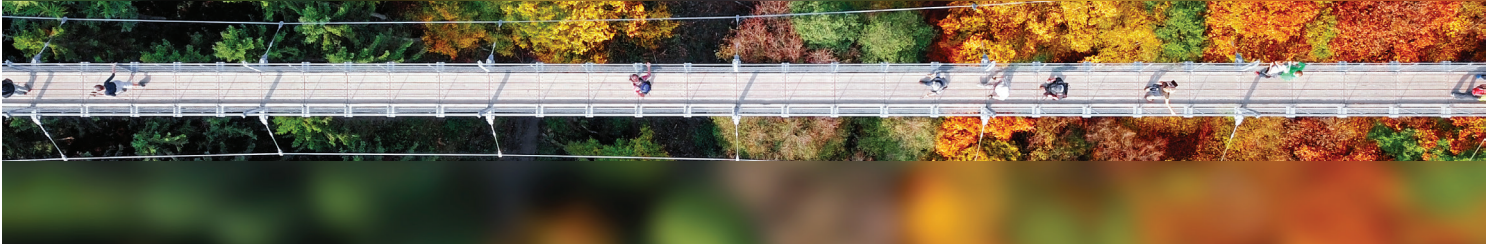


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THE EUROPEAN COMMISSION CONSULTS ON THE SFDR FRAMEWORK: FIVE KEY TAKEAWAYS

On 14 September, the European Commission published its much-anticipated public consultation on the Sustainable Finance Disclosure Regulation (SFDR), one of the key pillars of the European sustainable finance framework. Containing more than 95 questions, the consultation has been presented in two parts: a public consultation; and a more detailed targeted consultation of stakeholders familiar with SFDR implementation. Alongside the consultation, round tables and workshops will be held during the consultation period to facilitate discussion. The consultation closes on 15 December 2023 and the Commission is expected to issue its report in Q2 2024.

The consultation is extensive, covering a range of topics, and is intended to assist the Commission in understanding the issues that have arisen during SFDR implementation, as well as potential improvements. Here are our five key takeaways:

1. Product labels

As many expected, the Commission questions whether to introduce a product labelling regime, acknowledging that the SFDR Article 8 and 9 reporting regimes have become used as de facto product labels in the market, with significant regard being paid to whether a fund is categorised as Article 6, 8 or 9. This is probably the most important aspect of the consultation and, if the Commission goes down this route, it would be a sea change from the current disclosure framework. The Commission poses two options: the first, an attempt to turn the existing Articles 8 and 9 into formal product categories, clarifying and adding criteria to underpin the existing concepts of environmental/social characteristics, sustainable investment, do no significant harm, etc.; the second, the introduction of new categories that could, for example, be based on the strategy of the product (such as contribution to certain sustainability objectives or transition focus, etc.). The second option bears similarity to the UK FCA's proposed product labels under its forthcoming Sustainable Disclosure Requirements (SDR) regime, a welcome development, given that interoperability between the two regimes will be crucial. Importantly, both proposals would carve out a specific category for products with a transition focus, an area that many feel is inadequately catered for under the current SFDR framework.

Key Points

- On 14 September, the European Commission initiated an extensive consultation on the SFDR.
- Key elements relate to:
 - Product labels
 - Legislative uncertainty
 - Interaction with other EU sustainable finance requirements
 - Recognition of areas of particular implementation difficulty, such as PAI indicators
 - Product-level and entity-level disclosures, where there is potential for fundamental reform.
- The consultation closes on 15 December 2023.
- SFDR2 is a distinct possibility, although how different this may be will depend on the outcome of the Commission's review.
- The Commission is expected to issue its report in Q2 2024.

2. Legislative uncertainty

The Commission questions whether there is sufficient clarity around key concepts in the SFDR, such as the concept of ‘sustainable investment’. It refers in places to issues that have been at the heart of specific questions and answers to and from the Commission in its SFDR Q&As (such as whether the Taxonomy-aligned ‘environmentally sustainable’ economic activities can automatically qualify as ‘sustainable investments’ under the SFDR and whether products that passively track CTB and PAB can be deemed to be making sustainable investments), asking whether the market now has sufficient clarity on these points. These questions provide market participants with the opportunity to consider the direction in which they would like to take the SFDR: towards greater certainty, with more specific criteria around key terms and concepts, or to retain the existing flexibilities in the regime. While many have criticised the uncertainty of core concepts of the SFDR, such as the term ‘sustainable investment’, introducing more granular criteria at this stage could further complicate firms’ and investors’ (in particular retail investors’) understanding of how those terms are interpreted, running the risk of further fund upgrades, downgrades or repapering if the resulting interpretation differs significantly to that of today.

3. Interaction with other EU sustainable finance requirements

The consultation explores the interaction of the SFDR with other sustainable finance regulations, including MiFID2 and the IDD. This is an issue that has long been raised by the industry, concerned about a lack of regulatory harmonisation and proliferation of duplicative requirements. Of significance are the Commission’s questions relating to whether SFDR disclosures are consistent with the CSRD, which suggest that the Commission may be open to streamlining entity-level disclosure requirements to reduce overlap in this area. In general, greater clarity on how the various disclosure regimes operate alongside each other and interact is likely to be welcomed by the market.

4. Recognition of areas of implementation difficulty

The consultation contains focused questions on: (i) Principal Adverse Impact (PAI) indicators; (ii) implementation costs; and (iii) issues raised by data gaps and data quality, reflecting the considerable issues that have arisen in these areas due, for example, to the unavailability of data or certain PAI indicators not being relevant to all asset classes, particularly in the alternatives space.

The consultation also raises implementation issues for specific sectors and with respect to specific products. In particular, it asks whether the ‘good governance’ concept should be adapted to include investments in government bonds and investments in real estate, whether the current framework effectively captures investments in transition assets and whether confidentiality aspects need to be taken into account when specifying the information that should be made available to the public under the SFDR. The latter reflects concerns of some private fund managers, who are required to publicly disclose certain information under the SFDR, despite the private nature of their products.

5. Potential for fundamental reform

Unsurprisingly, entity-level and product-level disclosures receive a lot of attention. The Commission raises questions on the usefulness of the disclosures and what changes may be required, particularly if the SFDR transitions from a disclosure regime to a labelling regime. Significantly, the Commission questions whether standardised product disclosures should apply to **all** financial products offered in the EU, regardless of sustainability-related claims, or whether uniform disclosure requirements for **some** financial products may be a more appropriate approach, again regardless of their sustainability-related claims, for example where the product is intended solely for retail investors. In both scenarios, additional disclosure requirements for products that make sustainability claims could be required. These questions, together with the questions surrounding the potential introduction of product labels, suggest that the Commission could consider fundamental reforms to the existing SFDR framework.

Implementing SFDR2

Implementing SFDR has not by any means been plain sailing. Many issues have arisen over the past three to four years. This is reflected in the breadth of the Commission's consultation. Although nothing in the consultation should be taken as a foregone conclusion, it is likely that there will be a legislative proposal for SFDR2, which may differ considerably from the current framework. Implementation planning is made more difficult because there are other, related initiatives for which the outcomes are not yet known. Notably, we are still awaiting the report from the ESAs on the outcome of their April 2023 consultation on the SFDR RTS, as well as ESMA's report on its November 2022 consultation on ESG-related fund names. The timing of any changes that come out of these will be crucial, especially if SFDR2 imposes changes to the overall SFDR framework further down the road.

Next Steps

The Commission is scheduled to report on its findings in Q2 2024. Although not certain, it is highly likely that there will be an SFDR2 proposal. The key questions are how extensive the amendments will be and when will they apply. Any changes are likely to be several years in the future, as it is unlikely that any new requirements will come into force before the end of the current parliamentary session. EU Parliamentary elections take place in June 2024, so it could be the autumn of 2024 before the new Commission is appointed and we know its legislative priorities.

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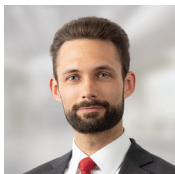
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