Stay Current

PAUL HASTINGS

Investment Funds & Private Capital

March 2024

Follow @Paul_Hastings

Investment Funds & Private Capital

SFDR II – No root and branch reform, please

By Ruth Knox, Costa Burkov, and Zach Milloy

The Targeted Consultation Document on the Implementation of the Sustainable Finance Disclosures Regulation ("**SFDR Consultation**") published on 14 September 2023 engendered an industry and media storm, with commentators referring to "*declarations of regulatory bankruptcy*" and a number of consultancies and asset managers issuing public statements supporting a business as usual approach, instead of wholesale changes.

As with everything under the SFDR, it can get technical. The SFDR Consultation asks broad and deep questions of stakeholders on their experience dealing with the regime, including but not limited to thorny topics such as:

1. Is the broad objective of supporting the EU's shift to a sustainable, climate neutral economy still relevant?

   Hard to answer no, but arguments could be made that a more precise objective targeting the worst kinds of greenwashing would be more likely to enable better outcomes.

2. Should all principal adverse impacts always be considered material or be subject to a materiality assessment?

   This points towards the requirement of the separate disclosure regime, the Corporate Sustainability Reporting Directive ("**CSRD**"), which enables those disclosing to conduct a materiality assessment before publishing their ESG disclosures. Parity on this point across disclosure regimes should enable better quality, more decision-useful disclosures, when done properly.

3. Are the disclosures on principal adverse impacts useful?

   Answer: No. Again, a materiality-based approach defined by the market will likely enable better quality outcomes over time.

4. Should a "sustainability product categorisation system" be established at the EU level?

   From a practical perspective, this is effectively what we have already. The debate on disclosure versus labelling is a highly academic one in a world where sponsors and asset managers are

presented with demands by investors for a certain product classification. Time is better spent examining other aspects of the regime, rather than splitting hairs on the typology or overhauling product categories.

5. Are website disclosures user-friendly?

No, they are duplicative, at risk of breaching US (and other markets') private placement/offering restrictions if published on a public website and add very little beyond the pre-contractual disclosures.

Ultimately, the three thorniest issues which have created the highest costs for stakeholders on interpretation of the regime are:

(i) What is the dividing line between an Article 6 and Article 8 strategy?

The ESA Q&A issued in July 2022 created a furore amongst GPs when it indicated that

"*promotion …encompasses…direct or indirect claims…as well as an impression that investments pursued by the given financial product also consider environmental or social characteristics in terms of*… a *general ambition*".

The answer surely must be that funds intended to be marketed as Article 6 funds should be given free rein to make limited ESG claims, albeit those which are fair, clear and not misleading. On Article 8, any specified minimum criteria ought to be couched as indicative – so as not to prohibit innovation.

(ii) What is a transition investment and can I account for such an investment within either an Article 8 and/or an Article 9 strategy?

Transition investments are put forward as a new potential product category in the SFDR Consultation, so stakeholders should make sure to articulate their views in their response.

(iii) What do the "do no significant harm" ("**DNSH**") requirements mean in the context of an Article 9 investment and in a world where data is still hard to come by, how do we make commercial judgement calls on what good or bad looks like?

The SFDR Consultation asks whether it is clear how the DNSH requirements should be applied in the context of product disclosures, without commenting on the oh-so-common scenario of data being unavailable specifically in respect of DNSH. As a minimum, a materiality assessment should be possible to identify potential harms caused by target investments.

Asset managers, banks, sponsors and investors have made huge investments getting to grips with a regime that requires fine judgements across multiple decision points, with potentially highly damaging reputational consequences where those judgements are subsequently deemed to have been technically inaccurate, or simply made on the wrong basis as more (changing) interpretative guidance is released. As such, wholesale changes to the structure of the regime are not only questionable in terms of the rule of law, but go against the principles of the EU's Regulatory Fitness and Performance (REFIT) Programme[1], which seeks to reduce unnecessary costs of regulation.

[1] REFIT – making EU law simpler, less costly and future proof (europa.eu)

The very recent ESMA Public Statement on the guidelines on funds' names using ESG or sustainability-related terms constitutes further iterative change, specifying that 80% of investments made by funds using such names should meet the relevant characteristics or objectives, and apply exclusions defined in the EU regulation governing Paris-aligned or decarbonisation benchmarks. For the regime to take root, clearer regulatory signals on these rules and the points outlined above will help turn grey into green.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Ruth Knox
44-020-3321-1085
ruthknox@paulhastings.com

Costa Burkov
44-020-3321-1009
konstantinburkov@paulhastings.com

Zach Milloy
44-020-3023-5190
zacharymilloy@paulhastings.com

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2023 Paul Hastings LLP.