GAM Investments

GAM EXPLAINS: SFDR

MARKETING MATERIAL FOR PROFESSIONAL INVESTORS ONLY

SFDR

What is it?
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The Sustainable Finance Disclosure Regulation (SFDR) has been law in European Union (EU) Member States since 10 March 2021, with subsequent implementation deadlines throughout 2022, 2023 and 2024. Introduced by the European Commission (EC) alongside the Taxonomy Regulation, the SFDR forms part of a package of legislative measures within the EU's sustainable finance strategy.

Its main aims are:

- to support investors to make more informed decisions regarding the sustainability characteristics of their investments
- to assess how sustainability risks are integrated into investment decisions
- ultimately to contribute to attractive private capital to support Europe's net zero and sustainability goals.

Since it was first introduced, markets within and outside the EU have developed additional guidance, taxonomies and proposed labelling regimes. In September 2023, the EC launched a consultation to assess the implementation of the SFDR framework. The EC sought to understand implementation challenges and potential limitations as well as exploring possible options to improve the framework. Further to this the European Securities and Markets Authority (ESMA), published its final report with proposed amendments to the Regulatory Technical Standards (RTS).

Here we look at the main features of SFDR and highlight the areas where it may develop.

WHAT IS IT?

The SFDR introduced standardised disclosures for market participants. The scope of the SFDR includes financial advisers that provide investment advice, and participants in financial markets producing or selling financial goods and portfolio management services. The regulation applies to firms based in the EU; however its scope includes investment managers or advisers outside of the EU who advise, or seek to market, products to European customers.

The impact of this regulation is far-reaching. Required disclosures cover a firm's sustainability practices and specific product level disclosures.

WHY IT MATTERS TO INVESTORS

The SFDR helps investors make better informed and more sustainable choices, with its main purpose to provide greater transparency on environmental and social characteristics and improve consideration of sustainability factors within investment decisions.

The regulation also seeks to boost transparency from the product level disclosure requirements, in particular those focused on principal adverse impacts (PAIs) and taxonomy alignment have added on additional drivers for corporate disclosure on these issues.

There are, however, often data gaps, especially for companies that have not been required to report sustainability-related metrics. The introduction of the Corporate Sustainability Reporting Directive (CSRD) should further support better data quality and consistency.

Ultimately the SFDR aims to re-orientate capital flows to finance the transition to a more sustainable economy, addressing systemic risks such as climate change, nature loss and inequality.

THREE TOP TAKEAWAYS

1- SFDR is about disclosure, not labelling

The SFDR categories represent levels of disclosures that a fund will make. There are clear parameters but currently no minimum thresholds or specific requirements on environmental or social characteristics, or a definitive definition of what constitutes a sustainable investment. Currently one of the challenges of the SFDR is that it is insufficiently clear on some key terms which makes it difficult for consistent interpretation across firms. With this uncertainty, we have seen certain funds change their classifications; for example in the final quarter of 2022, when Morningstar analysis showed 40% of funds were shifted from Article 9 to Article 8. While uncertainty remains, there is likely to be continued flux.

2- SFDR aims to level the playing field

The SFDR is not a standalone piece of regulation, and on top of helping investors to make informed decisions, stands to provide greater comparability for users. The framework aims to work in concert with the EU taxonomy and EU climate benchmarks to create strong sign-posting and stronger market incentivisation for more sustainability aware investment.

3- Further changes should be expected

Two key drivers of this are the EC consultation and the ESMA final report with proposed amendments to the RTS, both of which we discuss below.

WHAT TO LOOK OUT FOR

The dust has far from settled on the final agreements of the SFDR. In September 2023 the EC released a three-month consultation which aimed to understand how the SFDR has been implemented and review key concerns. The EC consultation included a set of questions for respondents to identify how they aligned with them, and appeared to raise the prospect of further developments for SFDR, including:

1. **Potential creation of a categorisation system for financial products:** As expected, the consultation sought to address the issue of Article 8 and Article 9 being used as de facto labels. To address this, the consultation explored potential options for how to develop a more precise EU-level product categorisation system. Two main options were put forward:

    a. build on the current distinction between Article 8 and Article 9 products, to convert these into formal product categories.

    b. develop an approach focusing on the type of investment strategy, based on different criteria and concepts (such as removing the distinction between Articles 8 and 9 from the disclosure framework). The categories proposed within the consultation have some overlap with the proposed labels of the Sustainability Disclosure Requirements (SDR) in the UK and, depending on the outcome of the consultation, this could indicate the future trajectory of the SFDR.

2. **Potential changes to entity level requirements:** The consultation asked the question whether “the SFDR [was] the right place to include entity-level disclosures” and in the context of other EU reporting frameworks, “to what extent is there room for streamlining sustainability-related entity-level requirements across different pieces of legislation?”.

This could indicate that the EC is considering the usefulness of entity-level disclosures, and whether potential changes are needed to these disclosures. If entity level disclosures were removed, alternative disclosure requirements could fall under other regulatory frameworks such as the CSRD or the Capital Requirements Regulations.

3. **Interaction with other regimes:** With other markets and regimes, such as the Sustainability Disclosure Requirements (SDR) in the UK outlining product label categories, investors are mindful of the challenges of international interoperability. At present, the SFDR and the Sustainability Disclosure Standards (SDS) are far from being aligned and although this could change based on the outcome of the consultation, firms should consider carefully the reporting requirements they may fall under.

Separate from this broader consultation of SFDR, in December 2023 the ESA published its final report with proposed amendments to the RTS and the EC will decide on whether to endorse the proposals within the next three months.

These changes could have implications for firms reporting under the SFDR, albeit when they would impact is yet to be clarified.

The proposed amendments introduced by the ESA include:

1. Changes to PAI indicators. This would see the addition of mandatory social and voluntary PAI indicators, and amendments and additional data points for existing PAIs.
2. New detailed disclosures for financial products which have greenhouse gas (GHG) emissions reduction targets.
3. A new dashboard for a simple summary of key information.
4. Enhanced disclosure of how sustainable investments comply with the Do No Significant Harm principle.

What is GAM Investments doing?

Transparency is a key pillar of our strategy and that is why we comply our funds with SFDR. A significant proportion of our 'in scope' funds promote environmental or social characteristics and operate in accordance with Article 8 or Article 9 of SFDR. Our in-house ESG assessment and processes were enhanced to more explicitly incorporate the consideration of PAI for these funds, and given we recognise regulatory requirements are likely to evolve, we continually review our products.

One example includes GAM's Sustainable Climate Bond Strategy, which by focusing on European financial institutions invests in a wide range of environmental projects from green mortgages to renewable energy farms, and which is categorised as Article 9. GAM's Impact Report for the strategy can be found here.

GAM's disclosures include:

- SFDR web disclosures; GAM's pre-contractual disclosures can be found in the relevant fund pages accessed via the gam.com fund list
- GAM's latest Sustainability Report here
- Entity level policies; GAM's Principal Adverse Impacts Statement can be found here
- A full list of our disclosures is available here.

Sustainable Finance Disclosure Regulation - Overview of key requirements

Entity level disclosures: Firms are required to publish entity level disclosures on their website. These obligations concern their policies on decision-making on sustainability risks and include:

Sustainability risks
- The Article 3 requirement relates to the disclosure of information relating to a firm's policies on the integration of sustainability risks in its investment decision-making process.

Principal Adverse Impacts (PAIs)
- Article 4 is a fundamental tenet of the SFDR and relates to reporting PAIs. Firms should provide a statement on their policies regarding the PAIs of investment decisions or advice. Firms should disclose information regarding the consideration (or not) of PAIs described as the most significant negative impacts of investment decisions on sustainability factors relating to environmental, social, and employee matters, respect for human rights, anti-corruption and anti-bribery matters. Specific indicators are prescribed within the RTS.
- Firms must provide a qualitative statement which includes a summary of the identified PAIs and an explanation of the actions taken to reduce its impact.
- Reporting against PAIs is a mandatory process for large firms (those with over 500+ employees). For firms with fewer than 500 employees, the 'Comply or Explain' principle applies; here firms are not required to comply with the PAI at firm-level, but they must explain why they do not.

Remuneration policies
- Under Article 5 firms need to provide an explanation for how remuneration policies are consistent with the integration of sustainability risks.

Product level disclosures: Reporting obligations concerning the financial products and their sustainability risks include:

Pre-contractual disclosures
- A number of articles are addressed here. This includes Article 6 (non-ESG funds), Article 8 (light green funds) and Article 9 (dark green funds) which are discussed below. It also includes Article 7 considerations of PAIs which complement the entity level disclosures.
- The pre-contractual disclosures at the product-level include consideration of sustainability risks, sustainability indicators used to measure environmental or social characteristics, sustainable investments, EU taxonomy alignment, PAIs and significant harm of the product.

Periodic reports
- Article 11 requires annual disclosures delineating the extent to which the characteristics outlined in the pre-contractual disclosures were met during the period. This might include percentage asset allocation, sustainable or taxonomy aligned investments, or the actions taken to meet the environmental or social characteristics.

Web disclosures
- Disclosures must be published on the website under Article 10 and this
includes details on the environmental or social characteristics, any sustainable investment objective, investment strategy, monitoring, data sources, methodologies and limitations, due diligence and engagement policies.

The disclosure requirements differ depending on whether the products are considered to have a sustainable investment objective (commonly referred to as Article 9), environmental and/or social characteristics (commonly referred to as Article 8), or neither of the above (commonly referred to as Article 6).

- "Article 6" strategies either integrate consideration of sustainability risks into the investment decision making process, or explain why sustainability risk is not relevant, but do not meet the additional criteria of Article 8 or Article 9 strategies.
- "Article 8" strategies promote social and/or environmental characteristics, include consideration of PAIs and good governance, and may invest in sustainable investments, but do not have sustainable investing as a core objective.
- "Article 9" strategies have a sustainable investment objective.

There is a requirement for enhanced disclosures for Article 8 and Article 9 financial products; reporting templates are provided depending on the disclosure ambition.

Additional terms and definitions

- Sustainable investment means an investment in an economic activity that contributes to an environmental or social objective, provided that the investment "does not significantly harm" any environmental or social objective and that the investee companies follow good governance practices.
- Good governance practices include sound management structures, employee relations, remuneration of staff and tax compliance.

GAM's purpose is to protect and enhance our clients' financial future. By attracting and empowering the brightest minds to think beyond the obvious, we strive to provide investment leadership, innovation and a positive impact on society and the environment.

For more insights from GAM, go to 'Our Thinking' here.
To read our other explainers, go to 'GAM Explains' here.

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Stephanie Maier is Global Head of Sustainable and Impact Investment, responsible for leading GAM's sustainable and ESG (environmental, social and governance) strategy.

Stephanie joined GAM Investments in January 2021 from HSBC Global Asset Management, where she was Director for Responsible Investment. Prior to that, she spent seven years at Aviva Investors, latterly as Head of Responsible Investment Strategy and Research, and was formerly Head of Research for EIRIS, an ESG research and consultancy firm.

Stephanie holds an MSc in Environmental Technology from Imperial College London, a BA in Biological Sciences from Oxford University and the Investment Management Certificate (IMC). She is based in London.

For more information, please visit GAM.com

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