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SFDR: Panorama of the sustainability-related disclosures from the Level 1 Implementation in March 2021

LuxFLAG welcomes the enhanced transparency and sustainability-related disclosures brought by the Level 1 implementation of the EU Sustainable Finance Disclosure Regulation[1] ("SFDR") on 10 March 2021, which will help the transition to both a sustainable economy and society. SFDR aims to support informed and qualified investment decisions by requiring disclosures on the integration of sustainability-related characteristics into investment processes and products.

LuxFLAG has updated its eligibility criteria following the entry into force of SFDR, requiring ESG Label and Environment Label applicant funds to be classified as either Article 8 or Article 9; and Climate Finance Label and Microfinance Label applicant funds to be classified as Article 9. The announcement can be found here.

As such, LuxFLAG has, from its unique position as a sustainable finance labelling agency, looked at the initial SFDR pre-contractual disclosures of its labelled funds, with the objective of understanding how asset managers have responded to this important step on the journey to making all finance become sustainable finance.

Methodology

LuxFLAG analysed the prospectuses of currently labelled funds, representing 125 managers/promoters and 326 investment vehicles under 13 jurisdictions. As at 30 May 2021, this pre-contractual documentation had been updated for SFDR in more than 91% of the cases and 297 investment policies had been reviewed by LuxFLAG. Notably, given their existing LuxFLAG label, the funds reviewed already had a significant tilt towards ESG and responsible investing overall.

Wherever available, the prospectus disclosures have been analysed to determine their content and level of detail, with a focus on the various parts of the prospectus constituting the SFDR disclosures and responsible investment strategy of the funds.

SFDR breakdown

Under the SFDR classification, Article 6 covers funds which do not integrate any kind of sustainability into the investment process, Article 8 products are described as products promoting environmental or social characteristics and Article 9 products are products having sustainable investment as their objective.

[1] https://eur-lex.europa.eu/eli/reg/2019/2088/oj

As per our review, the majority of LuxFLAG labelled funds are classified under Article 8 (67%) or Article 9 (24.5%). There is, however, a short transition period for a small number of funds that were labelled before SFDR came into play. These are either classified under Article 6 (6.1%) or SFDR does not apply to them. Any Article 6 funds will see their LuxFLAG label lapse by the end of Q3 2021, unless they act in the meantime to repurpose the funds to Article 8 or 9.

From a LuxFLAG label perspective, the balance between Article 8 and Article 9 depends on the label. Not surprisingly, the LuxFLAG ESG Label has the most important proportion of Article 8 funds (76.8%) versus Article 9 (15.6%). Current Environment Label funds are all classified under Article 9 and Climate Finance labelled funds are classified under Article 9 or SFDR is not applicable. Finally, Microfinance labelled funds are under Article 9 to a large extent (95.5%), with only a few currently classified under Article 8 (4.5%).

As such, existing LuxFLAG labelled financial products are already to a large extent compliant with the new LuxFLAG label eligibility criteria requiring compliance with the requirements defined under Article 8 or Article 9 of SFDR.

Disclosures review

SFDR has required a prospectus update for all funds, with new sections added, and significantly more information made available to investors.

Regarding the way the SFDR classification is displayed in the prospectus, Article 8 funds show clear identification of the chosen SFDR Article in 80.4% of cases while it is 76.7% for Article 9 funds. For these funds, the classification is explicitly mentioned in the prospectus, with no room for confusion for investors. We expect that this specific disclosure in the prospectus and other pre-contractual documentation will be the norm in the future.

Whilst responsible or sustainable investment policies are currently described in the general information sections of the prospectuses, LuxFLAG's analysis shows that the description of the ESG processes becomes more and more specific when the funds shift towards Article 9. As such, Article 6 funds rely only on generic descriptions in 94.4% of the occurrences; this proportion decreases to 73.4% for Article 8 funds and decreases further to 52% for Article 9 funds.

LuxFLAG's review of the prospectuses included analysis of standard ESG strategy characteristics and reporting criteria, with several observations made and highlighted in the following paragraphs.

Article 9 funds usually disclose a **minimum portion of holdings with ESG characteristics**, e.g. *the fund will hold at least 90% of securities subject to ESG screening*, with 35.6% of occurrences while it is 40% for Article 8 funds. One of the likely reasons for this difference is that the Article 9 funds tend to have a more thematic investment mandate or be focused on an asset class, which implies that the entire portfolio has ESG characteristics and hence does not require any mention of a minimum.

ESG Integration is explicitly mentioned in most cases and is present in more than 90% of all cases, regardless of the SFDR classification. This confirms the trend seen by LuxFLAG over the last 2 years to widespread adoption of the integration of ESG characteristics in the investment analysis and decision- making process.

Sector exclusions are part of the disclosures widely adopted by asset managers/promoters. Overall, 93% of the prospectuses reviewed mention the application of exclusions, with varying levels of details from one asset manager/promoter to the other.

The application of **norm-based screening** is quite often present for Article 8 funds (73.4%) but is less often explicitly used for Article 9 funds (45.2%).

Engagement and active ownership are mentioned for 77.4% of Article 8 funds and to a lesser extent for Article 9 funds (61.6%). A likely rationale for this lower figure is that engagement may already be fully part of the investment strategy for certain asset classes managed in Article 9 funds and hence not required to be mentioned, e.g. private equity or private debt funds.

Controversy screening is explicitly mentioned in a majority of Article 8 funds (66.8%), but this figure decreases for Article 9 funds (32.9%). This more limited use of controversy screening may be linked to the nature of the asset classes managed in many Article 9 funds; i.e. private assets.

Inclusion of a **minimum ESG rating** was observed in 29% of Article 8 funds and 34.2% of Article 9 funds. The ESG ratings can either be provided by a data vendor, the result of an internal scoring system or a combination of both.

Additional ESG characteristics and criteria encountered in LuxFLAG's review of investment policies are either related to the alignment with the Paris objectives or UN SDGs, or detailed ESG KPIs such as carbon emissions, gender equality targets, board independence targets or a carbon footprint reduction objective.

LuxFLAG's review of the prospectuses of currently labelled products reveals broad compliance with the disclosure requirements of the Level 1 of the SFDR and, as a result, the LuxFLAG label criteria. Disclosure of sustainable investment processes, as well as ESG characteristics and criteria will continue to be a key focus of both regulators and investors, especially with the introduction of the SFDR Level 2 ("RTS") requirements, the EU Taxonomy and other initiatives. Given the speed at which regulatory developments in sustainable finance are taking place, and further to ever increasing investor demand, LuxFLAG anticipates a significant shift in the amount and quality of this disclosure already in the coming months and over the next 12 months.

Glossary

ESG Integration relates to the structural integration of information on Environmental, Social and Governance (ESG) factors into the investment decision-making process.

Exclusions refer to the exclusion of sectors or companies from an investment portfolio if they do not comply with specific ESG criteria defined by the asset manager.

Norm-based screening relates to the application of international rules and standards when selecting securities, e.g. United Nations Global Compact or International Labour Organisation.

Engagement and active ownership are defined as the way capital owners use their influence to persuade the management teams of companies to act in a responsible manner.

Controversy screening refers to these incidents damaging financially and/or the reputation of both the companies themselves and their shareholders. These incidents can range from bribery and corruption to workplace discrimination and environmental incidents.

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