# "SFDR 2" – significant new policy direction revealed

# Top 10 talking points

# September 2023

**As trailed in our news alert, the European Commission has launched a public consultation on the functioning and future of SFDR. This is the first step in a regulatory review process which will eventually lead to significant amendments to the current SFDR regime (which we're calling SFDR 2).**

**While the consultation does not yet propose any specific new rules, its questions and associated commentary reveal a clear policy direction of travel. If implemented, this would potentially involve some fundamental changes to the entire policy concept of SFDR.**

**Most importantly, SFDR 2 could become a regime based around opt-in ESG product labels which reference objective criteria, rather than the current subjective article 8/9 disclosure regime. Although not expressly acknowledged in the consultation, the Commission's approach seems to be directly inspired by the UK FCA's product labelling proposals under the Sustainability Disclosure Rules (SDRs).**

**It is widely acknowledged that there are significant flaws with the current SFDR. The issues include unclear or missing definitions of key concepts, difficulties with the functioning of the principal adverse impacts (PAI) regime, and the use of the article 8 and article 9 disclosure rules as de facto product labels. The consultation does not shy away from addressing these issues, and for that reason we expect that the financial services industry will welcome the attention on those deficiencies. However, firms may be surprised by the pace of change, given that the technical standards under SFDR have been in force for less than a year.**

**This note provides our summary of the top 10 things that firms need to know about the consultation. This note assumes a working familiarity with the current SFDR regime. For more general information on SFDR, please see our ESG notes for clients.**

## 1. What is covered in the consultation?

On 14 September 2023, the European Commission launched a consultation exercise, to seek views from the public on the current SFDR regime, and on potential future regulatory models for sustainable finance disclosures.

***Format of the consultation:***

The consultation comprises two parallel questionnaires, a "public" consultation, and a "targeted" consultation aimed at SFDR experts. (The public consultation is effectively just the first half of the targeted consultation, and omits the more detailed questions in the second half of the targeted consultation. We expect that readers of this note would want to engage with the targeted consultation, and this note focuses exclusively on that version.)

The consultation is framed as a lengthy list of questions addressed to the financial services industry and other stakeholders. Most of the questions are in the format of statements about SFDR or about future policy, and respondents are asked to indicate their response to the statement on a sliding scale of 1 to 5.

An example is set out below.

**Question 1.1:** The SFDR seeks to strengthen transparency through sustainability-related disclosures in the financial services sector to support the EU's shift to a sustainable, climate neutral economy. In your view, is this broad objective of the regulation still relevant?

| 1 | 2 | 3 | 4 | 5 | Don't know |
|---|---|---|---|---|---|
| | | | | | |

*(1= not at all, 2= to a limited extent, 3= to some extent, 4= to a large extent, 5= to a very large extent)*

A minority of the questions include a free-text box to provide a narrative answer.

The consultation period is open until 15 December 2023. Respondents who wish to answer the questionnaire will need to use an online form on the Commission's website.

***Areas of focus:***

The consultation covers four distinct areas of focus, although there are significant overlaps between the themes.

1) Current requirements of the SFDR
2) Interaction between SFDR and other existing sustainable finance rules in the EU
3) Potential changes to the firm-level disclosure requirements
4) Potential changes to the product-level disclosure requirements

Section 4 is arguably the most important part of the consultation, as it outlines a proposed approach for sustainability product labels, to replace the current article 8 and article 9 disclosure regime. We have therefore addressed these requirements first (see questions 3 to 6 of this note below), given their relative importance.

***Simmons & Simmons crystal ball:***

While we don't know what the ultimate policy decisions will be, in a few cases we look into our crystal ball and make some educated guesses! This is meant as an unscientific prediction as to where we could end up. These conjectures are marked in boxes with this format.

## 2. Do firms need to take action in response to the consultation?

We emphasise that:

- there are no draft rules proposed in the questionnaire; and
- firms do not need to take any action or make any changes in response to the questionnaire.

Instead, the immediate question for firms is whether and how to engage with the consultation process.

We know from extensive discussions with clients in the last 2-3 years that there are deep concerns and challenges with the current SFDR regime. This consultation represents an important opportunity for firms to articulate those concerns, and to give views on the future direction of travel.

For that reason, we can see benefit to firms in being able to influence regulators' understanding of current challenges, and your opinions on the policy proposals.

We know that many firms often prefer to respond to consultations through trade bodies, industry working groups or other representatives. In this case, there may be some merit in responding individually as well, at least to the questions with a sliding scale response. This is so that if the Commission takes an "averaging" approach to the numerically-scaled responses, each firm has submitted its own view (the 'post bag effect').

## 3. What are the options for SFDR 2 to replace article 8/9 with product labels?

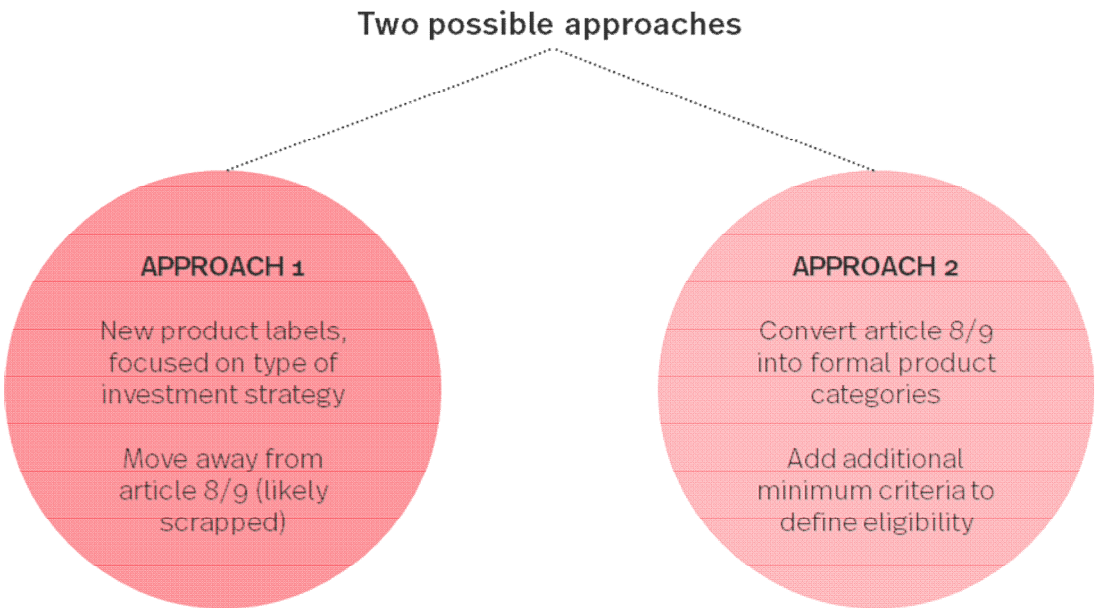
The European regulators have repeatedly voiced concerns that the SFDR article 8 / 9 disclosure regimes are being mis-used as labels or marketing tools, when they were instead intended as disclosure regimes. The primary concern is that this can lead to greenwashing.

The greenwashing risk arises as the regimes (particularly article 8) have a deliberately wide scope as a disclosure regime, to require any product making sustainability claims about the investment process to make disclosures. However, when the regime is used in practice as a product label, that wide scope becomes potentially unhelpful from a policy perspective.

In Part 4 of the targeted consultation, the Commission proposes two alternative approaches for a future product categorisation regime to replace the current article 8/9 disclosure regime. For simplicity, we refer to these as "labels".

***Two alternative approaches:***

The Commission proposes two alternative approaches, under which the article 8/9 disclosure-based regime could be replaced with an opt-in labelling regime.




The consultation asks for industry views on whether there is demand for SFDR 2 to include product categories, and which approach is preferred. In the next sections of this note, we summarise:

- Approach 1 (q. 4)
- how Approach 1 has parallels with the UK SDR proposals (q. 5)
- Approach 2 (q. 6).

***Common consultation questions across both approaches:***

Before turning to the specific detail of the two approaches, we note that the Commission raises a set of common questions across both proposed approaches.

- Disclosures: what product-specific disclosures should be required for the label? Options in the questionnaire include details on Taxonomy alignment, engagement strategies, exclusions and information about how the criteria required to fall within a specific category have been met.
- External verification vs self-declaration: the Commission is seeking views on whether the availability of the label should either be: (a) subject to mandatory third-party verification (both up-front and ongoing), or (b) open to firms to use on a self-declaration basis, subject to supervision by national regulators.
- Variables: what variables should be taken into account in the criteria for product categories, including, for example, whether underlying investments are outside the EU, are in SMEs, or are in emerging economies?
- Naming and marketing rules: similar to the UK SDR regime, the Commission proposes that there would be restrictions on the use of certain ESG-related names (unless the product qualifies for a label), and that naming and marketing rules would apply to products which don't qualify for a label.

***Simmons & Simmons crystal ball:***

Our money is on the Commission deciding to implement an opt-in product labelling regime for SFDR 2, based on Approach 1 in the consultation paper. European regulators have become increasingly dissatisfied with the (perceived) misuse of SFDR article 8/9 as a de facto labelling regime, and this solution allows the EU to address that concern.

We also expect that the Commission will prefer Approach 1 to Approach 2, as we are aware that EU regulators have informally indicated approval for the FCA's SDR proposals, on which Approach 1 is seemingly based.

Either approach would involve significant work for the financial services industry, to re-categorise and re-paper all funds and investment products which are in-scope of SFDR, to move away from SFDR1 to SFDR2's revised approach. This would also mean that some article 8 products potentially fall out-of-scope of being eligible for a sustainability label and may need adjustments to aspects such as investment process in order to become eligible.

## 4. What is Approach 1 to product labels?

Approach 1 for SFDR 2 involves moving away from the current article 8/9 regime, and replacing it instead with new voluntary product labels.

The Commission provisionally identifies four possible product categories (and additionally asks for views on other suggested categories). The Commission seeks views on whether product categories will be mutually exclusive (and we expect they would be). Note that the categories don't currently have names, only letter identifiers. There also does not seem to be a hierarchy to the categories.

| Category | Detail |
|---|---|
| A | Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability related problems that affect people and/or the planet, e.g. investments in firms generating and distributing renewable energy, or in companies building social housing or regenerating urban areas |
| B | Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme, e.g. investments in companies with evidence of solid waste and water management, or strong representation of women in decision-making |
| C | Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet |

| | |
|---|---|
| **D** | Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in, e.g. investments in economic activities becoming taxonomy-aligned or in transitional economic activities that are taxonomy aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonise, improve workers' rights, reduce environmental impact |

The Commission also seeks views on a proposed set of minimum criteria, based on the following themes, which could be mapped to each of the four categories (potentially with differentiated thresholds):

a) Taxonomy alignment

b) Engagement strategies

c) Exclusions

d) Pre-defined, measurable, positive environmental, social or governance-related outcome

e) Processes implemented by the product manufacturer to demonstrate how sustainability considerations can constrain investment choices. This could include for example:

- a minimum year-on-year improvement of KPIs, or
- a minimum exclusion rate of the investable universe

In a potentially helpful move, the Commission also asks for views on what measures would be needed to support a transition into the new regime. Firms responding to the consultation may want to suggest an appropriate transition period, and/or comment on whether any grandfathering is appropriate, including for example for closed funds or funds no longer marketed.

## 5. How is Approach 1 similar to the UK SDR proposals?

*"Imitation is the sincerest form of flattery."*

Approach 1 appears very close in parts to the UK FCA's proposals for the UK SDR regime, in respect of product labels. We are aware that EU regulators have informally endorsed the SDR proposals, and it would seem that these have inspired the Approach 1 proposals for SFDR 2.

Please see our client briefing note (October 2022) for more information on the UK SDR proposals. Please note that we do not yet have the FCA's final rules on the SDRs, which are expected to be published in Q4 2023.

Comparing the SFDR 2 proposals under Approach 1, it is immediately clear that categories A, B and D map to the UK SDR proposed labels of Impact, Focus and Improvers, respectively. We set out the headline definitions of each in the following table.

| SFDR 2 proposal under Approach 1 | Equivalent UK SDR label |
|---|---|
| **Category A**<br><br>Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability related problems that affect people and/or the planet, e.g. investments in firms generating and distributing renewable energy, or in companies building social housing or regenerating urban areas | **Impact**<br><br>Products with an explicit objective to achieve a **positive, measurable contribution to sustainable outcomes**. These are invested in assets that provide **solutions** to environmental or social problems, often in underserved markets or to address observed market failures |

| | |
|---|---|
| **Category B**<br>Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme, e.g. investments in companies with evidence of solid waste and water management, or strong representation of women in decision-making. | **Focus**<br>Products with an objective to maintain a **high standard of sustainability in the profile of assets** by investing to (i) meet a **credible standard** of environmental and/or social sustainability; or (ii) align with a specified environmental and/ or social **sustainability theme** |
| **Category C**<br>Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet | *[No direct equivalent]* |
| **Category D**<br>Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in, e.g. investments in economic activities becoming taxonomy-aligned or in transitional economic activities that are taxonomy aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonise, improve workers' rights, reduce environmental impact | **Improvers**<br>Products with an objective to **deliver measurable improvements in the sustainability profile of assets over time**. These products are invested in assets that, while not currently environmentally or socially sustainable, are selected for their potential to become more environmentally and/or socially sustainable over time, including in response to the stewardship influence of the firm |

For firms with product offerings across the UK and the EU, we expect that this implicit regulatory convergence will be extremely welcome. Firms may also want to consider lobbying in their consultation responses for express regulatory coordination between the UK and EU regulators on the topic of product labels.

## 6. What is Approach 2 to product labels?

Approach 2 for SFDR 2 involves keeping the current article 8/9 regime, but changing it to operate as an express product categorisation regime. The Commission seeks views in particular on what minimum criteria should be imposed to qualify for an article 8 or article 9 label. It is unclear what the position would be for products that currently fall under article 8 or article 9, but which do not meet any minimum criteria specified in SFDR 2; we assume that they would not be entitled to retain the article 8/9 "label".

The Commission also asks which aspects of the current regime are "fit for purpose". This includes the concepts of environmental and social characteristics, promotion of E/S characteristics, the "sustainable investments" definition (including contribution to an E/S objective, and the DNSH test), and the good governance test. These are many of the known-unknowns with the current SFDR regime, and firms may welcome clarity.

We turn now to the other areas of focus in the consultation.

## 7. What does the Commission ask about the current SFDR regime?

In Part 1 of the targeted consultation, the Commission asks a wide range of questions to understand better the limitations and successes of SFDR.

The Commission seeks general views on whether SFDR's policy objectives are still relevant, and whether SFDR has raised awareness or changed behaviours. The Commission asks for specific data on compliance costs, data challenges, and how SFDR triggered a change in product offerings.

Importantly for firms, the questionnaire allows respondents to articulate the practical issues caused by SFDR. These may include the usefulness of the mandatory disclosures, lack of clarity on key legal concepts, the use of article 8/9 as a de facto labelling regime, and data gaps. The questionnaire also requests firms to identify the consequences of the SFDR deficiencies, including legal uncertainty, reputational risk, distribution issues, and greenwashing risk.

Moving to more specific parts of SFDR, the questionnaire seeks views on the PAI regime. The Commission asks for views on whether to maintain the current mix of mandatory and optional harm indicators, or whether it would be better to move to a fully optional or fully mandatory list of harm indicators. The consultation also queries methodological challenges with the PAI regime, and how it applies under product-level disclosures, and its interaction with article 8/9 products.

***Simmons & Simmons crystal ball:***

We think that the PAI regime will be in the crosshairs for a significant overhaul. It's just our best guess, but we could envisage SFDR 2 including a more streamlined version of the PAI regime, which applies on a mandatory basis at both entity-level and product-level (if the most onerous proposals under discussion were to be implemented). This could be based primarily on disclosure of quantitative harm data, with the extra layer of taking steps to actively mitigate harm as a separate or additional regime.

## 8. How does the Commission approach SFDR's alignment with other EU regimes?

In Part 2 of the targeted consultation, the Commission examines the interaction between SFDR and other EU regulatory regimes.

The Commission raises the interaction between the SFDR definitions (which are broadly subjective) and the Taxonomy's equivalent definitions (which are broadly objective). This was also raised by the ESAs in their "SFDR 1.5" consultation.

Similarly, the question of alignment with the EU's rules on Climate Transition Benchmarks (CTB) and Paris-Aligned Benchmarks (PAB) is raised again. This includes whether passively tracking a CTB or PAB should automatically confer the status of sustainable investment, and whether there should be alignment in SFDR with the mandatory exclusions in the climate benchmarks.

***Simmons & Simmons crystal ball:***

We think that SFDR 2 will include significantly more alignment with the Taxonomy and the CTB/PAB regime. Specifically, we can envisage that SFDR 2's definitions will be based on more objective criteria (like the Taxonomy) and potentially include the mandatory exclusions from the CTB/PAB regime.

## 9. What changes are proposed to entity-level disclosures?

In Part 3 of the questionnaire, the Commission looks at the usefulness of SFDR's entity-level disclosures.

This includes the general usefulness of entity-level disclosures (including PAI), if SFDR is the right legal regime to deal with entity-level disclosures, and whether there is scope for streamlining across other regulatory regimes.

This appears to indicate a potential desire to reduce the burden of firm-level disclosures in SFDR 2, with the focus apparently to be on enhanced product-level disclosures.

## 10. What changes are proposed to product-level disclosures?

Part 3 of the questionnaire also examines the current product-level disclosure regime.

Most significantly, the Commission raises the possibility of uniform disclosure requirements for all financial products offered in the EU, regardless of whether they make sustainability-related claims or not. The Commission queries whether such uniform disclosures could include:

- disclosure of PAI data
- taxonomy alignment
- engagement strategies
- exclusions
- how ESG is used in the investment process

In the event that the uniform disclosure requirement were implemented, the Commission queries whether there should be a threshold which triggers the requirement. This could include AUM above a certain threshold, or for retail clients only.

*Simmons & Simmons comment*: *This is one of the most significant proposals considered in the consultation. We expect that many asset managers would want to resist the proposal for all financial products (i.e. including current "article 6" products) to have to make mandatory SFDR product-level disclosures, where they do not currently have to do so. This issue will be of considerable interest to non-EU managers since SFDR currently applies to those that market funds into the EU under AIFMD national private placement rules (NPPR); uniform minimum disclosure requirements for all NPPR funds would be a very onerous new requirement. To the extent that such requirements are introduced, firms may wish to lobby for appropriate trigger points, which could reasonably include retail marketing only.*

The Commission also seeks views on whether the same PCD template should be used across all financial products, and whether product disclosures should apply independently from entity-level disclosures. There are also proposals that product disclosures could be put on a mandatory scale to assist comparability of disclosures, requiring firms to disclose e.g. the decile into which the product falls.

In addition, the questionnaire focuses on the medium of disclosure. This includes the appropriateness of public website disclosure, and issues around machine readability, digitalisation, the European Single Access Point, and the use of the EET as the basis for digitalisation.

***Simmons & Simmons crystal ball:***

There is a clear direction of travel that SFDR 2 will reduce the burden of entity-level disclosures, while simultaneously increasing the burden of product-level disclosures., including mandatory PAI reporting at product level, and increasingly standardised disclosures to enhance comparability. We think it's unlikely that the industry would support mandatory sustainability disclosures across all products, but this remains in the mix.

## HOW SIMMONS & SIMMONS CAN HELP

If you require any further information on any of the issues referred to above, please contact one of the Simmons & Simmons team listed on the next page.

For more information, please see our online resource here.

# Simmons & Simmons key contacts

**Lucian Firth**
Partner
T +44 20 7825 4155
E lucian.firth@
simmons-simmons.com

**Catherine Weeks**
Partner
T +44 20 7825 3940
E catherine.weeks@
simmons-simmons.com

**James Wallace**
Partner
T +44 20 7825 4249
E james.wallace@
simmons-simmons.com

**Benedikt Weiser**
Partner
+49 96 907454 47
E benedikt.weiser@
simmons-simmons.com

**Iris Dingemans**
Partner
T +31 20 722 2335
E iris.dingemans@
simmons-simmons.com

**Augustin de Longeaux**
Partner
T +352 26 21 16 34
E augustin.delongeaux@
simmons-simmons.com

**Katherine Tracey**
Managing Associate
T +44 20 7825 4820
E katherine.tracey@
simmons-simmons.com

**Angus Brown**
Supervising Associate
T +44 20 7825 4076
E angus.brown@
simmons-simmons.com

**Nick Colston**
Partner
T +44 20 7825 4147
E nicholas.colston@
simmons-simmons.com

**Louise Tudor Edwards**
Partner
T +44 20 7825 4539
E louise.tudor-edwards@
simmons-simmons.com

**Dr Harald Glander**
Partner
T +49 69 907454 44
E harald.glander@
simmons-simmons.com

**Daniel Lühmann**
Partner
T +49 69 907454 25
E daniel.lühmann@
simmons-simmons.com

**Derek Lawlor**
Partner
T +353 1266 1158
E derek.lawlor@
simmons-simmons.com

**Tristram Lawton**
Managing Associate
T +44 20 7825 3488
E tristram.lawton@
simmons-simmons.com

**Patricia Schneider**
Supervising Associate, Rechtsanwältin
T +49 69 90745442
E patricia.schneider@
simmons-simmons.com

**William Clarke**
Supervising Associate
T +44 20 7825 3782
E william.clarke@
simmons-simmons.com