

Sustainability transparency challenges : the case of “Article 9 funds”

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The implementation of the Sustainable Finance Disclosures Regulation (SFDR) faces important challenges since its implementation in March 2021.

A first fundamental reason is that the financial investors are requested to assess their portfolios and their financial products vis-à-vis the ESG (Environment – including Climate –, Social, Governance) or sustainable criteria but that a large part of the investees do not disclose their ESG data and trajectories. Large and listed corporates have some transparency obligations due to NFRD (Non-financial Reporting Directive) but there are new and more important obligations in CSRD (Corporate Sustainability Reporting Directive), which will apply only for the 2024 accounts. For other corporates, listed SMEs and SMEs (on a voluntary basis), it will be later.

The difficulties of the so-called “article 9 funds” illustrate another weakness of SFDR. The financial sector has launched funds in line with two articles of SFDR, article 8 and article 9. The so-called “article 8 funds” were supposed to be “light green” (moderately sustainable) and the so-called “article 9 funds” were supposed to be “dark green” (sustainable). As it is now well known, there has been a massive declassification of so-called “article 9 funds” in 2022. According to Morningstar, while assets in “article 8 funds” rose by 7.3% in the fourth quarter of last year, assets dropped by 40% in “article 9 funds”, taking the total to € 175 billion (\$ 190 billion). This declassification is due to the fact that SFDR is not a labelling regulation and that there is a lack of clarity on the definition of sustainability. Therefore many “article 9 funds” could be accused of greenwashing and their producers preferred to change them in “article 8 funds”.

How can these difficulties be overcome? The first answer could be to be patient, to wait for the CSRD and the future European Sustainable Standards to be implemented; then financial investors will have a clearer assessment of the sustainability of their portfolios and their financial products.

But the declassification of the “article 9 funds” has created a troublesome uncertainty on the definition of sustainability which needs to be addressed.

1. SFDR in a nutshell

The aim of SFDR is to oblige financial investors to more transparency vis-à-vis sustainable (or ESG) criteria of their financial investments.

1.1 Its first major element is the definition of a sustainable investment in the article 2

According to which a sustainable investment can be:

- an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy;
- or an investment in an economic activity that contributes to a social objective in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations;
- or an investment in human capital or economically or socially disadvantaged communities;
- provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures.
(this last principle called “no sufficient harm” is a cornerstone of EU sustainable reporting regulation, including in the sustainable Taxonomy for instance).

1.2 Another major article, the article 8, aims to organize the transparency of investments with environmental or social characteristics

This article defines the information to be disclosed (cf. Annex 1).

1.3 The last major article, the article 9, does the same in three different cases:

- Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark,

the information to be disclosed must include information on the alignment of the index with that objective and an explanation as to why and how this index differs from a broad market index.

- Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed must include an explanation on how this objective is to be attained.
- Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed must include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

2. The declassification of “article 9 funds”

The financial sector invested in ESG assets has rapidly used article 8 and article 9 as new ESG labels. That was not their purpose as it has just been recalled.

“Article 8 funds” are then supposed to mean “light green” funds or more rightly “light ESG” funds (for they can be more focused on social issues than on green issues) and “article 9 funds” mean “dark green” funds or more rightly “dark ESG” funds.

Given the appetite of financial investors for ESG products, these funds have been very successful. There have been also a growing number of ETF “article 8 funds” and “article 9 funds”.

But, during the course of 2022, many doubts have been raised as to the true ESG nature of these funds, by market researchers like Morningstar or Novethic, by national supervisors (in the Netherlands, Sweden, etc.) and by journalists of important European newspapers (in November 2022). The “article 9 funds” have been criticized for not being transparent enough et not as green as they were supposed to be.

For example, Finansinspektion, the Swedish financial supervisor, has scrutinized the documentation of 30 “article 9 funds” during the summer of 2022 and concluded first that the information on the sustainability were not clear, difficult to understand and to compare, and secondly that the sustainable nature of the investments of some funds were questionable. A study of Clarity AI on 750 European “article 9 funds” – published in November 2022 – shows that 10% of these funds have more than 10% of their assets invested in the fossil energy sector and that 20% of these funds have at least 10% of their assets invested in corporates known for their violations of the principles of the Global Compact or of the Guiding Principles of the OECD.

Consequently, to avoid to be accused of greenwashing, the producers of “article 9 funds” have preferred to declassify most of these funds and transform them in “article 8 funds”. In the 4th quarter of 2022, more than 300 “article 9 funds”, representing total assets of \$ 175 billion have been declassified into “article 9 funds” (source: Morningstar). The “article 9 funds” represent now 3% of the market and the “article 8 funds”, 35%.

3. The interesting elements of the study by Novethic on the “article 9 funds”

Novethic, with the support of ADEME (French agency for the Environment), has studied 195 funds managed in France self-classified “article 9 funds” (143 invested in equities, 41 in bonds and 11 diversified).

Most of these funds give only a very general justification of the criteria according to article 9. 42 only published a document close to a template dedicated to SFDR which allows to better understand the goal of the investment (energetical transition, for instance) in guiding their investment in corporates.

The majority of indicators published by the funds are based on Annex 1 of the technical standards, which are the indicators called PAI (Principal adverse impacts). There are also indicators called “proprietary”, based on the ESG assessments of asset-managers.

During a conference in Paris in December to discuss the conclusions of this study with asset-managers, some interesting comments were made which confirmed that:

- asset-managers do not apply the same criteria;
- they often rely on ESG labels, which are themselves questionable (for example, the most important label in France and in the EU, ISR, does not exclude investment in fossil fuels companies);
- given the doubts about the ESG quality of article 9 funds, most asset-managers have preferred to reclassify some of them into article 8 funds;
- the communication to the customer about the ESG performance of a fund is sometimes very poor (for example, after the reclassification of an article 9 fund into an article 8 fund, the message was “your fund has been reclassified, but do not worry, its content is the same and it is still an ESG fund”);
- some national market authorities have publicly said that they do not have the capacity to control the conformity of the funds with SFDR;
- the asset-managers would like a clarification of SFDR by the European Commission and/or the European supervisory authorities (ESAs).

4. The different reactions and proposals of supervisors and regulators

4.1 In 2022, the ESAs have published clarifications related to the technical standards which will be implemented in 2023, including through a last FAQ in November

In September 2022, they have also asked 8 questions to the Commission in order to get clarification on crucial points in accordance with the UE legislation, notably on the concept of sustainability of the article 2 and on the consideration of the PAIs. The answers to these questions are expected in the first quarter of 2023.

Some national supervisors (in Belgium, Denmark, France, Ireland, Netherlands, etc.) have also started to publish recommendations.

4.2 In February 2023 the French market authority (AMF) published a proposal to the European Commission for overcoming the difficulties. The main points of this proposal are:

- to introduce minimum standards that a financial product should meet in order to be classified either as “article 8 fund” or “article 9 fund”;
- to clarify the definition of “sustainable investment” in Article 2 of SFDR, which should consist of a minimum alignment on the EU taxonomy, coupled with some clarifications on the possibility for Article 9 products to include investments not sustainable but made for liquidity and hedging purposes and also investments in “transition assets” (AMF recognizes that “transition assets” need to be defined by the legislators, but it sees this as a crucial long-term goal);
- to introduce a minimum standard of alignment with the EU taxonomy for Article 9 funds, which should be increased step by step, depending on how the EU’s economy alignment with the taxonomy progresses over time;
- article 9 products should exclude investments in fossil fuel activities that are not aligned with the Taxonomy;
- AMF also suggests to the policymakers to consider some possible additional requirements;
- producers of Article 8 and Article 9 funds could be required to adopt engagement policies and disclose them;
- producers of Article 8 and Article 9 funds could be required to report on the principal adverse impacts (PAI).

Conclusion

The difficulties of the “article 9 funds” have been very clearly shown in 2022 and have raised many comments and suggestions of reform.

There are two general axis of improvement, on the asset-management side and on the regulatory side.

On the asset-management side, there is room for more transparency and for more comparability, especially by a common work which has already started. In fact, one of the main difficulties with present article 9 funds is that they mix very different ESG objectives and data: climate, diverse environmental data, social data and they have also incorporated the NSH principle. A first solution should be for the corporates to be explicit on all these objectives and data. But another way forward would be **to offer ESG funds more focused on one sustainable objective**: a fund specialized on climate, one on social issue, one on environment (including or excluding some very specific aspects as biodiversity for instance), even funds on one very specific aspect like biodiversity. The part of judgement of the investor (and or ESG ratings agency) should be made easier.

On the regulator side, the first axis of improvement is the clarification of the regulation asked by many actors and by the European Supervision authorities to the European Commission. The clarification of article 2 about what is sustainable is a crucial element of improvement. But the difficulty is that this clarification probably needs an amendment to SFDR which must be approved by the European Parliament and the Council.

The regulation, even if it is improved, will always keep a place for judgement. This is the same for financial and accounting reporting after decades of fine-tuning: they cannot presume by themselves the degree of financial solidity and profitability of corporates. And therefore **what is needed is as much transparency as possible. The proposals of the AMF go in this direction with the setting of minimum environmental standards.**

This approach also requires probably to amend SFDR.

The regulation on sustainable transparency developed in the European Union is still a young regulation. It is normal that there are difficulties of implementation which were not foreseen by the legislators and which have to be corrected. But it should not put in doubt the general orientation to more transparency, which will be helped by the implementation soon of CSDR.

ANNEX 1 : MAIN EXCERPTS OF THE SFDR

Article 2.17:

‘Sustainable investment’ means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures.

Article 8

Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures

1. Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following:
 - a - information on how those characteristics are met;
 - b - if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.
2. Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the index referred to in paragraph 1 of this Article is to be found.
3. The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.

When developing the draft regulatory technical standards referred to in the first subparagraph, the ESAs shall take into account the various types

of financial products, their characteristics and the differences between them, as well as the objective that disclosures are to be accurate, fair, clear, not misleading, simple and concise.

The ESAs shall submit the draft regulatory technical standards referred to in the first subparagraph to the Commission by 30 December 2020.

Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010.

Article 9

Transparency of sustainable investments in pre-contractual disclosures

1. Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following:
 - a - information on how the designated index is aligned with that objective;
 - b - an explanation as to why and how the designated index aligned with that objective differs from a broad market index.
2. Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall include an explanation on how that objective is to be attained.
3. Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

4. Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology

used for the calculation of the indices referred to in paragraph 1 of this Article and the benchmarks referred to in the second subparagraph of paragraph 3 of this Article are to be found.

5. *The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.*

When developing the draft regulatory technical standards referred to in the first subparagraph of this paragraph, the ESAs shall take into account the various types of financial products, their objectives as referred to in paragraphs 1, 2 and 3 and the differences between them as well as the objective that disclosures are to be accurate, fair, clear, not misleading, simple and concise.

The ESAs shall submit the draft regulatory technical standards referred to in the first subparagraph to the Commission by 30 December 2020.

Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010.

ANNEX 2 BIBLIOGRAPHY

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