Chapters 6, 8 and 9 of the SFDR: What are they, and what does it mean for Product Providers, Investors and Companies?

In recent weeks, there have been quite stunning headlines from the shareholder meetings of oil firms or courtrooms where lawsuits were filed, forcing these firms to go so much further than before to meet new emissions standards and good environmental practice. This follows on the heels of the landmark publication of the EU Sustainable Finance Disclosure Regulation (SFDR) in March this year. The SFDR did not capture the public imagination that much, but it promises to bring tremendous change and potentially impact to the world of asset management.

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What does SFDR try to achieve?

By now, most investors will be aware that ESG criteria are set to become integral to asset management companies' investment process and the disclosure rules faced by companies that wish to access regulated markets for capital. The objective of the SFDR is to make the sustainability profile of funds more comparable for end-investors. There will be a set of pre-defined factors to assess the ESG outcomes of a company's investment process. In addition, there will be strong emphasis on disclosure. There will also be requirements that a financial product provider declares the harmful impact that any of the companies in its portfolio has.

Three main categories are identified

Under the SFDR, there are three main categories, described in Articles 6, 8 and 9. **Article 6** covers funds without any sustainability framework in the investment process. They could include holdings that are excluded from ESG mandates. **Article 8** applies where "a financial product promotes...environmental or social characteristics or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices". **Article 9** covers products that have sustainable investment as their objective, with a designated reference benchmark.

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If the recent victories for shareholder activism are anything to go by, it is to be expected that the future for Article 6 funds is limited. While the SFDR code is driven by the EU and applies to funds in the EU, most global fund management companies operate and sell financial products in the EU and are thus covered by the rules. The SFDR incorporates the two main policy frameworks: the Paris Agreement of 2015 and the European Green Deal, which targets carbon neutrality for the EU by 2050.

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In addition to the above classification system, a provider of financial products will be **required to disclose how it will respond to adverse impacts** that the companies it holds have on sustainability factors. The details of precisely what constitutes adverse impact have yet to be fully defined, but in the case of "environment", the focus will fall on carbon and other waste emissions. Under "social" the focus will be diversity and human rights issues like child and slave labour. Under "governance" it will be (exposure to) corruption and transparency of reporting.

The impact of these rules could end up being far-reaching

As the outcomes mentioned above have demonstrated very clearly, public opinion has shifted in a very material way. There is not much patience left with firms that drag their heels on any of the major ESG issues. Climate and emissions may be just the forerunner.

The impact on companies will be marked

As the rules become more clearly defined, we expect it will become very difficult for offending firms to continue to raise capital in the market, be that via equity or bonds. First, there is the compliance burden that such investment will impose on asset management firms. The more work that has to be done to justify an invest-

ment, the less likely it is to be allocated capital, especially if competing firms present fewer challenges. Second, the requirement to disclose adverse impact could likely bring additional public scrutiny to companies that might otherwise have remained under the radar. Activist shareholder groups will have been emboldened by the recent victories over fossil fuel companies. They could organise themselves around other ESG causes and increase the pressure on companies to comply or have plans to move towards compliance faster than would have been the case otherwise.

For investors, there should be better standardisation and clarity

By providing guidelines on the principles of impact investing and how to measure it, the EU aims to make it easier for the end investor to judge the relative merits of the ESG credentials of competing products. Without clear guidance, it has not always been entirely clear to what extent one product is pursuing ESG targets or actual impact relative to another. This has been so because the design framework has been somewhat ill-defined to date – certainly, in discussion with end investors in the private client space, this has been a familiar and frequent critique of the drive towards greater acceptance of ESG principles in financial product design.

Where to from here?

The implementation date of the standards was 10 March 2021, but due to some delays in the finalisation of definitions, firms will be expected to be fully compliant by 1 January 2022. However, many fund management companies are still in the process of tagging their products to comply with the new guidelines. This adds to the challenge for end clients to understand precisely what the "footprint" of their fund suite is. In the interim, it would require a deeper insight into the content of funds, coupled with familiarity with the content of the new regulations to be able to put together a solution for end clients.

Addressing this issue in your investment process is something that the GCIO can help with. We have insight into how to construct portfolios of funds that navigate the issues raised by the new regulations to allow you to position your investment proposition with confidence. ■

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