

Sustainable Investing:

Benefits and Challenges of Article 8 Funds

Sustainable Finance Disclosure Regulation (‘SFDR’) is a piece of European Union regulation introduced to improve transparency in the market for sustainable investment products, to reduce the incidence of greenwashing and to increase transparency around sustainability claims made by financial market participants. It is complemented by a suite of legislation aimed at delivering the sustainable development goals of the European Union.

Given the significant focus in the asset management industry on the implementation of SFDR this white paper will introduce the key elements of SFDR and will focus on the primary benefits and challenges for an investment fund aligning with Article 8 under SFDR.

Classification under SFDR

SFDR¹, in effect, classifies disclosure requirements of funds according to three distinct groups known as Article 6, Article 8 or Article 9. Some of the key distinguishing characteristics are shown below:

Scope for classification	Minimum Requirements	Examples of the type or orientation of Funds	Market Share ²
Article 6	Does <u>not</u> consider the promotion of environment and social (“E/S”) characteristics (grey)	Traditional market cap funds, factor funds with limited ESG considerations	Approximately 50% of SFDR classified universe in Europe
Article 8	Actively promotes E/S characteristics and may or may not have sustainable investments (light to medium green)	Broad market funds with ESG integration, Paris Aligned Indices	Approximately 45% of SFDR classified universe in Europe
Article 9	Must have an E/S objective and invest in a very high % of sustainable investments (~100%) (dark green)	Concentrated thematic funds or impact funds such as green energy funds etc. with few holdings (typically less than 100 stocks)	Approximately 5% of SFDR classified universe in Europe

Article 8 funds, often referred to as light to medium green funds, have varying approaches to the promotion of E/S characteristics. Some funds operate an exclusionary only policy (i.e., will not invest

¹ SFDR is not a labelling regime – references to Article 8 Funds as a grouping in this paper is for simplification purposes.

² Estimates as at September 2022

in particular types of industries or activities), some utilise ESG integration while others adopt an engagement led approach or utilise a mix of the aforementioned approaches.

Article 8 funds must commit to the promotion of E/S characteristics while ensuring the fund's investments adhere to "good governance". Article 8 funds are not currently required under SFDR legislation to commit to a minimum percentage of sustainable investments however they must show the impact on chosen E/S metrics of the fund. At time of writing there is some regulatory consultation in relation to the terminology being used in fund ranges as it relates to the promotion of ESG characteristics. This may have a bearing on fund names in the future.

Note: "sustainable investments" are currently loosely defined under SFDR with each financial market participant permitted to create their own definition and methodology for classifying sustainable investments. This potential divergence will hamper the ability of investors to compare investment fund offerings.

Benefits of Article 8 Funds

- SFDR should bring about enhanced transparency across financial products promoting E/S characteristics. Investors will now be able to see the "ESG" impact of Article 8 funds making it easier to compare differing offerings due to the uniformity of SFDR reporting. Additionally it helps forge links between investing and sustainability in the minds of investors, which many investors have historically not seen.
- While the specific approach across funds that are classified as Article 8 will vary, all Article 8 funds must promote environmental or social (or a combination of both) characteristics and assess companies for good governance standards. The long-term benefit of this promotion is ultimately linked to the regulatory objective – to take meaningful steps towards protecting the environment and having a positive social impact. This in time should direct more capital flows to taxonomy aligned green activities and to companies which are more aligned with sustainability objectives.
- There has been significant demand for fund products classified as Article 8 (and Article 9) since the introduction of SFDR³. Asset Management firms have a positive role to play in developing and distributing products that meet investor's expectations. An increase in Article 8 products can lead to increased levels of competition which ultimately benefits investors.

Challenges

- Availability of ESG data coupled with the inconsistency of ESG scores across different ESG data providers remains a challenge. This has a number of implications including:
 - Difficulties in measuring the attainment of goals promoted by Article 8.
 - Reduction in the ability of investors to compare different fund offerings.
 - Potential inaccurate identification and/or measurement of risks for funds – if a risk cannot be measured accurately it cannot be managed appropriately.

³ <https://www.morningstar.co.uk/uk/news/227898/article-8-funds-shed-another-%E2%82%AC287bn.aspx>

- Due to the breadth of investment approaches classified as Article 8 funds, this can lead to confusion for investors as to comparability between funds. Some Article 8 funds have committed to a minimum percentage of sustainable investments (often referred to as Article 8+ funds) while others do not.
- Due to the constraints of the SFDR templates, certain investment strategies may not be able to provide a full picture of the ESG credentials of the fund. For example, SFDR requires that only one minimum alignment figure is disclosed for the promotion both E and S features of a fund. This can potentially lead to confusion on the minimum being applied to either factor (same minimum applies to both rather than separate minimums for E and S features).
- There is a sizeable regulatory burden placed on SFDR reporting and compliance. This can disproportionately impact smaller investment houses who do not have the scale to internally resource ESG reporting specialists.
- Many goals promoted by Article 8 funds can have very long-time horizons and achievement may not be achieved in a linear fashion. One example is the promotion of a net zero economy by 2050. In reality this will be driven by strategic and macroeconomic initiatives that are multi-year in nature and a result accurate measurement of this may be difficult and may be very incremental in nature over a prolonged period of time.

Conclusion

SFDR remains a significant challenge to the industry with risks like greenwashing continuing to be a significant threat to the reputation of firms and ultimately the level of trust with investors.

However, opportunities abound for both asset managers and investors as new products are developed. The role of CFA charterholders in shaping and developing this new field is vitally important and takes two forms:

- Education – ensuring the market participants have access to learning opportunities (both for product providers and investors) in this area. CFA Institute offer a recently developed Certificate in ESG Investing⁴
- Investor outcome focussed – CFA charterholders comply with a code of conduct which at its heart promotes the fair and equitable treatment of investors and stakeholders. CFA charterholders have a role to play in ensuring that the implementation of ESG disclosures across the industry are fair, clear and not misleading.

For further information please contact info@cfaireland.com

⁴ See CFA Institute; Certificate in ESG Investing; <https://www.cfainstitute.org/en/programs/esg-investing>