", provided that there is "a proper justification of their high level of performance in terms of sustainability standards".

Article 9a—Combination of Categories

Article 9a is directed at financial products that constitute two or more underlying financial products in the Article 7, 8 and 9 categories. As such, it is directed at, for instance, insurance products that offer investment in underlying funds.

If a fund wishes to combine elements of the characteristics defined under the various Articles, it may use the Article 8 category, which allows a combination of investments under Articles 7, 8 and 9.

Criteria That Apply to More Than One Category

There are rules that apply to more than one category:

- Funds in Articles 7 or 9 categories can automatically meet the threshold requirement by having at least 15% of their investments in Taxonomy-aligned activities—with the Commission noting that about half of existing Article 9 funds already meet this threshold.

- In place of the current concept of funds "considering" principal adverse impacts, funds in the Article 7 (Transition) and Article 9 (Sustainable) categories will be required to identify and disclose the principal adverse impacts of their investments and explain any actions taken to address those impacts. The Regulation indicates that the Commission will build on the current set of principal adverse impact indicators, with flexibility for funds to use different indicators or a qualitative explanation of the principal adverse impacts.

- As above, the fund must apply the sustainability criteria to at least 70% of the fund's investments. The methodology for calculating this will be contained in the further Delegated Act and may address whether cash and hedging are classified as "investments" for the purpose of the threshold. Funds may specify a phase-in period for the fund to reach the 70% threshold.

- Funds falling within the Articles 7 or 9 categories cannot invest in investments issued by public sector bodies to meet the 70% threshold other than in "green bonds" issued by those bodies in accordance with the EU Green Bonds Regulation.

- Alongside examples of the types of investments that fall within each category, the Commission has included a "sweep-up" category of "other investments" that contribute to the relevant topic, provided "proper justification" is included in the disclosures.

- The Delegated Act will specify, for each category, indicators for "voluntary use" which build on both the existing SFDR principal adverse impact indicators and sustainability information reported under the separate Corporate Sustainability Reporting Directive.

- In line with ESMA's approach under the 2024 Guidelines on funds' names, there are mandatory exclusion criteria which apply to the whole portfolio—see Annex 2 below. Fund of funds managers may find the mandatory exclusion criteria difficult to apply in practice.

Data and Estimates

To address concerns about data quality, firms in scope of SFDR must ensure that they use data from external data providers on the basis of formal agreements and have formal methodologies in place for using estimated data. There is also a general obligation to provide clients on request with further sustainability information in relation to a product and information on data sources and methodologies used. For fund sponsors, this may involve the disclosure of proprietary information to investors.

Impact Funds

The Commission introduces criteria for funds to the use the term “impact” in their name or as their objective. The approach the Commission has taken is not to specify impact funds as a separate category but instead to require any such fund to adopt the Article 7 (Transition) and Article 9 (Sustainable) categories with the additional condition that it describes the intended environmental or social impact, underpinned by a pre-set impact theory, and provisions to measure, manage and report on the desired impact. The Commission’s conditions and its separate definition of an impact fund, which refers to funds with the objective of pre-defined, positive and measurable social or environmental impact, are aligned to definitions of impact in existing frameworks, including the FCA’s Sustainability Disclosure Rules.

Publishing Sustainability Information Outside the Product Categories

If a manager has not selected a product category, there are important new conditions for managers to describe the fund’s consideration of sustainability factors. In new Article 6a, managers with funds outside the product categories will not be permitted to make any claims on sustainability factors in their marketing communications or use sustainability-related terms in their name. For these funds, any discussion of sustainability factors must be limited to information in the pre-contractual disclosures (understood to mean the prescribed disclosures under Article 23 of AIFMD), may not be one of the types of “claims” that would trigger the product categorisation rules and may not be a “central element” of the pre-contractual disclosures. For this purpose, information is not considered a central element where it is secondary to the presentation of the product characteristics in breadth and positioning in the document, is neutral and is limited to less than 10% of the space occupied by the presentation of the fund’s investment strategy.

Any funds that discuss sustainability factors within the limits of Article 6a will also be required to produce an annual report on those sustainability factors.

Principal Adverse Impact Reporting

The requirement for firms to report, in respect of all their products, on principal adverse impacts was the centrepiece of the original SFDR. In SFDR 2, the Commission acknowledges that this reporting has not been successful in that it has "not led to a robust or comparable mechanism to ensure no harm". As a result, SFDR 2 removes the requirement for firm-level principal adverse impact disclosures. Under the original SFDR, large firms meeting certain thresholds were required to have regard to the principal adverse impact factors for the purpose of the "do no significant harm" test. Until the Delegated Act is published, it is not yet clear whether principal adverse impacts will continue to apply in the do no significant harm test. It is also likely that managers can continue to report voluntarily on their consideration of principal adverse impacts to investors at the fund level.

Other Simplifications

The Commission has introduced a number of other welcome simplifications to the regime:

- The separate product website disclosures (which duplicated much of the material in the precontractual disclosures) will be abolished. This has been replaced with a requirement to publish the pre-contractual and website disclosures online, which sponsors will likely satisfy by uploading them to their investor data rooms.
- The general requirement for all funds that promote environmental characteristics to disclose and report on the alignment of their investments to the EU Taxonomy (which may not commit to making Taxonomy-aligned investments) will only apply to Article 7 (Transition) and Article 9 (Sustainable) funds with an environmental objective.
- Financial advisers and portfolio managers will no longer be subject to the SFDR.
- The requirement to publish the firm's approach to the links between remuneration and sustainability risks will be deleted.
- The Key Information Document which funds marketed to retail investors must produce under the PRIIPS KID Regulation will have a new section indicating the product's category and objective with relevant indicators ("How sustainable is this product?").

Key Next Steps

Although there is some time—as much as two years—before SFDR 2 applies, during which the text may change, fund sponsors should start planning their implementation steps now. As a priority, sponsors should consider the impact on open-ended funds—which will still be admitting investors when SFDR 2 applies—and, similarly, any funds they launch from now until the SFDR 2 application date. Sponsors should consider the viability of mapping the sustainability characteristics of those funds to the new SFDR 2 criteria. Funds with sustainability names will inevitably be impacted.

The future SFDR categorisation of funds which admit individual investors (retail or semi-professional investors) needs particular consideration given that their distribution channels will incorporate the new categories. Related distribution agreements should be checked.

Sponsors will also need to consider whether they have flexibility in fund documentation to change the SFDR categorisation, and related sustainability characteristics, for impacted funds.

Lastly, sponsors should consider the impact on their global fundraising, in particular whether the new SFDR categories, including the mandatory-exclusion criteria, may conflict with conditions for approaching certain U.S. state investors.

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Annex 1 – Comparison with FCA Sustainability Disclosure Requirements ("SDR")

SFDR 2 category	FCA SDR category
Article 7 (Transition): clear and measurable transition objective	Sustainability improvers: assets that have the potential to improve environmental and/or social sustainability over time.
Article 8 (ESG Basics): integrate sustainability factors beyond risk management	None: The FCA SDR does not accommodate a broad category of "integrating sustainability risks beyond risk management".
Article 9 (Sustainable): invest in sustainable undertakings or contribute to sustainability	Sustainability focus: assets that are environmentally and/or socially sustainable, determined using robust and evidence-based standards.
Impact (combined with either Article 7 or Article 9)—objective of pre-defined, positive and measurable social or environmental impact, with investments directed at companies which provide solutions to address specific social or environmental challenges.	Sustainability impact: aim of pre-defined, positive and measurable impact in relation to an environmental and/or social outcome, requiring a "theory of change" of how and why the desired change will occur and needing to demonstrate that the manager's investment activities and the fund's assets achieve positive impact.

Annex 2 – Mandatory Exclusions

Category	Mandatory exclusion
Article 7 (Transition)	Companies referred to in Article 12(1)(a) to (d) of the Commission's Delegated Act, which governs Climate Transition and Paris-aligned Benchmarks (the "Benchmark Delegated Act"). These are companies involved in any activities related to controversial weapons or tobacco, companies that a benchmark administrator has found to violate UNGC Principles or OECD Guidelines for Multinational Enterprises, or companies which derive 1% or more of their revenue from exploration, mining, extraction, distribution or refining of hard coal and lignite. In addition, companies that: (*i*) develop new projects for the exploration, extraction, distribution or refining of hard coal and lignite, oil fuels or gaseous fuels; or (*ii*) develop new projects for, or do not have a plan to phase out from, the exploration, mining, extraction, distribution, refining or exploitation of hard coal or lignite for power generation.
Article 8 (ESG Basics)	Companies referred to in Article 12(1)(a) to (d) of the Benchmark Delegated Act, as above.
Article 9 (Sustainable)	There are two broad types of excluded investments: 1. The full exclusion list for EU Paris-aligned Benchmarks, contained in Article 12(1)(a) to (g) of the Benchmark Delegated Act. In addition to the companies referred to above, these are companies that derive: • 10% or more of revenue from the exploration, extraction, distribution or refining of oil fuels; • 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels; or

Category	Mandatory exclusion
	• 50% or more of their revenues from electricity generation with a GHG intensity of more than 100gCO2e/kWh. 2. Companies that: (*i*) develop new projects for the exploration, extraction, distribution or refining of hard coal and lignite, oil fuels or gaseous fuels; or (*ii*) develop new projects for, or do not have a plan to phase-out from, the exploration, mining extraction, distribution, refining or exploitation of hard coal or lignite for power generation.