

The Sustainable Finance Disclosure Regulation and the Definition of Sustainable Investment

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In this article, the authors discuss the criteria to classify an investment as sustainable based on European Union guidance given to date, trace the development of the term since the inception of the Sustainable Finance Disclosure Regulation and consider possible future changes to the concept.

A “sustainable investment,” as defined in the Sustainable Finance Disclosure Regulation (the SFDR), is an investment in an economic activity that generates clear and measurable social and/or environmental benefits without doing significant harm to other social or environmental objectives. A fund pursuing sustainable investments will select investments with the potential to contribute to a particular social or environmental outcome. A fund disclosing under Article 8 of SFDR, which is a fund that promotes environmental or social characteristics, may allocate a proportion, without any minimum threshold, of its investments in sustainable investments. A fund disclosing under Article 9 of SFDR, which is a fund with sustainable investment as its objective, such as a fund dedicated to renewable energy, must invest entirely in investments which at the time of the investment qualify as

sustainable investments, other than cash or hedging positions. Reflecting its importance, EU authorities have published extensive guidance on the concept of “sustainable investment” and tabled changes to its broad definition in the forthcoming SFDR review.

This article discusses the criteria to classify an investment as sustainable, traces the development of the term since the inception of SFDR and considers possible future changes to the concept.

SUSTAINABLE INVESTMENT DEFINITION

The SFDR definition includes examples of sustainable investments. For environmental objectives, sustainable investments may be measured by indicators on energy use, renewable energy, raw materials, water and land,

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waste production, greenhouse gas (GHG) emissions or biodiversity impact and contributions to the circular economy. For social objectives, examples are investments that contribute to tackling inequality; foster social cohesion, social integration and labour relations; or support human capital or economically or socially disadvantaged communities.

As well as the definition in the SFDR, sponsors need to take into account the pre-contractual disclosures and periodic reporting templates, which set out the questions sponsors must answer to describe their own criteria for selecting sustainable investments. Sponsor must also consider EU guidance on this topic. The European Supervisory Authorities (the ESAs) have consolidated almost all guidance published by the ESAs and the European Commission (the Commission) into the single SFDR Q&A,¹ which is updated from time to time. This article also considers ESMA's Final Report on the integration of sustainability risks and disclosures (June 2025),² which includes commentary on funds' use of the sustainable investment definition.

The Commission has confirmed that the SFDR "does not set out minimum requirements that qualify concepts such as contribution, do no significant harm, or good governance, i.e. the key parameters of a 'sustainable investment.'" Instead, sponsors are expected to define their own criteria to demonstrate how they meet these parameters - although the Commission has given its view on investments that qualify as sustainable where the company conducts its activities in a sustainable manner, as discussed below. When completing the pre-contractual disclosure template, managers need to make a compromise between adopting sufficiently concrete

criteria and retaining enough flexibility to accommodate a range of future investments, particularly for a fund with broad investment objectives. Managers should be mindful of the importance of a consistent approach across products, although in practice, many managers have developed their definition of "sustainable investment" since the SFDR's inception in 2021.

RELATIONSHIP BETWEEN SFDR AND THE EU TAXONOMY REGULATION

The EU Taxonomy Regulation (the Taxonomy), a classification system for environmentally sustainable economic activities, is distinct from the SFDR and designed for application across a variety of fields.

Investors have a high degree of flexibility in determining whether they qualify an investment as "Taxonomy aligned" according to the technical screening criteria in the Taxonomy. Where an investment is deemed Taxonomy aligned, it will in most cases automatically qualify as a sustainable investment under the SFDR. As a proviso to this principle, according to a Commission Notice³ on the links between the Taxonomy and the SFDR, where an investor invests in the equity or debt in a company which has a degree of Taxonomy alignment and seeks to qualify the whole investment as a sustainable investment, the investor must assess whether the company's contribution to the environmental objective is, overall, sufficient, and must check whether the other activities carried on by the company comply with the do no significant harm principle.

Currently, even where an investment falls within a type covered by the Taxonomy (such as renewable energy or low GHG transport),

managers do not need to commit to aligning the investment with the Taxonomy. In practice, some managers pursue Taxonomy alignment, while others do not, given the detailed and often challenging technical criteria involved. A manager's decision to pursue Taxonomy alignment will be partly informed by whether it invests in the European Union (EU) or outside the EU, noting that the Taxonomy criteria substantially refer to EU standards.

Looking ahead, the EU Platform on Sustainable Finance, in its report⁴ on proposed changes to the SFDR (December 2024), proposed that, as the Taxonomy develops, any activity that is covered by the Taxonomy cannot be considered a sustainable investment unless it meets the Taxonomy's technical criteria. If adopted, this would represent a significant tightening of the current framework.

CONTRIBUTION TEST

In pre-contractual disclosures and ongoing reporting, managers need to describe how an investment's activities contribute to the fund's social or environmental objective. This includes reporting qualitative and quantitative data, such as the number of under-served individuals or households benefitting or the amount of renewable energy generated. For this purpose, firms often refer to the UN Sustainable Development Goals (the SDGs) and the related Sustainable Development Investment Asset Owner Platform, which provides a comprehensive list of business activities that contribute to each SDG, together with suggested metrics.

In its 2023 guidance (included in the SFDR Q&As), the Commission confirmed that investors may also qualify investments as sustain-

able where the investee company conducts its activities in a more sustainable manner than its peers or industry - such as manufacturing with a lower environmental footprint or distinguishing itself through its social impact. This approach allows investors to qualify companies as sustainable investments by reference to attributes of their operations rather than and regardless of their core product or service. In part, this reflects that some social goals - such as employing disadvantaged individuals and improving working conditions - are more achievable through the way the company operates than through the company's product or service, although these goals might be achieved by high standards of corporate governance, as opposed to promotion of particular environmental or social topics. It is fair to say that the qualification of an investee company in any sector (such as information technology) as a sustainable investment purely through an attribute (such as the rate of its energy consumption) remains controversial. Investors generally expect sustainable investments to be linked to companies that carry on activities with inherent environmental or social benefits, such that a good portion of the company's revenue is linked to such activities.

The Commission also addressed the treatment of companies engaged in more than one activity. Funds may either (i) qualify only a proportion of the company's activities as sustainable (the "look-through" method), or (ii), more simply, qualify the whole investment as sustainable if the relevant activities make a sufficiently large contribution. In practice, most investors seek to qualify the whole company as a sustainable investment, partly because the "look-through" approach raises the challenge of tracking and reporting on the relevant

proportion of underlying activities on an ongoing basis. However, the EU Platform on Sustainable Finance suggested in its December 2024 report that under future changes “contribution to a sustainable investment objective can only be measured at activity level.” If adopted, the revised version of SFDR would remove the current flexibility to qualify the entire company as a sustainable investment by reference to a subset of its activities.

Finally, the Commission’s 2023 guidance addressed transition investments. The Commission confirmed that investments covered by a transition plan - such as “brown to green” property redevelopment - may not qualify as sustainable investments until the transition plan is complete. The Commission stated that “[sustainable] investments shall not significantly harm any of the [environmental or social objectives]. Therefore, referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient.” While this, in our view, leaves open the possibility of qualifying an investment on the basis of a transition plan that remedies partial harms, such as addressing human rights issues in a supply chain, it is clear that where the investment is made with a transition thesis, particularly in infrastructure or real estate, it will generally not qualify as sustainable until the identified environmental harm, such as a building’s energy efficiency, has been addressed.

“DO NO SIGNIFICANT HARM” TEST

The “do no significant harm” (DNSH) test in the SFDR definition reflects a long-standing principle of impact investing: alongside the

positive contributions of an investment, investors must consider the risks of environmental or social harm. EU guidance requires firms to use the SFDR principal adverse impact (PAI) indicators in applying the DNSH test.

Questions here arise as to the relevance of the indicators applied, the availability of data and the appropriate thresholds when determining whether or not the investment is causing significant harm. Inevitably, when assessing actual harm or the risk of harm, some PAI indicators will be more relevant than others, and some indicators - particularly certain environmental indicators - will not be relevant to some types of businesses. In its 2025 Final Report⁵ on the integration of sustainability risks and disclosures, ESMA stated that firms should take into account all mandatory PAI indicators, and any relevant optional indicators, for the DNSH test. ESMA also suggested that firms use third-party data providers or reasonable assumptions to address data gaps. In practice, many firms prioritise data collection for the most relevant PAI indicators for the purpose of the test. As ever, transparency is important as to the data collected, its quality and the use of any estimates.

Determining thresholds for “significant harm” is another area of uncertainty. The ESAs have suggested⁶ that best practice is to publish values for each PAI indicator for each investment and demonstrate DNSH compliance by reference to a defined threshold. The ESAs suggest using the DNSH criteria in the Taxonomy as a resource. These criteria are partly qualitative (e.g., acceptable level of GHG emissions for a given activity) and partly quantitative (e.g., compliance of a low energy cement plant with EU standards for environ-

mental degradation or environmental impact assessments).

For GHG emissions, carbon footprint and GHG intensity, managers may set thresholds by reference to the company's sector and may require the company to commit to a science-based reduction target to satisfy the DNSH test. In some sectors companies with GHG emissions which are below the sector average may still be considered to do significant harm. In practice, many managers, particularly those with broad investment policies over multiple sectors and jurisdictions, are unwilling to set any fixed thresholds at the outset, preferring instead a case-by-case analysis informed by due diligence.

In their Final Report⁷ on updates to the SFDR RTS (December 2023), the ESAs suggested that firms should disclose the "thresholds or criteria used" to determine that a sustainable investment does not significantly harm any environmental or social objectives and explain how these thresholds or criteria are determined by reference to the PAI indicators. This may require funds in pre-contractual disclosures to specify thresholds, at least where the indicator is quantitative, which may be challenging. Alternatively, funds may describe the general criteria they will adopt for the purpose of the test.

The DNSH test applies on an ongoing basis, requiring firms to monitor both actual harm and the risk of harm during the life of the investment. For funds investing in public securities, the expectation is that they will divest if an investment is causing significant harm. By contrast, in the private funds context, firms are much more likely to address the breach, rather than dispose of the investment, allowing

themselves a potentially long leniency period to address the harm. However, there is no clear regulatory guidance on this point.

GOOD GOVERNANCE TEST

Article 8 of SFDR includes the proviso that companies in which investments are made follow "good governance" practices. The SFDR refers to the good governance concept in the definition of a "sustainable investment" as meaning "in particular sound management structures, employee relations, remuneration of staff and tax compliance." The principle that sustainable investment always involves promotion of good corporate governance principles is widely accepted. However, the SFDR concept of good governance is broadly drawn, leaving a high degree of discretion as to its application in practice. Good governance is synonymous with best business practices and sound risk management.

A range of resources is available to managers in assessing governance. A private equity investor will typically review both the policies that an investee company has in place (e.g., supplier codes of conduct) and the outcomes of those policies (e.g., management reporting or actions taken against noncompliant suppliers), as well as prior breaches and related remedies. Sponsors will need to take a proportionate and risk-based approach, depending on the type of instrument being acquired and the types of activities carried on by the company.

The OECD Guidelines for Multinational Enterprises⁸ provide a comprehensive set of best business practices and responsible business conduct, although managers must use their judgment to focus on the policies and prac-

tices most relevant to a company’s environmental and human rights risks. Managers that do not have access to an investee company’s policies may rely on external data sources, including ESG ratings and adverse events databases, and exclude companies known to be in breach of accepted international standards of good governance.

The EU has confirmed in the SFDR Q&A that the “good governance” condition applies only to investments in “companies” and does not apply to government bonds. Assets such as real estate held in special purpose vehicles or holding companies do not require a good governance check.

There remains debate as to the steps a manager should take if serious governance concerns arise during the holding period. In its Final Report⁹ on integration of sustainability risks and disclosures from June 2025, ESMA noted that managers should adopt criteria for how long a company may remain in the portfolio while showing improvement but still falling short of good governance principles and when a breach is sufficiently severe to justify exclusion from the product.

The SFDR disclosure templates reinforce the above, requiring funds to explain how their sustainable investments are aligned with the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions of the International Labour Organisation Declaration on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

POSSIBLE FUTURE CHANGES

Under the current framework, which allows managers to set their own criteria to meet the definition of sustainable investments, managers should adhere to the principles of making transparent disclosures, retaining evidence to meet the standards set and ensuring consistency across products. However, going forward, the EU has signalled stricter criteria to qualify funds under Articles 8 and 9 of SFDR and investments made by those funds as sustainable investments - at least for environmental investments.

In particular, the proposal that, where an eligible investment activity or sector is covered by the Taxonomy, it should only qualify as a “sustainable investment” by alignment with the Taxonomy will leave a substantial subset of investments which are Taxonomy eligible but not Taxonomy aligned as unable to qualify as sustainable investments. A similar concern arises for funds making transition investments when the Taxonomy is extended to cover transition investments. It is also possible that a revised version of SFDR will more precisely define “good governance,” narrowing managers’ current discretion. It is fair to say that the sustainable investments categorisation will become less flexible over time.

NOTES:

¹ <https://www.esma.europa.eu/document/consolidated-qa-sfdr>.

² https://www.esma.europa.eu/sites/default/files/2025-06/ESMA34-1592494965-764_Final_Report_on_2023-2024_CSA_on_sustainability.pdf.

³ https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=oj:JOC_2023_211_R_0001.

⁴ https://finance.ec.europa.eu/publications/categorisation-products-under-sfdr-proposal-platform-sustainable-finance_en.

⁵ https://www.esma.europa.eu/sites/default/files/2025-06/ESMA34-1592494965-764_Final_Report_on_2023-2024_CSA_on_sustainability.pdf.

⁶ https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf.

⁷ https://www.esma.europa.eu/sites/default/files/2023-12/JC_2023_55_-_Final_Report_SFDR_Delegate

d Regulation amending RTS.pdf.

⁸ https://www.oecd.org/content/dam/oecd/en/publications/reports/2023/06/oecd-guidelines-for-multinational-enterprises-on-responsible-business-conduct_a0b49990/81f92357-en.pdf.

⁹ https://www.esma.europa.eu/sites/default/files/2025-06/ESMA34-1592494965-764_Final_Report_on_2023-2024_CSA_on_sustainability.pdf.