Ep. 49: SFDR for Beginners

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Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host Jose Garriga.

If you've been following our recent episodes, you'll know that ESG, or environmental, social and governance, is top of mind for business and governments around the globe. This episode kicks off a three-part miniseries that features Akin Gump financial regulatory partner Ezra Zahabi, who returns to *OnAir*.

She'll be sharing her thoughts on three key topics concerning EU-related ESG disclosure matters that should also be on the minds of those outside Europe who are doing business on the continent or thinking of doing so.

In this first episode, we look at the Sustainable Finance Disclosure Regulation, or SFDR, where it comes from and what it means.

Welcome to the podcast.

Ezra, thank you for appearing on the show today. As previewed, we're talking SFDR, so let's dive right into the topic. Just to give listeners a bit of background, what is the SFDR, and what are its origins?

Ezra Zahabi: Thanks, Jose. So the SFDR, as you mentioned, is the Sustainable Finance Disclosure Regulation. It's a piece of legislation that comes from the European Union, and it applies across the EU on a uniform basis. It's a tool, essentially, one of a package of tools that the European Union is using in order to push forward its European Green Deal, which is a set of policies and legal initiatives that seek to address what the European Union considers an existential threat as a result of climate change and environmental degradation. So, to overcome the risks arising from climate change and environmental degradation, Europe has put together this European Green Deal, which is really packed for its plan for the future to make EU's economies sustainable. So, the SFDR slots into this greater plan, the European Green Deal, in that it addresses the financial and capital aspect of the new Green Deal.

So, it forms a part of the package of legal initiatives, including, at the moment, the Taxonomy Regulation and the Low Carbon Benchmark Regulation, but other measures are expected to be promulgated and put forward in due course. And, so, the SFDR was introduced by the European Commission, really with a view to sort of leveling the playing field in the financial markets, in that improving transparency, number one, of what different financial market participants are doing in terms of identifying and managing and mitigating sustainability risks. And, on the other hand, enhancing transparency on how financial market participants, in fact, actually engaged with ESG. What's their approach to ESG? What practical measures do they take, and so forth?

Jose Garriga: Thank you. So, looking at this, I guess my next question would be to whom does it apply? Is it EU only, or is it also applicable to non-EU entities?

Ezra Zahabi: It applies to financial market participants. So that includes investment managers, other financial institutions, financial advisors in the EU. And it, potentially, also applies to non-EU entities that meet that description, at least to the extent that they are offering services, offering financial products in the EU. And the reason I say “probably” is because that is actually a point that has specifically been raised by the European financial regulatory authorities to the European Commission for clarification. So, there are a number of items within the SFDR that, frankly, are unclear to the market. But this kind of threshold question of what is the actual geographic scope of the regulation is yet to be determined. So, probably, the market view at the moment is that it does apply to investment managers outside the EU who are actively marketing their products in the EU to EU investors. And otherwise in the EU, it applies to anybody that falls within the specified categories, most notably MiFID [*Markets in Financial Instruments Directive*] firms’ investment managers, MiFID firms’ investment advisors, and AIFMs, that is, alternative investment fund managers.

Jose Garriga: Thank you. In terms of, we’re talking about different types of fund managers, so, does it, in fact, differentiate between all the different types of funds?

Ezra Zahabi: It doesn't. That's an excellent question. So, the answer is a “yes and no” in that it applies to all the different types of funds. It applies to retail funds, it applies to wholesale funds, it applies to private equity, to real estate, to credit funds, you name it. So, the baseline requirements, that is, disclose how you deal with sustainability risk and disclose what your approach to ESG is, broadly. Those requirements apply to everybody. It differentiates between different funds in terms of the level of their commitment or the way that they promote ESG as part of their operations. So, there are funds who are required to disclose their ESG risk approach, are generally referred to as Article 6 funds. And those are just funds that don't have any particular ESG focus. Probably the majority of the funds in the market. In that category, may fall funds, any kind of strategy really, and also UCITS [*Undertakings for Collective Investment in Transferable Securities*]. So it could be retail funds, could be others.

Article 8 funds are funds that promote certain environmental or social characteristics. So, in some way, in their marketing materials and in their approach, ESG features as a sort of an important dimension. And then Article 9 funds are funds that, effectively, have sustainability as their objective. And, so, those funds are the kind of pure impact funds or pure ESG funds. So, there's additional disclosure that then applies to Article 8 funds and Article 9 funds. They also need to provide the same disclosure as Article 6 funds, but there's additional information about their approach to ESG and what exactly what they do by way of either promoting ESG characteristics or having sustainability investment as their objective.

Jose Garriga: Thank you. A reminder, listeners, we're here today with Akin Gump financial regulatory partner Ezra Zahabi discussing the EU's Sustainable Finance Disclosure Regulation.

You mentioned Articles 6, 8, and 9. Let's drill down a bit on them. What should listeners know about product-related disclosure with regard to those three articles?

Ezra Zahabi: Right. I guess that the Article 6 disclosures are the most common disclosure across the market. And, so, as I mentioned earlier, really the key in understanding the disclosure is understanding what the manager does internally in terms of assessing sustainability risk, what is the sustainability risk policy with respect to that product? So it's like, what's the strategy? And what are the sustainability risks associated with that strategy? Clearly, in some areas, like real estate, you may have very obvious sustainability risks that are relevant to the product. And sustainability risk, in this context, is a risk of any event taking place that, in effect, can reduce or adversely impact the value of the fund. And, so, really the key is to look at the portfolio and look at the strategy and think about not only immediate financial risks, but more broadly.

Sustainability risks for a real estate fund could include energy inefficiency, or legal disputes in terms of the construction quality, changes or outlaws in certain types of building materials, things like that.

In some strategies, like credit strategies for example, the sustainability risks may be more remote, or you may have to think more thoroughly about what sustainability risks actually would be relevant to the strategy and to that product. So, you need to think about, as a whole, really, like, what is the fund? What do they do? And where's their exposure? That's not purely sort of immediate kind of balance sheet exposure, but has a broader ESG dimension too. In terms of, then, the Article 8 and the Article 9 disclosures, the sustainability risk, those disclosures are clearly relevant there. But you have this additional overlay of thinking about, really, what is it, what's the ESG focus?

So, if you're selling a product as an Article 8 fund, and you're saying ESG is very important to us, you have to have something to actually link it to, in terms of the managers' operational policies, the actual investment process, the investment criteria, the systematic basis on which you think about investment decisions, the actual portfolio composition. And, so, I think that the tension in managers thinking about their product disclosures is between what they actually do and what they aspirationally think they might want to do. What they are telling their investors that they are doing at a high level from a policy point of view. And then their very practical operations and what they can actually point to as evidence that they are doing what their policies states. I think one of the key points in the SFDR around ESG is that there's a widespread concern in the EU, in the U.K., in the U.S., around greenwashing, a kind of a regulatory view that greenwashing is a far too common practice on the market.

And, so, the product-level disclosure is really intended to be something that allows investors an informed choice, and that choice will include adequate transparency on the ESG risks and on the ESG approach of the manager and of the specific product. It can be expected that those disclosures will be vetted by the regulators in due course. It's also probably true that the disclosures, the framework under the rule SFDR is subject to some really quite significant clarification. So, the clarification requests by the European regulatory authorities that I've referred to earlier, that also includes a whole host of other items that require clarification by the European Commission. That includes what actually is an Article 8 fund? What actually is an Article 9 fund? If you have an ESG policy, is that enough to make you an Article 8 fund?

If you're saying that you're an Article 8 fund, do you need to have a minimum proportion of investments that, in some way, meet some kind of sustainability criteria or not? But I think that, even at this time, when those definitions are really not yet settled, and there's quite a lot of variance on the market in terms of how people disclose and how they classify their funds.

I think that the key, really, is accuracy. It's the internal consistency in the approach. If you think that ESG is really important to the fund, then you need to be able to demonstrate how that manifests itself throughout the investment process. If you think that your fund has ESG as a kind of a unique selling point for investors, then some focused thinking around, what do you mean by ESG? Are you after investments or investment actions that promote social justice? Are you interested in gender equality? Are you interested in carbon neutrality? When you say "ESG," what do you actually mean? So, I think that those are probably some of the kind of broader things to think about in terms of the product level disclosures.

Jose Garriga: That's interesting. Thank you. So, you've touched on this before in what you've been saying, but see if we can maybe gather your thoughts on this for the listeners. If you're an investor looking at the various fund categories in the EU, what are the implications, then, of SFDR? What should you be thinking about?

Ezra Zahabi: That's very interesting. So, one of the key things that European investors, in particular, are thinking about at the moment is that they often themselves are subject to the SFDR reporting requirements. And, so, when they are looking to engage, invest with investment managers, they may be engaging European investment managers, and they know that they need to provide this disclosure. They're interested in understanding what exactly they're doing. But also very focused on understanding what their non-EU managers are doing and what their non-EU managers are providing to them by way of information to enable them to then adequately meet their own disclosure obligations. So, on the one hand, the impact of the SFDR, there's a sort of direct legal impact. But there's also an indirect impact in that, even if you're not formally subject to the SFDR, there's a real push on the European investors to publicly make these disclosures available.

And, so, those European investors will also be asking for similar types of information from their European and non-European investment managers and financial institutions that they engage with. And I guess that, in terms of the disclosures, really, and what people are looking at, I think that the disclosure about how the product provider, the manager, integrates sustainability risks into the investment decision-making process with respect to that specific product that you might be looking at, I mean, the question is, number one, how does your manager measure sustainability risk? Do they? Do they, separately, even think about that? If they do measure sustainability risk, is that on the basis of the purely in-house kind of proprietary program? Do they use other comparable tools or resources? How do they measure what's sustainable, what isn't? What are their information sources? That kind of thing.

There's also a requirement to disclose the results of the manager's assessment of the likely impact of sustainability risks on returns. That disclosure, currently, there's really huge variation in terms of how people are making that disclosure. And very often, frankly, it's a very high-level kind of narrative disclosure of these are the types of risks that might be ESG risks relevant to this product, and were they to materialize, how that might have an impact. What we haven't seen very much of is any kind of hard-data, quantitative assessment of any likely impact of sustainability risks on returns. And I think that, that might be partly because the very key risks that would be absolutely integral to the portfolio were likely incorporated into the investment process already because they were just material risks. The fact that they happened to be key risks was, really, a separate point. I think that it's more a question of how broadly will people think about risk? How rigorous, eventually, will either the framework requiring them to disclose or market practice, eventually, once it evolves, how rigorous will it be on seeking disclosure on things like scenario testing? If the global temperatures increase by 0.5%, what's the impact of that on this portfolio? And, so, I think that that kind of thing is, I think, there's a lot that is still in the nascent stages, but, eventually, I suspect the kind of product-level disclosure will be more data heavy and less narrative focused than it currently is in terms of the risk disclosures.

There's another aspect of disclosure that has been taken up less by the market, because it is effectively optional at this stage. And that is the disclosure as to whether the manager considers the principle adverse impacts of its investment decisions on quote-unquote sustainability factors. And that disclosure basically means, this portfolio in its composition, like what kind of harm is it doing the environment? What kind of carbon footprint does it have? What kind of impact on biodiversity might it have? Those disclosures are currently not mandatory because those disclosures, ultimately, will be made in a heavily quantitative, heavily prescribed format. There's 14 mandatory data fields that need to be completed and few optional that many managers at this time have elected not to comply with that. Eventually, we think that there will be more widespread compliance and there will be more widespread disclosure. What the ESG impact of the portfolio is, and the way that those disclosures are required to be made, have this very heavily prescribed quantitative dimension and also will have a very detailed narrative dimension explaining exactly what the policies are. How do you engage with your portfolio companies? If your portfolio companies continue to pollute, then maybe they have good policies in place, but, actually, their track record continues to be dire for whatever reason, what the appropriate actions might be. There's a lot of disclosure I think, that will develop in the future that investors will be looking out for. But at the moment, the disclosures, I think, are still at the kind of, “to be developed more fully” stage.

Jose Garriga: Thank you. So, this is a very rich topic, and I guess, in closing, what would be the takeaways, one or two key takeaways, that listeners should be keeping in mind? As you say, it's a nascent topic. There's more clarification and specification to come. But what would you offer as a couple of key takeaways for people to think about SFDR right now?

Ezra Zahabi: I think that one is to really go back as an institution and kind of consider, what is the ESG strategy? And I say that because I think there's real momentum on the market for ESG products. And as a result of that momentum, there's a real push on the investor-relations side often to focus on the ESG positive dimensions. But I think that the reality is that there's all sorts of formal announcements by regulators to the market that greenwashing is an issue, and that they will be looking at this. This is probably the time for managers to start thinking about what will they do in terms of ESG? What are they willing to do? Are they willing to either develop new products or develop new policies that they apply to the existing products where they set specific parameters, or they have sort of binding criteria that, effectively, precludes some investments if they don't meet specific types of criteria.

So if ESG, institutionally, you think that ESG is, it's a big selling point, and you want to benefit from that, then your internal policies then must be consistent with what you're selling. I think that my key takeaway for people is just to think in terms of what the existing strategy and what the existing investment approach is and think what's realistic from that and what your clients are expecting in terms of your returns, in terms of your profile. What are the next steps you can take? And for some, I think, it may be engagement with investee or portfolio companies and active engagement in a shareholder capacity. For others, it may be more hard criteria in terms of ruling out certain types of investments or seeking greater exposure on other types of investments.

But I think across the investment universe, I think the one theme that we have found very relevant is that there's currently a dearth of good-quality information from companies. And while legislation is, there are sort of legislative changes that seek to change that and address that, really, I think that being proactive with your investee companies and engaging with them in light of a clear understanding of what it is, institutionally, that you are about in terms of ESG, I think that that's probably the next steps that we think that will be relevant for managers to think about.

Jose Garriga: Listeners, you've been listening to Akin Gump financial regulatory partner Ezra Zahabi. Thank you, Ezra, for walking listeners through this important development in EU regulatory. There's some fascinating concepts in there. And greenwashing, I think, is one that I have not encountered before, and I think is going to be really interesting for people to follow or keep in mind.

And thank you, listeners, as always, for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, SoundCloud, and Spotify.

And stay tuned for the next installment of this ESG regulatory miniseries, as Ezra will be discussing the Taxonomy Regulation she referred to earlier.

To learn more about Akin Gump and the firm's work in, and thinking on, ESG and financial regulatory matters, look for “ESG” or “Regulatory” at the Experience and Insights & News tabs at akingump.com, take a moment to read Ezra's bio on the site and then visit our new *Speaking Sustainability* blog, which features our lawyer's thinking and analysis on all matters ESG-related.

Until next time.