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Bridging the sustainability information gap: an assessment of the European sustainable finance framework

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Citation

Hartman-Ohnesorge, L. G. L. (2026, February 4). *Bridging the sustainability information gap: an assessment of the European sustainable finance framework*. Meijers-reeks. Retrieved from <https://hdl.handle.net/1887/4288732>

Version: Publisher's Version

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Note: To cite this publication please use the final published version (if applicable).

5 | The Sustainable Finance Disclosure Regulation

Overcoming the Principal-Agent Problem in Sustainable Investing

1 INTRODUCTION

1.1 Previous Chapters

In Chapters 1 and 2, I explained that the aim of the EU Sustainable Finance Framework (“EU SFF”) is to channel more private capital into sustainable investments, ultimately facilitating the transition to a low-carbon society. This objective aligns with enhancing market efficiency and increasing overall welfare. One of the primary mechanisms of the EU SFF to realise its aim of enabling investors to invest more sustainably is by providing them with sustainability information on their potential investments. My research aims to answer the question: *To what extent does the European Sustainable Finance Framework enable investors to make better informed investment decisions that integrate sustainability considerations, and how can this framework be improved to facilitate the reorientation of capital flows toward sustainable economic activities?* To answer this question, I use Law & Economics (“L&E”) as a qualitative method: I identify which market failures impede the efficient functioning of the market and analyse whether the legislation addresses these market failures. For this, I use a simplified model of financial markets, consisting of issuers, intermediaries, and investors. These three actors represent the investment chain through which capital should be allocated to sustainable investments. In Chapters 3 and 4, I focussed on the direct flow of information between issuers and investors: what sustainability information is provided by issuers to investors on the sustainability of their investment? Chapter 3 focuses on the information that is provided to investors on the basis of ongoing disclosure requirements from the Corporate Sustainability Reporting Directive (“CSRD”) and article 8 Taxonomy Regulation (“TR”), which apply to issuers. Chapter 4 discusses the initial disclosures that are made by issuers to investors, when assets are sold for the first time, on the basis of the Prospectus Regulation (“PR”) and the European Green Bond Standard Regulation (“EuGBR”). Together, the ongoing and initial disclosure requirements significantly contribute to overcoming the information asymmetries on sustainability information that exist between issuers and investors. There is however room for improvement: the ongoing disclosure framework of the CSRD and TR is complex, making compliance costly and possibly overloading investors with information. The initial disclosure regime is not embedded sufficiently in the

EU SFF: the PR, predating the EU SFF, is not aligned with the TR. This creates the risk that the information contained in prospectuses is incomplete and/or incoherent. The EuGBR is aligned with the EU SFF but has a very limited scope of application and may not be relied upon much by issuers. Overcoming these issues is vital to decreasing the information asymmetries between issuers and investors on sustainability information.

1.2 This Chapter

In this Chapter, I assess the question: How effective are the disclosure requirements from the Sustainable Finance Disclosure Regulation in reducing the principal-agent problem between intermediaries and investors? The focus of this Chapter expands on the previous two chapters, in which it was presumed that investors rely on information that is directly provided to them by issuers. This chapter concerns the situation in which investors and issuers are matched with the help of a third party – an intermediary. While any party that assists in the functioning of the market could be described as a financial intermediary – from market makers to credit rating agencies to traditional investment firms I limit myself to the financial intermediaries that fall within the scope of the Sustainable Finance Disclosure Regulation (“SFDR”), as that Regulation is the central subject of investigation in this chapter.¹ In paragraph 3.3 on the scope of the SFDR, I elaborate on the exact delineation of the parties that are subject to this regulation. Here it suffices to say that the focus is on financial businesses that advise investors and/or manage capital on behalf of the investor. These businesses help ‘end investors’ – physical or legal persons who hold shares for their own account – to engage in financial transactions.

The SFDR aims to resolve one of the main market failures that can arise when investors rely on intermediaries: the so-called principal-agent problem.² For this, the SFDR focuses on reducing information asymmetries between investors and intermediaries in the area of sustainability risk and impact. To assess whether the SFDR is successful at minimizing the principal-agent problem in the context of sustainability information, I have formulated three criteria in the normative framework contained in paragraph 2. Subsequently, I discuss and analyse the main obligations that follow from the SFDR. These obligations will be evaluated in paragraph 4 using the criteria that I outline in my normative framework.

1 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR).

2 Recital 10 SFDR.

2 NORMATIVE FRAMEWORK

In Chapter 2, I explained that in the principal-agent theory, the principal delegates some of its decision-making power to the agent.³ In the context of this chapter, the principal is the investor. The investor tasks the intermediary, the agent, to make investment decisions on his behalf or to provide investment advice. There is a certain risk involved in this delegation of power, namely that the agent does not (fully) act in the interest of the principal. This is called the principal-agent problem, which has two prerequisites: that the principal and the agent have different interests and that there is information asymmetry between them.⁴

The principal-agent problem puts pressure on the efficient allocation of capital, and thus on the financing of the transition to a climate-neutral society, in a number of ways.⁵ First, prior to concluding a contract with an intermediary, intermediaries who are aware of the information asymmetries between them and the investor may exploit this vulnerability, which can lead to an adverse selection problem.⁶ The investor may attempt to overcome this vulnerability by conducting research before selecting an intermediary, which increases information costs.⁷ Second, after the conclusion of the contract, the investor may incur monitoring costs to verify whether the intermediary is carrying out its tasks in the investor's best interests.⁸ The costs that the investor incurs prior to and after the conclusion of the contract, transaction costs, undermine the efficient allocation of resources.⁹ In general, a large part of financial regulation therefore aims to decrease transaction costs by minimizing the principal-agent problem.¹⁰ The SFDR, more specifically, aims to minimize the principal-agent problem in relation to sustainability information.¹¹ In this Chapter, I evaluate how effective the SFDR is to that end.

Before I set out the criteria for my assessment, I briefly summarize the principal-agent problem in the context of sustainability information. As I

3 Jensen M. C. & Meckling W.H., "Theory of the firm: Managerial behavior, agency costs and ownership structure", *Journal of Financial Economics* 1976, vol. 3(4), p. 305, 308.

4 Shah S.N., *The Principal-Agent Problem in Finance*, CFA Institute Research Foundation 2014, p. 2-5.

5 See: paragraph 3.4.1 of Chapter 2.

6 Veil R. (ed.), *European Capital Markets Law* (2nd edition), Hart Publishing 2017, p. 266; Akerlof G.A., "The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism", *The Quarterly Journal of Economics* 1970, vol. 84(3), p. 488.

7 Dahlman C.J., "The Problem of Externality", *Journal of Law & Economics* 1979, vol. 22(1), p. 141, 147-148.

8 Jensen M. C. & Meckling W.H., "Theory of the firm: Managerial behavior, agency costs and ownership structure", *Journal of Financial Economics* 1976, vol. 3(4), p. 305, 308; Dahlman C.J., "The Problem of Externality", *Journal of Law & Economics* 1979, vol. 22(1), p. 141, 147-148.

9 See: paragraph 3.3 and 3.4.1 of Chapter 2.

10 For example, the duty to act in the best interest of the client in article 24 MiFID II.

11 Recital 10 SFDR.

already pointed out, the principal-agent problem has two prerequisites: information asymmetries and diverging interests between principal and agent. Regarding the information asymmetries, it can be assumed that the intermediary has (access to) more sustainability information on the investment than the investor.¹² With regard to diverging interests between principal and agent in the context of sustainability information, two key issues can be identified. First, the investors and intermediaries may have a different time horizon for risk management. When intermediaries prioritize short-termism, long-term risks, including sustainability-related risks, may be underestimated.¹³ Also, short-termism stands in the way of the research and development necessary to transition to a climate-neutral society, which requires long-term vision and investment.¹⁴ Second, the increased demand for sustainability disclosures and the increasing demand for sustainable investment opportunities can be an incentive for intermediaries to present investment opportunities as more sustainable than they are in order to win or keep more investors as clients. This risk is referred to as greenwashing, which is defined by the ESAs as “a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants.”¹⁵ Greenwashing is a principal-agent problem because, at its core, the interest of the intermediary diverges from those of the investor: whereas the investor may be interested in aligning its investment strategy to specific sustainability aims, the intermediary is primarily interested in acquiring and keeping the investor as a client.

To reduce the principal-agent problem, there are two categories of solutions: decreasing the information asymmetry or better aligning the interests of the principal and the agent. The SFDR focuses on the former: decreasing informa-

12 After all, the investor relies on the intermediary to collect and analyse information instead of doing this herself.

13 Fried J.M. & Wang C.C.Y., “Short-Termism and Capital Flows”, *The Review of Corporate Finance Studies* 2019, vol. 8(1), p. 207; Ofir M. & Elmakiess T., “The Eco-Agency Problem and Sustainable Investment”, *LSE Legal Studies Working Paper* 2023, no. 26, available at: <https://ssrn.com/abstract=4652981>; Lydenberg S., “System-Level Considerations and the Long-Term Investor: Definitions, Examples, and Actions”, *The Investment Integration Project* 2017, available at: https://www.tiiproject.com/wp-content/uploads/2017/03/Systems_Level_Considerations_Long_Term_Investor.pdf.

14 Roe M.J., “What is Stock Market Short-Termism?”, *European Corporate Governance Institute – Law Working Paper* 2022, no. 658, available at: <https://ssrn.com/abstract=4194910>.

15 ESMA, Progress Report on Greenwashing, Response to the European Commission’s request for input on “greenwashing risks and the supervision of sustainable finance policies”, 31 May 2023, ESMA30-1668416927-2498, p. 11. A comprehensive overview of definitions can be found in: Freitas Netto S.V. de, e.a., “Concepts and forms of greenwashing: a systematic review”, *Environmental Sciences Europe* 2020, vol. 32(19), available at: <https://doi.org/10.1186/s12302-020-0300-3>. Also: Marquis C., e.a., “Scrutiny, Norms, and Selective Disclosure: A Global Study of Greenwashing”, *Organization Science* 2016, vol. 27(2), p. 483.

tion asymmetries.¹⁶ I use three criteria to assess how successful the SFDR is in realizing this aim. As these are similar to the assessment criteria for reducing information asymmetries that I have formulated in Chapter 3, I only provide a brief overview here:

1. Complete, meaning that the information disclosed covers all necessary areas of sustainability information. For this, I rely on the double materiality principle and will therefore assess whether the disclosed information covers positive and negative sustainability impact and sustainability risk.
2. Standardised, meaning (a) that the information is harmonised between intermediaries to enable the investor to make a meaningful comparison between intermediaries, and (b) that information is standardized for financial products to enable comparisons.
3. Accurate, meaning (a) that the information flow from issuer to intermediary is consistent to prevent that information is obscured or lost in translation and (b) that the information is sufficiently supported by scientific consensus.

Since the principal-agent problem is relevant both prior to and after the conclusion of the contract between the principal and agent, I take both dimensions into account.

3 THE SUSTAINABLE FINANCE DISCLOSURE REGULATION

3.1 Introduction

The SFDR entered into force on 10 March 2021 and establishes harmonized rules for financial market participants (“FMPs”) and financial advisers (“FAs”) on the disclosure of how they integrate sustainability risks, consider adverse sustainability impacts in their processes, and provide sustainability-related information regarding financial products.¹⁷ The SFDR focuses on the transparency of processes, for example, the disclosure of policies – it does not qualify activities as sustainable or non-sustainable and does not contain thresholds or closed definitions.¹⁸ It was the first piece of legislation from the EU SFF that was published and entered into force.¹⁹ The Regulation applies both

¹⁶ Recital 10 SFDR.

¹⁷ Article 1 and article 20 SFDR. For a general introduction on the SFDR: Poulle J.-B., e.a., *EU Banking and Financial Regulation*, Edgar Elgar 2024, Chapter 69 Sustainable Finance Disclosure Regulation (SFDR), p. 625-633.

¹⁸ For a discussion on the implication of the lack of absolute thresholds: Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>.

¹⁹ The SFDR was published in 2019. The Taxonomy Regulation was published in 2020, the CSRD in 2022.

before the conclusion of a contract between investor and intermediary (*ex ante*; para. 3.5) and after the conclusion of such a contract (*ex post*, para. 3.6). Disclosure requirements exist both at entity and at product level.

3.2 Aims and Practice

According to recital (10), the aim of the SFDR is “to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment.”²⁰ To realize this aim, the SFDR creates a disclosure framework for how sustainability risks and impacts are integrated into decision-making processes on entity and product level. The SFDR is part of the EU SFF, which means that one of its overarching objectives is to contribute to a climate-resilient economy.²¹ At the same time, the regulation fits seamlessly into a wider framework of European financial regulation that aims to protect investors who rely on an intermediary to make their investments.²² With a focus on both investor protection and climate transition, the topics of disclosure that the SFDR aims at are, on the one hand, sustainability risk and, on the other hand, impact on sustainability by investments.²³ Although the term is not mentioned, this parallels the double materiality principle of the CSRD, which requires issuers to disclose both how they impact sustainability factors and how they are impacted by sustainability factors.²⁴

3.2.1 Labelling or Transparency Regime?

The SFDR requires FMPs and FAs “to disclose specific information regarding their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts.”²⁵ This aligns with the aim of reducing the information asymmetries in the principal-agent relationship between intermediary and investor instead of a requirement to put on the market financial products with a sustainability profile that is mandated by the legislator.²⁶ The legislative approach is thus to be transparent about how sustainability risk is integrated and adverse impacts are considered, not any man-

20 Recital 10 SFDR.

21 Recitals 1-3 SFDR.

22 Recital 4 SFDR. These include the regulation of UCITS, credit institutions, investment firms, insurance undertakings, among others.

23 Recitals 5, 10, 12, 13, 14 SFDR.

24 Lange J. de, “EU Sustainable Finance Regulation: A missed opportunity for transformative change?”, *Tijdschrift voor Financieel Recht* 2024, nr. 6, p. 85, 92.

25 Recital 8 SFDR.

26 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 26.

datory thresholds or changes in sustainability policy.²⁷ These transparency requirements vary for different articles and prescribe different intensity and focus of disclosures when products are put on the market as having no sustainability characteristics (articles 6 and 7), promoting environmental or social characteristics (article 8), or having sustainable investment, a term defined in article 2 (17) SFDR, as their core objective (article 9). Whereas there is a significant amount of discretion for FMPs and FAs to categorise and explain why a product falls under article 8 or 9 SFDR, there are also extensive limitations to this categorisation – for example, it is not possible to randomly qualify a financial product as having sustainable investment as its core objective.²⁸ This means that the product categorisation of the SFDR has some similarity to a labelling regime, with articles 8 and 9 products referring to a certain degree of sustainability.²⁹

However, the SFDR is not intended to be a labelling regime.³⁰ This has been communicated by the Commission and ESMA multiple times.³¹ That the Commission does not see the SFDR as a labelling system is, for example, made clear in the explanatory memorandum in the draft delegated act for MiFID II sustainability preferences from April 2021, which focuses on the distinction between procedural transparency and material impact in sustainable investing.³² Under the MiFID II sustainability preferences, firms providing investment advice and portfolio management must incorporate clients' sustainability preferences into their suitability assessments.³³ However, when a client

27 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 27.

28 Arriba-Sellier N. de & Caenegem A. van, "Sustainability-related Materiality in the SFDR", *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 2.

29 Eurosif, "EU Sustainable Finance & SFDR: making the framework fit for purpose Eurosif Policy Recommendations for Article 8 & 9 product labels", June 2022, p. 10; Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, *European Parliament* 2024, No. PE 754.212, p. 10.

30 In his chapter on the SFDR, Zukas shows how various official key players like the Commission and ESMA have tried for the first few years to clearly communicate that the SFDR is not a labelling regime: Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33. See also: Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, *European Parliament* 2024, No. PE 754.212, p. 10.

31 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33.

32 COMMISSION DELEGATED REGULATION (EU) .../... amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms C/2021/2616 final, p. 3.

33 Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment

expresses sustainability preferences, this should be interpreted as a desire for investments with substantive environmental or social impact rather than merely receiving transparency about sustainability policies.³⁴ The explanatory memorandum, therefore, also stresses that the fact that a financial product has been classified as an article 8 or 9 product under the SFDR is not sufficient to determine that the product materially meets a client's sustainability preferences. Instead, the firm should conduct a substantive analysis of whether the financial product meets the sustainability preferences of the client.³⁵ This implies that articles 8 and 9 SFDR should not be treated as sustainability labels but as procedural transparency requirements. This is why the sustainability preferences in MiFID II do not refer to article 8 or 9 products but to financial instruments that contain a proportion of sustainable investments as defined in article 2 (17) SFDR or have a minimum proportion of Taxonomy-aligned investments.³⁶

That the SFDR is not intended as a label but as procedural transparency regime also aligns with the architecture of the EU SFF. After all, the EU SFF already contains a label for sustainable investments: the European Green Bond, which I discuss in the previous Chapter. This label is indeed based on the presumption that it is the label itself that carries material information. This is guaranteed by the fact that in order to qualify as a European Green Bond, the issuer must meet material thresholds: the activities financed must be Taxonomy-aligned.

Although the intention of the SFDR is a disclosure regime, the practical market impact has been different: it has effectively created an informal labelling

firms (MiFID II sustainability preferences). See: Colaert V., "On the Sustainability of the MiFID II and IDD Investor Protection Frameworks", in: Alexander K., Gargantini M., & Siri M. (eds.), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press 2025, p. 317. See also: Raas R.P., "Duurzaamheidsvoorkeuren: Een hernieuwde kennismaking", in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022; Rijsbergen M.P.M. van & Rogge E., "De integratie van duurzaamheid in MIFID II ken-uw-cliënt- en productontwikkelingsbepalingen", in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023 Wallinga M.W., "Ook MiFID II in het teken van duurzaamheid" in: Wallinga M.W., Nuijten S.M.C., & Karagianni A., *Europeanisering van financieel recht. Preadvies voor de Vereniging voor Financieel Recht*, Wolters Kluwer 2024; Jorritsma J.J., "De uitbreiding van de ken-uw-cliëntverplichting met de duurzaamheidsvoorkeuren van de belegger", *Tijdschrift voor Financieel Recht* 2023, nr. 3, p. 60.

34 COMMISSION DELEGATED REGULATION (EU) .../... amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms C/2021/2616 final, p. 3.

35 COMMISSION DELEGATED REGULATION (EU) .../... amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms C/2021/2616 final, p. 3.

36 Article 1 MiFID II sustainability preferences.

system.³⁷ For example, financial products for which information is disclosed on the basis of article 8 or 9 SFDR are being marketed, as an ‘article 8’ or ‘article 9’ fund or as ‘light green’ or ‘dark green’ funds.³⁸ The market practice has become undeniable, culminating in the 2022 speech of ESMA’s chair Verena Ross, in which she recognised the factual market practice:³⁹ “While SFDR was designed to enhance transparency around sustainability, we have noted that in practice the disclosures are often being used as product classification. Status as “Article 8” or “Article 9” funds are being used in marketing material by fund managers as quality labels for sustainability.”⁴⁰

This raises the question of why it is relevant whether the SFDR is a labelling regime or a procedural transparency regime. The answer lies in how these two types of regulatory approaches function and what rules they require to be effective. As Tröger and Steuer explain, labels and procedural transparency serve distinct purposes.⁴¹ Labels imply a normative assessment based on a predefined set of criteria or thresholds, which creates a binary classification system that is based on compliance with the criteria or thresholds.⁴² In contrast, procedural transparency requirements focus on disclosing qualitative or quantitative data that enable an informed investment decision that is based on their own assessment of the information that has been provided.⁴³ This distinction has significant implications for how each type of disclosure should be structured. While a procedural transparency regime should provide rules to ensure the disclosure of comprehensive and relevant information that meets the investor’s needs, for example, by a double materiality approach, a labelling regime should focus on establishing material thresholds. This difference is relevant for evaluating whether the criteria from the normative framework

37 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33.

38 Ramos Muñoz D., Lamandini M. & Siri M., “The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)”, *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, European Parliament 2024, No. PE 754.212, p. 10; Becker M.G., Martin F. & Walter A., “The power of ESG transparency: The effect of the new SFDR sustainability labels on mutual funds and individual investors”, *Finance Research Letters* 2022, vol. 47, part B, 102708.

39 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33.

40 ESMA, Verena Ross, Key priorities for EU retail fund investors, Irish Funds Annual Global Funds Conference, 31 May 2022, ESMA34-466-284, p. 7.

41 Tröger T. & Steuer S., “The Role of Disclosure in Green Finance”, *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8.

42 Tröger T. & Steuer S., “The Role of Disclosure in Green Finance”, *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8; Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 2-3.

43 Tröger T. & Steuer S., “The Role of Disclosure in Green Finance”, *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8.

that I set out in paragraph 2 are met, as will become clear in the concluding paragraph.

3.3 Scope

The SFDR has an extensive scope.⁴⁴ According to article 1 SFDR, the regulation applies to financial market participants (“FMP”) and financial advisers (“FA”). Note that the SFDR uses its own system of definitions instead of adopting existing definitions from MiFID II, despite considerable substantive overlap between the definitions used in the two pieces of legislation.⁴⁵ FMP is defined in article 2 and applies to ten types of financial businesses:

- “(a) an insurance undertaking which makes available an insurance-based investment product (IBIP);
- (b) an investment firm which provides portfolio management;
- (c) an institution for occupational retirement provision (IORP);
- (d) a manufacturer of a pension product;
- (e) an alternative investment fund manager (AIFM);
- (f) a pan-European personal pension product (PEPP) provider;
- (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013;
- (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013;
- (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or
- (j) a credit institution which provides portfolio management.”⁴⁶

FAs are businesses that provide investment advice: “the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments.”⁴⁷ The scope of the SFDR, thus is as broad as possible.

44 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 487; Siemers B.T.B., “Informatieverschaffing over duurzaamheid door beleggingsinstellingen”, *Tijdschrift voor Financieel Recht* 2021, nr. 1/2, p. 16, 18; Oostrum C. van, “Sustainability Through Transparency and Definitions: A Few Thoughts on Regulation (EU) 2019/2088 and Regulation (EU) 2020/852”, *European Company Law* 2021, vol. 18(1), p. 15, 16-17.

45 Article 4 MiFID II.

46 Article 2 SFDR.

47 Article 1 and article 2 (11) SFDR: “Financial adviser’ means: an insurance intermediary which provides insurance advice with regard to IBIPs; an insurance undertaking which provides insurance advice with regard to IBIPs; a credit institution which provides investment advice; an investment firm which provides investment advice; an AIFM which provides investment advice in accordance with point (b)(i) of Article 6(4) of Directive 2011/

The unifying aspect among these businesses is that they make or influence investment decisions on behalf of end investors, which creates principal-agent relationships. This is most obvious for investment firms and credit institutions that provide portfolio management – managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments listed under article 2 (1) (b) and (j) SFDR, respectively.⁴⁸ The principal-agent dynamic, however, extends beyond direct portfolio management. For instance, AIFMs, which manage collective investment undertakings that raise capital and invest according to predefined policies, factually have been delegated the decision-making power by the shareholders in the investment fund. Similarly, FAs have not been delegated decision-making power by investors, but their advice significantly influences the decision-making of the investor, which effectively establishes a principal-agent relationship.⁴⁹

Two factors play a role in the large scope of application of the SFDR: the broad definitions of FMPs and FAs as just discussed, and the fact that the SFDR applies to FMPs and FAs, regardless of whether their explicit engagement with sustainability objectives. However, substantively, there are limitations to the scope as well. First of all, the SFDR contains varying levels of transparency obligations, depending on whether and how FMPs and FAs engage with sustainability.⁵⁰ For example, FMPs that do not offer products falling under articles 8 or 9 SFDR are subject to less stringent disclosure requirements compared to those marketing products with environmental or social characteristics or sustainable investment objectives. In other words, the SFDR contains voluntary norms that only apply when FMPs choose to offer products that fall under those articles.

61/EU; or a UCITS management company which provides investment advice in accordance with point (b)(i) of Article 6(3) of Directive 2009/65/EC." Investment advice is defined in article 4 (1) (4) of Directive 2014/65/EU (MiFID II).

48 The principal-agent dynamic extends beyond direct portfolio management. Take for example the alternative investment fund manager (AIFM) under article 2 (1) (e) SFDR. An AIFM manages an alternative investment fund, which is a collective investment undertaking that raises capital from investors with a view to investing it in accordance with a predefined investment policy for the benefit of those investors. From a legal point of view, the end investor is a shareholder in the alternative investment fund that is managed by the AIFM. Economically speaking, the end investor has delegated the power to make investment decisions on his behalf to the AIFM. Thus, also for the types of financial businesses from article 2 (1) SFDR with whom there is no direct contractual relationship by which the investor delegates the power to take investment decisions on his behalf, practically speaking there is a principal-agent relationship.

49 See: Accounting Insights, "Understanding the Principal-Agent Problem, Concepts, Relationships, Solutions", 19 July 2024, available at: <https://accountinginsights.org/understanding-the-principal-agent-problem-concepts-relationships-solutions/>, accessed on: 1 November 2024.

50 Siemers B.T.B., "Informatieverschaffing over duurzaamheid door beleggingsinstellingen", *Tijdschrift voor Financieel Recht* 2021, nr. 1/2, p. 16, 18.

Next to this, the substantive scope differs for FMPs and FAs, with FMPs being subject to more substantive articles of the SFDR than FAs, as is shown in the table below.⁵¹ Additionally, there is a *de minimis* exception for FAs, exempting them from the SFDR when they employ fewer than persons.⁵² This means that although the SFDR has a substantial scope, it nonetheless maintains a level of proportionality that corresponds to the degree of engagement with sustainability by the FMPs and FAs.⁵³ These substantive differences will be discussed more elaborately in paragraphs 3.5 – 3.7, which contain the disclosure requirements that apply on the basis of the SFDR. However, the core difference is that FA need not make disclosures at product level on sustainability impact (article 7) and for products that promote environmental and social characteristics (article 8), or that have sustainable investment as their objective (article 9).

Table 5: SFDR disclosures

	Disclosures at entity level			Disclosures at product level						Marketing communications
	Art. 3	Art. 4	Art. 5	Art. 6	Art. 7	Art. 8	Art. 9	Art. 10	Art. 11	
FMP	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
FA	Y	Y	Y	Y	N	N	N	N	N	Y

3.4 Definitions and Concepts

The SFDR intends to inform investors about the sustainability impact and sustainability risks.⁵⁴ To do so, the Regulation relies on four sustainability-related definitions and concepts that are used throughout the various disclosure requirements and which I explain in the next paragraphs:

1. sustainable investment as defined in article 2 (17) SFDR;
2. sustainability risk, which entail risks that could have a material negative impact on the value of the investment, as defined in article 2 (22) SFDR;
3. sustainability factor, which are the factors defined in article 2 (24) SFDR;

51 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 487.

52 Article 17 (1) SFDR. This does not apply to the obligation to factor sustainability risk into advisory processes, see recital 6 SFDR.

53 Siemers B.T.B., “Informatieverschaffing over duurzaamheid door beleggingsinstellingen”, *Tijdschrift voor Financieel Recht* 2021, nr. 1/2, p. 16, 18.

54 Recitals 5, 8, 10 SFDR.

4. the principal adverse impacts, which are the “impacts of investment decisions and advice that result in negative effects on sustainability factors”.⁵⁵

3.4.1 Sustainable Investment

Article 2 (17) defines ‘sustainable investment’. To qualify as a sustainable investment under the SFDR, the investment must thus comply with three cumulative criteria:⁵⁶

1. contribute to an environmental or social objective (“E/S objective”);
2. do no significant harm (“DNSH”) to those objectives;
3. good governance practices.

3.4.1.1 Contribute to an environmental or social objective (E/S objective)

When it comes to the E/S objective criterion, the definition in article 2 (17) SFDR contains a material description of what E/S objectives entail:

“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.”

The definition of sustainable investment in article 2 (17) SFDR lacks specific thresholds. Thresholds could easily have been implemented by aligning the term ‘environmental objective’ in article 2 (17) SFDR with its counterpart in article 9 of the Taxonomy Regulation, which establishes concrete thresholds

⁵⁵ Recital 20 SFDR.

⁵⁶ Article 2 (17) SFDR: “‘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, employee relations, remuneration of staff and tax compliance.” [emphasis added].

through the technical screening criteria.⁵⁷ However, the missing link between article 2 (17) SFDR and article 9 TR is not a legislative mistake.⁵⁸ Instead, as has been recognized by the ESAs in 2020, although TR-alignment would have been beneficial for the comparability of sustainable investments and combating greenwashing, the SFDR is purposefully not aligned with the TR to cater for a broader range of economic activities than those contained in the TR.⁵⁹

In the current substantive approach to defining E/S objectives, the FMP must substantiate why the investment can be considered to have E/S objectives.⁶⁰ After all, the description in article 2 (17) SFDR contains the clear legislative intent that a product which does not objectively contribute to E/S objectives cannot qualify as a sustainable investment. This legislative approach aligns with the procedural transparency nature of the SFDR.

3.4.1.2 Do No Significant Harm and the Principal Adverse Impacts

The second criterion of ‘sustainable investment’ in article 2 (17) SFDR is that the investment does no significant harm to an E/S objective. Article 2a SFDR tasks the ESAs to develop the DNSH-criterion, which has been done by CDR 2022/1288. According to recital 10 CDR 2022/1288, financial products that have sustainable investment as their objective fulfil the DNSH criterion by considering the Principal Adverse Impacts, which are discussed below. However, as I discuss in paragraph 3.6.4 on article 9, it is not mandatory to consider the PAI in order to fulfil the DNSH-criterion on the basis of the articles contained in the SFDR and CDR 2022/1288; FMP have the option to fulfil the DNSH-criterion by considering the PAI but may also rely on their own assessment, as long as they are transparent about doing so.⁶¹

This raises the question of how the DNSH criterion should be interpreted when no PAI are considered. Notably, the TR also contains a DNSH criterion, for which specific disclosures have been formulated in the Technical Screening

57 Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 10-11; Kuipers W.B. & Klerk J.E., de, “Hoe duurzaam belegd is de impact van de “SFDR”?”, *Ondernemingsrecht* 2021, afl. 17, p. 809, 819; Nagel S., Lorenz L. & El-Qalqili J., “Nachhaltige Investitionen im System der Offenlegungs-VO und Taxonomie-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht*, 2022, Heft 5, p. 360, 363.

58 Nagel S., Lorenz L. & El-Qalqili J., “Nachhaltige Investitionen im System der Offenlegungs-VO und Taxonomie-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht*, 2022, Heft 5, p. 360, 363.

59 Joint ESAs Consultation on ESG Disclosures, 23 April 2020, JC 2020 16, p. 8.

60 Article 9 SFDR and article 19 CDR 2022/1288. Boogaard R.J., “Classificatie van financiële producten op grond van artikel 8 en 9 SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 1, p. 13, 16-17.

61 Glander H., Kropf C. & Lühmann D., “Praktische Umsetzung der Pflichten aus der Offenlegungs-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 32.

Criteria (“TSC”).⁶² The SFDR or CDR 2022/1288 do not specifically link the DNSH criterion for ‘sustainable investment’ in the SFDR to that in the TR. However, recital 36 of the TR indicates that the DNSH criteria in the TR and the SFDR should be consistent. This aligns with the intent that the information generated on the basis of the TR should supplement the SFDR.⁶³ Glander, Kropf & Lühmann conclude from this that the legislative intent is that the DNSH criteria between the two regulations are interpreted coherently.⁶⁴ However, I argue that this is necessarily the case. First, if coherence was the intent, then this intent has not been translated into any real obligations in either the SFDR or the TR – a mere indication in the recitals is insufficient to constitute the obligation to apply the two DNSH criteria coherently. Secondly, articles 8 and 9 SFDR, which mandate DNSH-disclosures, are further worked out in articles 5 and 6 TR, from which follows that the DNSH-criteria from the TR only must be considered for information on explicitly Taxonomy-aligned investments. Third, the type of information that is disclosed under the SFDR, which is a procedural transparency regime, aligns better with a more open-ended approach to a DNSH criterion that allows FMP the discretion to choose a DNSH method that best fits their needs.⁶⁵ This can be opposed to the TR, which contains a quantitative qualification of environmentally sustainable economic activities, which therefore necessitates more specific DNSH criteria.⁶⁶

3.4.1.3 Minimum safeguards: Good governance practices

The ‘good governance practices’ criterion in article 2 (17) SFDR refers to four categories: sound management structures, employee relations, remuneration of staff, and tax compliance. According to a Commission FAQ, this criterion is considered to be satisfied if the criteria of article 18 of the Taxonomy Regulation are complied with.⁶⁷ These are in alignment with the OECD Guidelines

62 See paragraph 5.2.2 in Chapter 3.

63 Recital 19 TR.

64 Glander H., Kropf C. & Lühmann D., “Praktische Umsetzung der Pflichten aus der Offenlegungs-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 30.

65 Recitals 5, 8, 10 SFDR. See the discussion in paragraph 3.2 of this Chapter on Labelling or transparency regime. Related: Tröger T. & Steuer S., “The Role of Disclosure in Green Finance”, *ECCI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8; Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 2-3.

66 Recitals 5, 8, 10 SFDR. See the discussion in paragraph 3.2 of this Chapter on Labelling or transparency regime. Related: Tröger T. & Steuer S., “The Role of Disclosure in Green Finance”, *ECCI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8; Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 2-3.

67 Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation 2023/C 211/01 C/2023/3719, p. 5.

for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.⁶⁸ This is thus the only one of the three criteria for ‘sustainable investment’ under the SFDR that is explicitly aligned to the TR.⁶⁹

In general, given that the first two criteria of ‘sustainable investment’ from the SFDR – namely to contribute to an E/S objective and the DNSH criterion – do not contain any thresholds to qualify as sustainable, they can be seen as easier to comply with than the criteria for ‘environmentally sustainable economic activities’ and DNSH under the Taxonomy Regulation. The third criterion for ‘sustainable investment’ of the SFDR, good governance practices, is fulfilled when the minimum safeguards from article 18 TR are fulfilled.⁷⁰ Therefore, the Commission considers that investments that qualify as ‘environmentally sustainable’ under the TR (Taxonomy-aligned investments) automatically qualify as ‘sustainable investments’ under the SFDR – but not vice versa.⁷¹

3.4.2 Sustainability Risk

The term ‘sustainability risk’ is defined in article 2 (22) as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.” Even though the SFDR demands disclosure of sustainability risks in articles 3, 5, and 6, there is no further guidance in the regulation itself, its delegated regulations, and the consolidated Q&A on the SFDR by the joint ESAs on how to establish what qualifies as a sustainability risk.⁷² Neither are the definitions linked to, for example, ‘financial materiality’ under the European Sustainability Reporting Standards (“ESRS”).⁷³ According to the ESRS, a sustainability impact is financially material “when it could reasonably be expected to affect the undertaking’s financial position, financial performance, cash flows, its

68 Including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights (1998).

69 See also: Glander H., Kropf C. & Lühmann D., “Praktische Umsetzung der Pflichten aus der Offenlegungs-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 31.

70 This would follow from article 18 (2) TR according to Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation 2023/C 211/01 C/2023/3719, p. 5.

71 Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation 2023/C 211/01 C/2023/3719, p. 5.

72 Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Stribos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 72-73.

73 Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards (ESRS). See specifically: ESRS 1, section 3.3 and 3.5 Financial Materiality.

access to finance or cost of capital over the short-, medium- or long-term.”⁷⁴ The ESRS also provide some guidance on how the open norm of ‘material’ should be delineated by assessing both the likelihood of occurrence and the potential magnitude of the financial effects.⁷⁵

Partiti notes that when considering sustainability risk, this can be done through various methods, including, for example, assessing how aligned a portfolio is with sustainability targets or by modelling the impact of ESG risk on their risk profile and expected returns.⁷⁶ The lack of guidance on ‘sustainability risk’ thus means that FMPs and FAs will have to develop their own interpretation of this term. Nonetheless, this may be less problematic than the open-endedness of ‘sustainable investment’. There are two reasons for this. First, because ‘sustainability risk’ is not (misguidingly) used to label certain financial products as sustainable. Second, the identification of and dealing with sustainability risk fits into a broader, already existing framework of dealing with financial risk in general (see para. 3.6.2).

3.4.3 Sustainability Factors

The term ‘sustainability factors’ is defined in article 2 (24) SFDR as “environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.” Sustainability factors are relevant for the disclosure of ‘principal adverse impacts of investment decisions on sustainability factors’, discussed in the next paragraph. These are contained in Tables 1, 2, and 3 of Annex I CDR 2022/1288. It is not entirely clear whether the indicators contained in this table should be seen as a limitative list of sustainability factors. Two indicators that the list is not limitative are, first, that Table 1 contains a section for FMPs to indicate other indicators for PAI on sustainability factors.⁷⁷ Second, the broad definition of sustainability factors in article 2 (24) SFDR, in combination with the procedural transparency nature of the SFDR in general, points toward the fact that the sustainability factors that are listed

74 ESRS 1, section 3.3.

75 ESRS 1, section 3.5, point 51.

76 Partiti E., “Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence”, *European Business Organizational Law Review* 2024, vol. 25, p. 299, 314-15.

77 Annex I Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of ‘do no significant harm’, specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports (CDR 2022/1288).

in Tables 1, 2, and 3 CDR 2022/1288 should not be considered a limitative list.

3.4.4 Principal Adverse Impacts

The Principal Adverse Impacts (“PAI”) – sometimes referred to as principal adverse sustainability impacts – are “impacts of investment decisions and advice that result in negative effects on sustainability factors”.⁷⁸ They play a role in a number of disclosure requirements: the disclosure of PAI at entity level (article 4), PAI at financial product level (article 7), and the DNSH analysis for article 8 and 9 on product level.⁷⁹ These articles are primarily focused on FMPs. When the PAI are considered, the FMP can or must make use of the PAI statement prescribed in Commission Delegated Regulation (“CDR”) 2022/1288.⁸⁰ The obligation to disclose how PAI have been taken into account is worked out in more detail in Chapter II on ‘Transparency about adverse impacts on sustainability factors’ in CDR 2022/1288.⁸¹ The two most important elements of the PAI are (1) the description of the PAI itself (article 6 CDR 2022/1288) and (2) the description of the policies to identify and prioritize the PAI (article 7 CDR 2022/1288). To describe the PAI, Table 1 of Annex I of CDR 2022/1288 must be completed, which contains the mandatory indicators for identifying and describing the PAI.⁸² Tables 2 and 3 contain voluntary indicators. Table 1 has four important sections:

1. Summary, a description of a maximum of two pages, containing, inter alia, that the PAI are considered and a summary thereof;⁸³
2. Description of the PAI, containing a description of the policies to identify and prioritise PAI, and how those policies are kept up to date and applied, including the methodologies to select the indicators for the PAI and an explanation of how those methodologies consider the probability and severity of the PAI;⁸⁴
3. Indicators applicable to investments in investee companies. For this, FMP must “complete all the fields that relate to the indicators related to principal adverse impacts of their investment decisions on sustainability factors”,⁸⁵ which are contained in Table 1. Moreover, FMPs must add information

78 Recital 20 SFDR.

79 See: ESMA, Concepts of sustainable investments and environmentally sustainable activities in the EU Sustainable Finance framework, 22 November 2023, ESMA30-379-2279, p. 5.

80 Article 2a and 4 (6) and (7) SFDR. Consolidated version of 20 February 2023 of CDR 2022/1288 has been used for this Chapter.

81 Article 2a and 4 (6) and (7) SFDR. Consolidated version of 20 February 2023 of CDR 2022/1288 has been used for this Chapter.

82 Siemers B.T.B., “De verklaring belangrijkste ongunstige effecten conform de SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 278.

83 Article 5 CDR 2022/1288.

84 Article 7 CDR 2022/1288.

85 Article 6 CDR 2022/1288.

on “one or more” additional indicators on climate and environment from Table 2,⁸⁶ and for social and employee matters, respect for human rights, anti-corruption and anti-bribery matters, from Table 3.⁸⁷ Tables 2 and 3 thus are not entirely voluntary either.⁸⁸ FMPs may also add their own PAI where appropriate. For each indicator, the FMP must describe the impact in a specific year and the previous year, explain the impact and describe what actions have been taken and what actions are planned for the next reference period. Moreover, FMPs must describe whether and to what extent international standards and business conduct codes have been followed, as well as the degree of alignment with the Paris Agreement, where relevant.⁸⁹

4. Engagement policies, which describe, where applicable, their policies on shareholder engagement and summaries of other engagement policies to reduce principal adverse impacts. Of particular interest is the requirement to disclose “how those engagement policies will be adapted where there is no reduction of the principal adverse impacts over more than one period reported on.”⁹⁰ De Klerk & van der Velden argue that this implies a material obligation to take action when an indicator has worsened during the reporting period.⁹¹ However, I find that this interpretation may exceed the intent of the CDR: when examined within the broader context of the SFDR and CDR 2022/1288, it seems more likely that this is a procedural disclosure obligation than a substantive obligation to act.

86 Indicators in Table 2 include, for example, tonnes of inorganic pollutants equivalent per million EUR invested, expressed as a weighted average; share of securities in investments not issued under Union legislation on environmentally sustainable bonds.

87 Article 6 CDR 2022/1288. Indicators in Table 3 include, for example, share of investments in investee companies without a workplace accident prevention policy; number of workdays lost to injuries, accidents, fatalities or illness of investee companies expressed as a weighted average.

88 Siemers B.T.B., “De verklaring belangrijkste ongunstige effecten conform de SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 279.

89 Article 9 CDR 2022/1288.

90 Article 8 (2) (b) CDR 2022/1288.

91 Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, para. 3.2.7.1. This seems also implied in: Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 9.

To better illustrate this, the beginning of Table 1 is shown in the image below:

Table 1

Statement on principal adverse impacts of investment decisions on sustainability factors

Financial market participant [<i>Name and, where available, LEI</i>]					
Summary [<i>Name and, where available, LEI</i>] considers principal adverse impacts of its investment decisions on sustainability factors. The present statement is the consolidated statement on principal adverse impacts on sustainability factors of [<i>name of the financial market participant</i>] [<i>where applicable, insert 'and its subsidiaries, namely [list the subsidiaries included]'</i>]. This statement on principal adverse impacts on sustainability factors covers the reference period from [<i>insert '1 January' or the date on which principal adverse impacts were first considered</i>] to 31 December [<i>year n</i>]. [<i>Summary referred to in Article 5 provided in the languages referred to in paragraph 1 thereof</i>]					
Description of the principal adverse impacts on sustainability factors [<i>Information referred to in Article 7 in the format set out below</i>]					
Indicators applicable to investments in investee companies					
Adverse sustainability indicator	Metric	Impact [year n]	Impact [year n-1]	Explanation	Actions taken, and actions planned and targets set for the next reference period
CLIMATE AND OTHER ENVIRONMENT-RELATED INDICATORS					
Greenhouse gas emissions	1.GHG emissions	Scope 1 GHG emissions			
		Scope 2 GHG emissions			
		Scope 3 GHG emissions			

Figure 5: The beginning of Table 1, showing Summary, Description of PAI, and Indicators applicable to investments in investee companies. The first indicator, 1. GHG emissions, is shown in the picture. This is followed by another 17 indicators

Producing a PAI statement encompasses a significant effort, given the extensive requirements set out in CDR 2022/1288. However, while the format is prescriptive, the PAI statement does not contain material commitments, such as, for example, to exclude investments that have a negative impact on sustainability factors.⁹² Instead, the PAI framework mandates that FMPs scrutinize the effect of their investment decisions while maintaining transparency regarding any mitigation strategies – or the lack thereof.⁹³ In a way, the formats for the PAI statement reminiscence the European Sustainability Reporting Standards from the CSRD, which set out detailed formats for the disclosures in the annual sustainability report. Both frameworks provide comprehensive guidance on content requirements while abstaining from imposing mandatory

92 Labeur R.E., “Vermogensbeheerders & duurzaamheidstransparantie”, in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022p. 283-284.

93 Labeur R.E., “Vermogensbeheerders & duurzaamheidstransparantie”, in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022p. 283-284.

thresholds. A crucial distinction emerges, however, in that the ESRS incorporate a general materiality threshold which is absent from the PAI. Note that, although neither the SFDR nor CDR 2022/1288 explicitly mandates action on PAIs, Partiti argues that to show that they consider PAI, FMP are de facto forced to actively engage with the PAI.⁹⁴ Furthermore, Partiti suggests that this could even lead to FMPs engaging with investee companies to minimize adverse impacts.⁹⁵

One question that arises is how voluntary the indicators in Tables 1, 2, and 3 are.⁹⁶ This is not entirely clear.⁹⁷ Table 1 seems to be mandatory for FMPs required to produce PAI statements, though the absence of mandatory thresholds permits FMPs to designate specific indicators as inapplicable, unknown, or lacking associated action plans.⁹⁸ Tables 2 and 3, containing additional indicators, appear to have a quasi-mandatory status, with Article 6 CDR 2022/1288 requiring the completion of at least one indicator. Recital 4 CDR 2022/1288 implies that this should be the indicator with the most significant impact.⁹⁹

Another point that merits closer inspection concerns the methodology by which FMPs must gather information for their PAI statements.¹⁰⁰ The indicators specifically address investments in investee companies, necessitating that FMPs disclose information about these entities rather than about themselves. However, this presents significant complexities. In principle, the annual sustainability report that investee companies must disclose on the basis of the CSRD should provide sufficient data for FMPs to populate the adverse sustain-

94 Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 316.

95 Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 316.

96 Siemers argues that Table 1, at least, is mandatory, in: Siemers B.T.B., "De verklaring belangrijkste ongunstige effecten conform de SFDR", *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277.

97 Siemers B.T.B., "De verklaring belangrijkste ongunstige effecten conform de SFDR", *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277; Glander H., Lühmann D. & Jesch T.A., "Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)", *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 490-491.

98 Siemers B.T.B., "De verklaring belangrijkste ongunstige effecten conform de SFDR", *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277.

99 Siemers B.T.B., "De verklaring belangrijkste ongunstige effecten conform de SFDR", *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277.

100 Glander H., Lühmann D. & Jesch T.A., "Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)", *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 491.

ability indicators.¹⁰¹ After all, the CSRD explicitly aims to ensure that FMPs “have the information they need from investee undertakings to be able to comply with their own sustainability disclosure requirements” under the SFDR.¹⁰²

However, a number of practical problems may arise in this context. First, the jurisdictional scope for investee companies remains unrestricted – FMPs may invest in entities both within and outside the EU. Consequently, while CSRD sustainability reports will be available for some companies, others will produce sustainability reporting, if at all, according to different standards.¹⁰³ Furthermore, even within the ESRS framework, certain standards lack mandatory methodologies, potentially resulting in diverse compliance approaches among investee companies.¹⁰⁴ Such non-uniform data present significant challenges for FMPs attempting to aggregate information into comprehensive PAI indicators.¹⁰⁵ This regulatory complexity poses particular difficulties for smaller FMPs.¹⁰⁶ Even when FMPs manage to aggregate this heterogeneous information, the absence of standardized metrics in certain PAI indicators may lead different FMPs to produce varying types of disclosures. This, in turn, may diminish the comparative value of the PAI statement to investors.¹⁰⁷

There thus are four challenges inherent in the current PAI Statement requirements: (i) the extensive regulatory burden imposed by the PAI statement, (ii) the voluntary nature of certain aspects, including the absence of material thresholds or a materiality threshold, (iii) the challenges surrounding data collection and standardisation across different jurisdictions and reporting

101 Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 8.

102 Recital 21 CSRD; Roelofsen E.P., “Wat is de toekomst van het IMVB-convenant voor pensioenfondsen in het licht van de verplichtingen uit hoofde van artikel 4 van de SFDR?”, *Tijdschrift voor Pensioenvraagstukken* 2021, afl. 4, p. 10, 14.

103 Roelofsen E.P. & Taha R., “Over nut en noodzaak van de Principal Adverse Impact (PAI) indicatoren in de SFDR-regelgeving”, *Tijdschrift voor Financieel Recht* 2023, nr. 11, p. 372, 376-377; Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 490-491.

104 See: paragraph 4.3.1 on Quantitative data in Chapter 3.

105 Roelofsen E.P. & Taha R., “Over nut en noodzaak van de Principal Adverse Impact (PAI) indicatoren in de SFDR-regelgeving”, *Tijdschrift voor Financieel Recht* 2023, nr. 11, p. 372, 376-377; Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485.

106 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485.

107 Roelofsen E.P. & Taha R., “Over nut en noodzaak van de Principal Adverse Impact (PAI) indicatoren in de SFDR-regelgeving”, *Tijdschrift voor Financieel Recht* 2023, nr. 11, p. 372, 376-377.

frameworks for investee companies, and (iv) the comparative value of the PAI statement for investors. These reverberate through the disclosure requirements under the SFDR that either mandate or provide optionality for PAI statement disclosure, as I discuss in this Chapter.

3.5 Ex Ante Disclosures at Entity Level

3.5.1 Introduction

As I explained in paragraph 2, the principal-agent problem is relevant prior to and after the conclusion of a contract between the investor and the intermediary. Prior to the conclusion of the contract, intermediaries may exploit the information asymmetry between them and the investor, which can lead to an adverse selection problem.¹⁰⁸ The investor can attempt to overcome this vulnerability by conducting research before selecting an intermediary, which increases information costs. This inhibits the efficient functioning of the market. In this section, I discuss the two main disclosure obligations that the SFDR introduces to reduce information asymmetries before the conclusion of the contract at entity level: the disclosure of sustainability impact (article 4) and sustainability risk (article 3).¹⁰⁹ Taken together, these two disclosure obligations can be seen as a reflection of the double materiality principle at entity level: they pertain to both the negative impact of the FMP or FA on sustainability factors and the negative impact of sustainability risks on the FMP or FA. They are, however, limited to the negative dimension of the double materiality principle, as the positive impacts on sustainability factors, as well as the opportunities that arise for FMP and FA through sustainability factors, are not included in these disclosures.

3.5.2 Article 4 – Sustainability Impact at Entity Level

Article 4 SFDR concerns the disclosure of due diligence policies on the consideration of principal adverse impacts of investment decisions on sustainability factors at the level of the FMP or FA.¹¹⁰ These disclosures are

108 Veil R. (ed.), *European Capital Markets Law* (2nd edition), Hart Publishing 2017, p. 266; Akerlof G.A., “The Market for “Lemons”: Qualitative Uncertainty and the Market Mechanism”, *The Quarterly Journal of Economics* 1970, vol. 84(3), p. 488.

109 A portfolio managed in the sense of article 4 (1) (8) MiFID II.

110 See: Krakuhn J., Stiefel K., Gilles E., “Die nachhaltige Finanzwirtschaft: Ausgewählte Reportingpflichten auf der Internetseite von Kreditinstituten und Versicherungsunternehmen nach der Offenlegungsverordnung und dem finalen Entwurf des technischen Regulierungsstandards”, *Zeitschrift für International Rechnungslegung* 2021, Heft 3, p. 133, 136; Roelofs E.P., “Wat is de toekomst van het IMVB-convenant voor pensioenfondsen in het licht van de verplichtingen uit hoofde van artikel 4 van de SFDR?”, *Tijdschrift voor Pensioenvraagstukken*

voluntary: they must only be made whenever the FMP or FA considers principal adverse impacts.¹¹¹ When FMPs or FAs do not consider those, they merely must publish clear reasons for why they do not do so.¹¹² For FMPs with more than 500 employees, the publication of these due diligence policies are mandatory.¹¹³

To disclose adverse sustainability impacts at entity level, FMPs and FAs must publish on their websites a statement on the businesses' due diligence policies concerning those impacts.¹¹⁴ These policies should be contained in a section titled 'Statement on principal adverse impacts of investment decisions on sustainability factors'.¹¹⁵ The purpose of this section is to provide information on how the FMP or FA, in general, considers the PAI of investment decisions on sustainability factors.¹¹⁶ This section must include at least:

- “(a) information about their policies on the identification and prioritisation of principal adverse sustainability impacts and indicators;
- (b) a description of the principal adverse sustainability impacts and of any actions in relation thereto taken or, where relevant, planned;
- [...]
- (d) a reference to their adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement.”¹¹⁷

Note that the obligation to disclose the due diligence procedures on principal adverse impacts on entity level, thus also includes the obligation to disclose the PAI itself.¹¹⁸

The exact contents of the 'Statement on principal adverse impacts of investment decisions on sustainability factors' are further specified in articles 4 – 10 for FMPs and articles 11 – 13 for FAs of CDR 2022/1288. The information in the statement should pertain to the preceding year and must include the information in Table 1 Annex I of CDR 2022/1288: the 'Description of the principal adverse impacts on sustainability factors'.¹¹⁹ This means that the FMPs and FAs that publish such a statement, must make a PAI assessment

2021, afl. 4, p. 10, 13-14; Labeur R.E., “Vermogensbeheerders & duurzaamheidstransparantie”, in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022, p. 283-284.

111 Article 4 (1) sub (a) and article 4 (5) sub (a) SFDR for FMP and FA respectively.

112 Article 4 (1) sub (b) and article 4 (5) sub (b) SFDR for FMP and FA respectively.

113 Article 4 (1) and (3) SFDR.

114 Article 4 (1) (a) SFDR.

115 Article 4 (1) and (3) CDR 2022/1288; article 11 CDR 2022/1288.

116 Article 4 (1) SFDR.

117 Article 4 (2) SFDR.

118 Roelofsen E.P., “Wat is de toekomst van het IMVB-convenant voor pensioenfondsen in het licht van de verplichtingen uit hoofde van artikel 4 van de SFDR?”, *Tijdschrift voor Pensioenvraagstukken* 2021, afl. 4, p. 10, 13-14.

119 Article 4 (1) and (2) CDR 2022/1288.

on entity level. Additionally, the policies and methods to identify and prioritise the PAI must be described.¹²⁰

As mentioned in paragraph 3.4.4 the PAI framework lacks explicit material thresholds for qualifying negative impacts or a general materiality threshold enabling FMPs and FAs to disregard immaterial impacts, article 4 (1) (a) SFDR appears to include a materiality principle – although the term ‘principal’ adverse impacts suggests a materiality threshold.¹²¹ The article requires FMPs and FAs to publish website statements on due diligence policies regarding PAI, “taking due account of their size, the nature and scale of their activities and the types of financial products they make available.” This seems to be a general materiality principle, which however begets two questions. First, the provision leaves ambiguous the precise reference point for materiality assessment. It remains unclear whether FMPs and FAs may exclude investment decisions based on their relative monetary significance within their product portfolio, or whether materiality should be evaluated primarily through the lens of environmental impact. Second, the methodology for conducting materiality assessments remains undefined. Other than, for example, the CSRD/ESRS, there is no guidance in the SFDR on this question. Given the multiple implicit materiality norms contained in the term ‘principal’ adverse impacts and in article 4 (1) (a) SFDR, thus leads to the conclusion that there is room for FMPs or FAs to publish an ‘incomplete’ statement on the sustainability impacts at entity level, depending on how the FMP or FA interprets the various materiality norms.¹²²

For FMPs with fewer than 500 employees, publishing adverse sustainability impacts at entity level is voluntary. When they do not choose to make public this information, they must state the reasons for this decision, including information on whether and when they plan to publish adverse sustainability impacts on entity level.¹²³ Article 4 thus contains a ‘comply-or-explain regime’ for FMPs with fewer than 500 employees.¹²⁴ For FAs, the ‘comply-or-explain’ regime applies regardless of their size – the disclosures thus are of a voluntary

120 Article 7 CDR 2022/1288.

121 Partiti E., “Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence”, *European Business Organizational Law Review* 2024, vol. 25, p. 299, 315-316.

122 Siemers concludes that it should not be possible to publish a negative statement that PAI were not considered in combination with an incomplete Statement on the consideration of adverse impacts that does not include all relevant information. Siemers B.T.B., “De verklaring belangrijkste ongunstige effecten conform de SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277.

123 Article 4 (1) (b) SFDR; the statement explaining why they do not consider adverse impacts must be in line with article 12 CDR 2022/1288.

124 Busch D., “The EU Sustainable Finance Disclosure Regulation”, *Capital Markets Law Journal* 2023, vol. 18(3), p. 303, 313.

nature.¹²⁵ FAs that publish ‘Statement on principal adverse impacts of investment decisions on sustainability factors’ do not have to make their own assessment of PAI of the financial products that they advise on. Rather, they must publish how they use the information that is disclosed by FMPs in the selection of the products that they advise on.¹²⁶ The disclosures of FAs thus directly depend on the disclosures of FMP. This means that when an FA advises on products for which the FMP has not made a PAI assessment, the FA lacks the necessary information to make disclosures under article 11 CDR 2022/1288.¹²⁷

For FMPs with more than 500 employees, disclosing adverse sustainability impacts at entity level is mandatory.¹²⁸ As Siemers points out, this threshold seems misaligned with the aim of making disclosures mandatory for FMPs that have a high impact: whether FMPs have a high impact depends less on the number of employees and more on the size of the investments.¹²⁹ Moreover, the question arises regarding how the entity-level disclosures from article 4 SFDR relate to the entity-level disclosures of sustainability impact that must be made pursuant to the CSRD. Article 4 SFDR disclosures are mandatory for FMPs with more than 500 employees, which also fall within the scope of the CSRD.¹³⁰ The CSRD requires a much broader assessment of sustainability impact at entity level, which is to be disclosed in the annual sustainability report that is part of the management report.¹³¹ Even though the type of disclosure and the aim of the CSRD differ from the website disclosure that is demanded by article 4 SFDR, it may be inefficient to require FMPs with more than 500 employees to make two distinct assessments of their sustainability impact at entity level. Nonetheless, the information that investee companies generate on the basis of the CSRD hopefully provides enough details to enable the FMP to make the PAI Statement.¹³²

125 Article 4 (5) SFDR; the statement explaining why they do not consider adverse impacts must be in line with article 13 CDR 2022/1288.

126 Article 11 (3) (a) CDR 2022/1288.

127 Which is easily manageable under the “comply or explain” regime for FAs under article 4 (5) SFDR.

128 Article 4 (1) and (3) SFDR. Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 488.

129 Siemers B.T.B., “De verklaring belangrijkste ongunstige effecten conform de SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 11, p. 276, 277.

130 Article 1 (1) CSRD, amending article 1 AD. The scope is repeated in article 19a CSRD.

131 See: paragraph 3 of Chapter 3.

132 Roelofsen E.P., “Wat is de toekomst van het IMVB-convenant voor pensioenfondsen in het licht van de verplichtingen uit hoofde van artikel 4 van de SFDR?”, *Tijdschrift voor Pensioenvraagstukken* 2021, afl. 4, p. 10, 14.

3.5.3 Article 3 – Sustainability Risk at Entity Level

According to article 3 SFDR, FMPs and FAs must publish on their website information about their policies on the integration of sustainability risks in their investment decision-making process or investment advice.¹³³ This article applies to all FMPs and FAs regardless of their size, in contrast to the entity-level disclosure of sustainability impact from article 4 SFDR which only must be disclosed by FMPs with more than 500 employees. As I already discussed in para. 3.4.2, the definition of ‘sustainability risk’ is “environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters” but there is no further guidance on how this term should be interpreted.¹³⁴ Neither is there guidance on how the policies on the integration of this risk should be disclosed. This also stands in contrast with the disclosures in article 4 SFDR on sustainability impact at entity level, for which elaborate directions can be found in CDR 2022/1288. This lack of guidance means that FMPs and FAs have discretion in fulfilling the obligation from article 3 SFDR, which can put pressure on the degree of standardisation of sustainability risk disclosures on entity level across the sector.¹³⁵

Another issue, which was also touched upon in the previous paragraph on sustainability impact, is the relationship with the CSRD. Article 3 SFDR applies to all FMPs and all FAs, and although not all of them will have to comply with the CSRD, a significant portion of them likely will.¹³⁶ Under the CSRD, businesses must make public “the resilience of the undertaking’s business model and strategy in relation to risks related to sustainability matters”. Moreover, the ESRS, which set out in detail what to disclose under the CSRD, demand the disclosure of material risks in relation to sustainability matters.¹³⁷ In particular, the business must disclose its process, methodologies and assumptions for identifying and assessing material risks for all disclosure

133 Article 3 (1) and (2) SFDR for FMPs and FAs respectively.

134 Article 2 (24) SFDR.

135 See also: Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 26; Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 488-489.

136 See paragraph 3.3 of Chapter 3 on the scope of the CSRD. As I explained in Chapter 3, the CSRD applies (i) credit institutions; (ii) insurance companies; (iii) all large companies; (iv) all listed companies regardless of their size, as follows from article 19a CSRD. It is likely that many FMPs and FAs will have to comply with the CSRD because they are large undertakings that exceed the size thresholds, or because they are credit institutions, insurance undertakings, or public-interest entities that are explicitly covered regardless of size. Additionally, asset managers that are listed on European financial markets fall within the scope of the CSRD even if they are SMEs.

137 ESRS 1 para. 2.

requirements in the topical ESRS.¹³⁸ For example, ESRS E1 on climate change requires that the business discloses the process to identify material risks, including a description of how the business identifies climate-related physical and transition risks.¹³⁹ While it seems efficient to use the CSRD disclosures as a basis for the SFDR disclosures, the question arises whether the CSRD's focus on the business model and strategy sufficiently covers the SFDR's focus on policies regarding the investment decision-making process. Moreover, the CSRD disclosures are limited by the general principle of materiality that is central to that directive, whereas article 3 SFDR does not contain any reference to a materiality norm.¹⁴⁰ The value of entity-level disclosures has also been subject to a targeted consultation by the Commission. In this consultation, the majority of FMPs and FAs responded that they did not consider the SFDR the right place to include entity-level disclosures (in contrast to respondents who were NGOs).¹⁴¹ A large majority of respondents expressed the need for better streamlined and simplified disclosure requirements across the EU SFF, and in particular between the SFDR and the CSRD disclosure obligations at entity level.¹⁴²

3.6 Ex Ante Disclosures at Product Level

3.6.1 Introduction

Articles 6-10 of the SFDR establish disclosure requirements at the product level. The definition of 'financial product' under article 2 (12) SFDR, financial products includes portfolios, Alternative Investment Funds (AIFs), and UCITS. What unites these 'products', is that they comprise multiple individual invest-

138 ESRS 2 para. 2 (a). The disclosure requirements from ESRS 1 are jointly applicable with the disclosure ESRS 2, which *inter alia* describe what information must be disclosed under the material risk sections; ESRS 2 para. 53.

139 ESRS E1 para. 20.

140 Glander H., Lümann D. & Jesch T.A., "Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)", *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 488-489.

141 European Commission, Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), 14 September 2023 – 22 December 2023, Summary report: public and targeted consultations on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), 3 May 2024, available at: https://finance.ec.europa.eu/document/download/0f2cfde1-12b0-4860-b548-0393ac5b592b_en?filename=2023-sfdr-implementation-summary-of-responses_en.pdf, p. 7.

142 European Commission, Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), 14 September 2023 – 22 December 2023, Summary report: public and targeted consultations on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), 3 May 2024, available at: https://finance.ec.europa.eu/document/download/0f2cfde1-12b0-4860-b548-0393ac5b592b_en?filename=2023-sfdr-implementation-summary-of-responses_en.pdf, p. 2.

ments. The fact that the ‘products’ consist of multiple investments, is challenging for sustainability disclosures as the impact or risk must be disclosed on an aggregated basis instead of the impact or risk in relation to individual securities. The SFDR establishes three distinct categories of financial products, each with its own disclosure requirements:

1. Products with no specific sustainability characteristics (Articles 6 and 7)
2. Products that promote environmental or social characteristics (Article 8)
3. Products that have sustainable investment as their core objective (Article 9)

Similar to the entity level disclosures, the double materiality principle is also reflected in the product level disclosures, with article 6 focusing on sustainability risk, i.e. the (potential) negative impacts of sustainability on the product, article 7 focusing on the negative impact of the product on sustainability factors, and articles 8 and 9 focusing on the positive impact on sustainability.

3.6.2 Article 6 – Sustainability Risk at Product Level

Article 6 SFDR requires the pre-contractual disclosure to include: (a) how sustainability risks are integrated into investment decisions or advice, and (b) the likely impacts of sustainability risks on the returns of the available financial products.¹⁴³ In essence, article 6 SFDR thus establishes two distinct types of disclosures: a procedural requirement to disclose the process of integrating sustainability risk under (a) and a substantive requirement to assess and disclose how these risks impact product value under (b). While the article thus may be framed as a procedural transparency requirement, it appears to implicitly require FMPs and FAs to conduct a risk assessment and disclose the outcomes. However, when FMPs or FAs find that the risks are not relevant to the investment decision or advice, they merely need to disclose the reasons therefor.¹⁴⁴ This, however, should not be equated to the comply-or-explain approach under article 4 SFDR, as article 6 SFDR contains a strict materiality threshold: only when risks are not relevant may they be dismissed.

The disclosures under article 6 SFDR must be made in line with the applicable sectoral legislation governing the pre-contractual disclosures for each type of FMP or FA.¹⁴⁵ For example, investment firms providing portfolio management services must make the SFDR disclosures in accordance with article 24 (4) of MiFID II.¹⁴⁶ That article requires investment firms to provide appropriate information in a timely manner on *inter alia* the investment strategies

143 Article 6 (1) and (2) SFDR; Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 41.

144 Last sentence of article 6 (1) and (2) SFDR respectively.

145 This follows from article 6 (3) SFDR; Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 36.

146 Article 6 (3) (h) SFDR.

used. This must also include information on and warnings about the risks associated with investments and investment strategies.¹⁴⁷ Article 6 (3) SFDR thus ties the disclosures of sustainability risk at product level into the sectoral disclosure framework that applies to FMP and FA. One question that arises in this context, is whether article 6 SFDR creates a standalone obligation or merely clarifies the scope of existing financial risk disclosure requirements under sectoral legislation.¹⁴⁸ In particular, the question arises whether article 6 SFDR imposes additional disclosure obligations on FMPs and FAs or simply confirms that the term ‘risk’ under Article 24 (4) (b) MiFID II encompasses sustainability-related financial risks.¹⁴⁹

On the one hand, the latter interpretation appears more convincing, as it seems reasonable to include sustainability-derived financial risks in MiFID II as the fundamental purpose of the risk disclosure is to enable clients to comprehend investment risks in order to make an informed investment decision.¹⁵⁰ This would also seem in line with the fact that CDR 2017/565, which supplements MiFID II concerning the organizational requirements for investment firms, includes, where relevant, information on sustainability factors (although not sustainability risk) in investment advice under article 24 (4) MiFID II.¹⁵¹ On the other hand, article 6 SFDR contains a significantly more elaborate obligation than the disclosure of “guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies.”¹⁵² After all, the FMP or FA must disclose under (a) how sustainability risks are integrated into investment decisions or advice, which implies a level of risk management on behalf of the FMP or FA, and under (b) conduct a risk assessment and disclose the outcomes. The requirements from article 6 SFDR thus are much more comprehensive than the

147 Article 24 (4) (b) MiFID II.

148 Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 76: the authors argue that better alignment between article 6 SFDR and the sectoral legislation would have been desirable.

149 A similar discussion in relation to the interpretation of the term ‘klimaatarisico’ (climate risk) in risk management on the basis of articles 3:10 and 3:17 Wft (Dutch implementation of MiFID) can be found in: Nuijten S.M.C., Vermeulen S.A.M. & Eerden F.W.J. van der, “Alleen samen krijgen we klimaatverandering onder controle? Over handhaving van duurzaamheidsverplichtingen voor financiële ondernemingen”, *Tijdschrift voor Financieel Recht* 2021, nr. 8/9, p. 314, 318-319, 322.

150 Recital 3, 78 MiFID II.

151 Article 52 (3) (c) CDR 2017/565 (consolidated version of 2 August 2022).

152 Article 24 (4) (b) SFDR; Salerno M.E., “Integrating Sustainability in the MiFID II Package-Based Regulations: Effects on Financial Intermediaries’ Accountability and Potential Conflict Between Regulatory Objectives”, in: Ramos Muñoz D.R. & Smoleńska A. (eds.), *Greening the Bond Market: A European Perspective*, Springer International 2023, p. 175-203.

disclosures that have to be made under article 24 (4) MiFID II.¹⁵³ Consequently, article 6 SFDR is best understood as complementary to the sectoral disclosure obligations regarding financial risks.

3.6.3 Article 7 – (Negative) Sustainability Impact at Product Level

Article 7 SFDR contains the obligation to disclose whether, and if so, how negative sustainability impacts are considered at product level. Whereas under article 6 SFDR all FMPs and FAs must disclose sustainability risk at product level, the obligation to disclose sustainability impact only applies to FMPs that comply with article 4 (1) (a) or 4 (3) or (4) SFDR.¹⁵⁴ This means that all FMPs that disclose sustainability impact at entity level, whether voluntarily or because they are required to do so due to their size, must also disclose sustainability impact at product level in line with article 7 SFDR.¹⁵⁵ The information has to be disclosed according to article 6 (3) SFDR, which, as discussed in the previous paragraph, prescribes that the disclosure should be included in the sectoral pre-contractual disclosure framework that applies to the FMP.¹⁵⁶ For example, investment firms providing portfolio management services must disclose sustainability impact at product level in accordance with Article 24 (4) of MiFID II.

When a financial product does consider principal adverse impacts, FMPs have to explain *how* the financial product considers principal adverse impacts on sustainability factors.¹⁵⁷ While FMPs may use CDR 2022/1288 for PAI disclosure, as examined in paragraph 3.4.4, this may be challenging.¹⁵⁸ That is because CDR 2022/1288 lacks guidance on how to consider PAI at product level: articles 4-10 CDR 2022/1288 concern the disclosures of PAI at entity-level disclosures; articles 14 – 49 contain rules on pre-contractual disclosures at product level for article 8 and 9 products, which however do not pertain to

153 See also: Nuijten S.M.C., Vermeulen S.A.M. & Eerden F.W.J. van der, “Alleen samen krijgen we klimaatverandering onder controle? Over handhaving van duurzaamheidsverplichtingen voor financiële ondernemingen”, *Tijdschrift voor Financieel Recht* 2021, nr. 8/9, p. 314, 318-319, 322.

154 Article 7 (1) SFDR. If an FMP does not consider sustainability impacts at entity level in line with article 4 (1) (b) SFDR, that FMP should, according to article 7 (2) SFDR, include for each financial product a statement that it does not consider the adverse impacts and the reasons therefor. Glander H., Kropf C. & Lühmann D., “Praktische Umsetzung der Pflichten aus der Offenlegungs-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 36.

155 FMPs with more than 500 employees must disclose the negative sustainability impact at entity level, for other FMPs and for FAs there is a comply or explain regime.

156 Article 7 (1) SFDR.

157 Article 7 (1) (a) SFDR.

158 Article 7 (1) last sentence SFDR. Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 2)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 11, p. 545, 546.

PAI at all. Consequently, FMPs must develop their own method to determine product-level principal adverse impacts on sustainability factors.

To illustrate why this is challenging, consider an individual asset management portfolio, a financial product in the sense of the SFDR, that contains 100 distinct investments, each with unique sustainability impacts. To comply with article 7 SFDR, the FMP must develop a method to aggregate these individual impacts into a coherent portfolio-level assessment. There are three primary challenges when developing such a method. First, the issuers of the individual investments that are contained in the portfolio are not obligated to assess PAI according to CDR 2022/1288 metrics. FMPs must therefore devise methodologies to translate available information – primarily CSRD disclosures (if at all available) and Taxonomy alignment data (if applicable) – into principal adverse impacts. This may be even more complicated for investments that are issued outside the scope of the CSRD and/or TR and those issued outside of the EU, for which no such data may be available. A second challenge is that not all individual investments in the portfolio may be investments in issuers in the real economy with direct economic impact measurement capabilities, such as derivatives, index funds, or exchange-traded funds, complicating meaningful PAI assessment. A third challenge is how to weigh the different impacts across the portfolio given the dynamic nature of portfolio composition.

It is crucial to note that the SFDR mandates disclosure of the methodologies for considering principal adverse impacts at product level, rather than actual PAI assessment outcomes. However, the absence of specific guidance within both the SFDR and CDR 2022/1288, combined with the aforementioned complexities, creates substantial challenges for FMPs in establishing robust methodologies. Moreover, whilst the considerable discretion afforded to FMPs in methodology may align with the procedural transparency nature of the SFDR, it may also diminish the comparative value of these disclosures for investors.

3.6.4 *Articles 8 and 9 – Products that Promote Environmental or Social Characteristics and Products that have Sustainable Investments as their Objective*

Articles 8 and 9 SFDR contain the respective disclosures for products that contain investments that promote E/S characteristics in companies with good governance practices (article 8) and products that have sustainable investments as their objective and follow a designated reference benchmark (article 9). The articles only apply to FMPs. The prescribed disclosures must be made along the pre-contractual sectoral disclosure requirements applicable to FMPs.¹⁵⁹ For example, investment firms providing portfolio management services must make article 8 and 9 SFDR disclosures in accordance with article 24 (4) of

¹⁵⁹ Article 8 (1) and 6 (3) SFDR; article 9 (1) and 6 (3) SFDR.

MiFID II.¹⁶⁰ Furthermore, this information must be published on the FMP's website in accordance with article 10 SFDR.

While articles 7, 8 and 9 SFDR all address the sustainability impact of financial products, they have a different focal point: whereas article 7 SFDR focuses on the negative impact on sustainability factors, articles 8 and 9 focus on the disclosure of positive impacts. This positive focus has led to article 8 and products to be referred to as light green products (article 8) and dark green products (article 9).¹⁶¹ This can be contrasted to the financial products under articles 6 and 7 SFDR, with no sustainability ambition, sometimes referred to as grey or colourless products.¹⁶²

When FMPs make available article 8 or 9 SFDR products, the scope of the disclosure requirements will increase substantively compared to the disclosures under articles 6 and 7 SFDR. For article 8 SFDR products, FMPs must disclose how the E/S characteristics are achieved, whether and through what methodology an index has been designated as a reference benchmark, and how this designated index demonstrates consistency with the E/S characteristics promoted by the financial product.¹⁶³ Similarly, for article 9 SFDR products, the FMP must disclose how the sustainable investment objective of the product is aligned to the designated reference benchmark and how that benchmark relates to a broad market index.¹⁶⁴ For both articles 8 and 9 products, the disclosure requirements have been elaborated in CDR 2022/1288 in articles 14 – 17 and articles 18 – 19 respectively.¹⁶⁵ Moreover, Annexes II and III of CDR 2022/1288 provide templates according to which these pre-contractual disclosures can be made, respectively for articles 8 and 9 SFDR.¹⁶⁶ To analyse

¹⁶⁰ Article 8 (2) and 9 (2) SFDR respectively.

¹⁶¹ Even the ESAs have referred to these products as light green and dark green, in: Joint ESAs Consultation on Taxonomy-related sustainability disclosures, 15 March 2021, JC 2021 22, p. 5. Also, for example: Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON), European Parliament 2024*, No. PE 754.212, p. 10.

¹⁶² Steuer S., "Grüne Transparenz und nachhaltige Verwirrung – Die produktbezogenen Informationsvorschriften der SFDR", *Zeitschrift für Bankrecht und Bankwirtschaft 2022*, vol. 34(1), p. 31, 35.

¹⁶³ Article 8 (1) SFDR.

¹⁶⁴ Article 9 (1) SFDR.

¹⁶⁵ An elaborate analysis of the disclosure classification of financial products under article 8 and 9 SFDR, as well as the applicable transparency requirements, can be found in: Boogaard R.J., "Classificatie van financiële producten op grond van artikel 8 en 9 SFDR", *Tijdschrift voor Financieel Recht 2022*, nr. 1, p. 13.

¹⁶⁶ Boogaard R.J., "Classificatie van financiële producten op grond van artikel 8 en 9 SFDR", *Tijdschrift voor Financieel Recht 2022*, nr. 1, p. 13.

¹⁶⁷ Annex II CDR 2022/1288 as amended by Annex I CDR 2023/363.

these disclosures in the next sections, I have summarised the most important disclosures on the basis of articles 8 and 9 SFDR in the table shown on the next page, derived from articles 14 – 19 and Annexes II and III of CDR 2022/1288.

Table 6: Article 8 and 9 SFDR disclosures from Annexes II and III of CDR 2022/1288. Source: Own image.

Article 8 and 9 SFDR disclosures from Annexes II and III of CDR 2022/1288		
	Article 8 pre-contractual disclosures ¹⁶⁷	Article 9 pre-contractual disclosures ¹⁶⁸
1	Statement that the financial product does not have sustainable investment as objective but promotes E/S characteristics ¹⁶⁹ <ul style="list-style-type: none"> - Minimum proportion of sustainable investments in % 	Statement that the product has sustainable investment as objective ¹⁷⁰ <ul style="list-style-type: none"> - Percentage of sustainable investments with environmental objective - Percentage of sustainable investment with social objective
2	E/S characteristics <ul style="list-style-type: none"> - What E/S characteristics are promoted by this financial product? - What sustainability indicators are used to measure the attainment of E/S characteristics promoted by this product? 	Indication of sustainable investment objectives <ul style="list-style-type: none"> - What is the sustainable investment objective of this financial product? - Indicators for measuring attainment objectives
3	DNSH: in principle not mandatory in the sense of art. 3 TR of art. 2 (17) SFDR ¹⁷¹ <ul style="list-style-type: none"> - If the product contains a minimum proportion of sustainable investments, then mandatory in the sense of 2 (17) SFDR for those investments - If the product contains taxonomy-aligned investments, then mandatory on the basis of article 3 TR for those investments. 	DNSH: mandatory in the sense of article 2 (17) SFDR ¹⁷² <ul style="list-style-type: none"> - If the product contains taxonomy-aligned investments, then mandatory on the basis of article 3 TR for those investments.

168 Annex III CDR 2022/1288 as amended by Annex II CDR 2023/363.

169 Article 14 CDR 2022/1288.

170 Article 18 CDR 2022/1288.

171 Glander H., Kropf C. & Lühmann D., "Praktische Umsetzung der Pflichten aus der Offenlegungs-VO", *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35.

172 Glander H., Kropf C. & Lühmann D., "Praktische Umsetzung der Pflichten aus der Offenlegungs-VO", *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35.

Article 8 and 9 SFDR disclosures from Annexes II and III of CDR 2022/1288		
4	Minimum Safeguards: in principle not mandatory ¹⁷³ - If the product contains a minimum proportion of sustainable investments, then mandatory in the sense of 2 (17) SFDR for those investments - If the product contains taxonomy-aligned investments, then mandatory on the basis of article 3 and 18 DTR for those investments.	Minimum Safeguards: mandatory in the sense of article 2 (17) SFDR ¹⁷⁴ - If the product contains taxonomy-aligned investments, then mandatory on the basis of article 3 and 18 DTR for those investments.
5	Does this financial product consider PAI? [Y/N]	
6	Investment strategy – what are the binding elements to select E/S characteristics?	Investment strategy – what are the binding elements to select the sustainable investment objectives?
7	Planned asset allocation ¹⁷⁵ – to what extent are sustainable investments with an environmental objectives Taxonomy-aligned? <i>See: Figure 6</i>	Planned asset allocation - to what extent are sustainable investments with an environmental objectives Taxonomy-aligned? <i>See: Figure 7</i>
8	To what minimum extent are sustainable investments with an environmental objective aligned with the EU Taxonomy? ¹⁷⁶ <i>See: Figure 8</i>	
9	What is the minimum share of sustainable investments that are not Taxonomy-aligned? (SFDR sustainable but not TR sustainable?) ¹⁷⁷ [e.g. 0%]	
10	What investments are not sustainable, what is their purpose & are there any minimum E/S safeguards?	
11	Is a specific index designated to determine alignment with E/S characteristics or sustainable investment objectives?	

173 Glander H., Kropf C. & Lühmann D., "Praktische Umsetzung der Pflichten aus der Offenlegungs-VO", *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35.

174 Glander H., Kropf C. & Lühmann D., "Praktische Umsetzung der Pflichten aus der Offenlegungs-VO", *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35.

175 Article 16 CDR 2022/1288.

176 Article 15, 17 CDR 2022/1288.

177 Article 19 CDR 2022/1288.

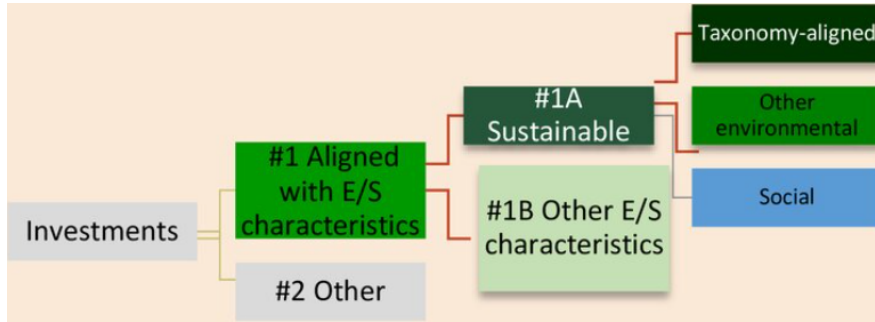


Figure 6: Planned asset allocation article 8 SFDR. Source: Annex II CDR 2022/1288 as amended by Annex I CDR 2023/363

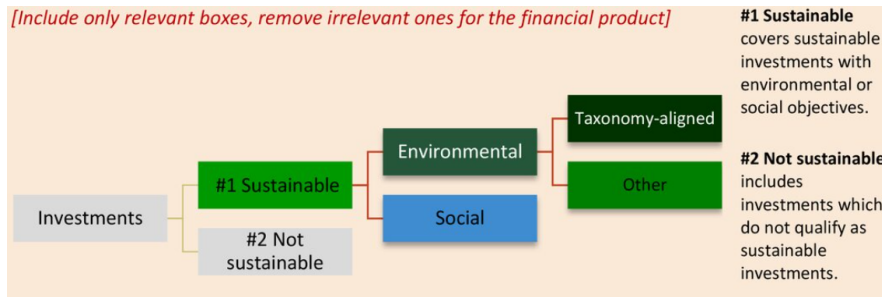


Figure 7: Planned asset allocation article 9 SFDR. Source: Annex II CDR 2022/1288 as amended by Annex I CDR 2023/363.

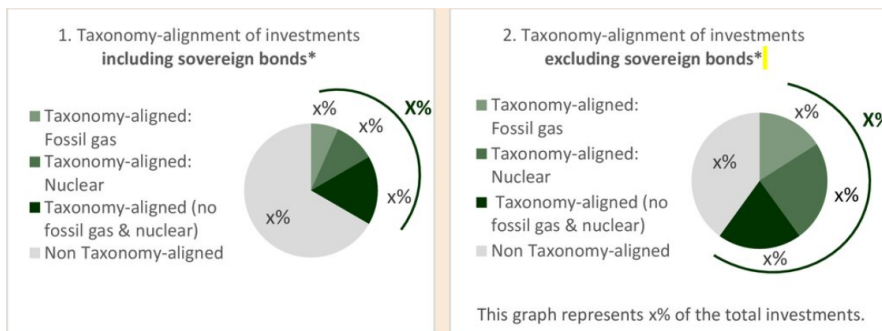


Figure 8: Minimum Taxonomy-alignments. Source: Annex II CDR 2022/1288 as amended by Annex I CDR 2023/363.

3.6.4.1 Articles 8 and 9 SFDR as Procedural Transparency Framework

As discussed in paragraph 3.2 of this Chapter, the SFDR is intended as a procedural transparency regime that enables investors to form their own judgement of an investment on the basis of the information provided to them.¹⁷⁸ Therefore, the disclosure requirements under articles 8 and 9 SFDR should primarily be analysed through the lens of a transparency regime. In line with the regulatory approach of a procedural transparency regime, this analysis should focus on how the SFDR requires the disclosing of qualitative or quantitative data that enable an informed investment decision.¹⁷⁹ What is crucial under this regulatory approach, is that the disclosures are comprehensive and relevant, which is realised by using the double materiality principle as the organising principle for disclosures.¹⁸⁰ Additionally, the disclosures should be neutral and not contain normative judgements as this impedes the ability of the investor to make their own assessment of the information provided.¹⁸¹

– Double Materiality

While the double materiality principle necessitates disclosure of both positive and negative impacts, risks, and opportunities, the current regulatory framework exhibits a significant bias toward positive sustainability impact disclosures: FMPs must describe what E/S characteristics or the sustainable investment objective of the financial product are, including what indicators are used to measure these. Conversely, the disclosure of negative impacts is limited. For article 8 SFDR products that neither pursue sustainable investment objectives nor contain Taxonomy-aligned investments, there are no mandatory requirements for material DNSH disclosures, minimum safeguards, or PAI considerations. While article 9 SFDR products face more stringent requirements, including mandatory DNSH and minimum safeguards disclosures, FMPs can still avoid the disclosure of PAI considerations by simply indicating that these have not been taken into account. This creates a situation in which articles 8

178 In his chapter on the SFDR, Zukas shows how various official key players like the Commission and ESMA have tried for the first few years to clearly communicate that the SFDR is not a labelling regime: Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33; Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 300.

179 Tröger T. & Steuer S., "The Role of Disclosure in Green Finance", *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8.

180 Paragraph 2 of this Chapter.

181 Tröger T. & Steuer S., "The Role of Disclosure in Green Finance", *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8; Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 301.

and 9 SFDR emphasise positive sustainability impacts and potentially over-looking adverse effects.¹⁸² This asymmetry is also highlighted in the Annual Commission Report on Principal Adverse Impact disclosures of 30 October 2024, in which it is stressed that there are financial products for which article 8 or 9 disclosures have been made (positive impact) but no article 7 disclosures (negative impact).¹⁸³ This discrepancy stems from the differing applicability criteria: whether mandatory disclosures have to be made under article 7 SFDR depends on the size of the FMP or FA, whereas the duty to disclose information under article 8 and 9 SFDR depends on whether the FMP chooses to rely on either of the articles. An additional shortcoming in light of the double materiality principle is that articles 8 and 9 SFDR products need not per se disclose the financial risks and opportunities of sustainability factors for the financial product. The reason for this is that the same application criterion of article 7 SFDR also applies to article 6 SFDR: disclosing financial risk at product level is dependent on the size of the FMP. For the disclosure of financial opportunities, there is no transparency requirement at all in the SFDR.

– *Neutral Information*

A regulatory approach that aims at procedural transparency also provides for neutral information and avoids normative judgments to facilitate independent investor assessment.¹⁸⁴ In general, articles 8 and 9 SFDR achieve this by using open-ended concepts and focusing on the disclosure of methods, which encompasses a neutral approach to, i.e., the product's design, investment methodologies and other elements.¹⁸⁵ For article 8 products, the central criterion, the promotion of environmental or social characteristics, remains undefined in the SFDR. Instead, CDR 2022/1288 mandates the FMP to explain what characteristics are promoted, specify measurement indicators, optionally reference benchmarks, and disclose to what extent assets are Taxonomy-aligned.¹⁸⁶ Similarly, article 9 SFDR, requires that the product has sustainable

182 Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, European Parliament 2024, No. PE 754.212, p. 29.

183 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68.

184 Tröger T. & Steuer S., "The Role of Disclosure in Green Finance", *ECGI Law Working Paper* 2021, available at: https://www.ecgi.global/sites/default/files/working_papers/documents/steuertrogerfinal.pdf, p. 7-8; Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 301.

185 Commission Decision, on the adoption of the answers to be provided to questions submitted by the European Supervisory Authorities under Article 16b(5) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010, Regulation (EU) No 1095/2010 of the European Parliament and of the Council in the period from 1 January 2021 to 30 January 2021, 14 July 2021, Ares(2021)4556843, Annex, p. 5, 7.

186 Annex II CDR 2022/1288 as amended by Annex I CDR 2023/363.

investment as defined in article 2 (17) SFDR as its objective. While article 2(17) establishes that investments must pursue E/S objectives, avoid significant harm to other E/S objectives, and maintain minimum safeguards, it purposefully refrains from strictly delineating E/S objectives.¹⁸⁷ The disclosure requirements under article 9 SFDR and CDR 2022/1288 can therefore be seen as a framework in which the FMP can explain its rationale for their product classification.¹⁸⁸

The procedural nature of articles 8 and 9 SFDR becomes even more evident when comparing it to the TR. Articles 8 and 9 SFDR share a number of conceptual similarities with the TR, particularly the concept of ‘environmental objectives’ (art. 3 jo 9 TR), the DNSH criterion (art. 3 and 17 TR), and minimum safeguards (art. 18 TR). However, SFDR products need not substantively satisfy these TR standards.¹⁸⁹ Instead, the focus remains on delivering methodologically neutral information, enabling investors to conduct unbiased assessments.

There are three notable exceptions to the procedural transparency approach of articles 8 and 9 SFDR. First, there is the fundamental question of why a procedural transparency framework even necessitates categorising financial products into two different categories.¹⁹⁰ After all, such categorisation by law seems unnecessary for a regulatory strategy that is focused on providing neutral information to investors in order to enable them to make their own assessment.¹⁹¹ Second, financial products under articles 8 or 9 SFDR containing Taxonomy-aligned investments must satisfy the TR’s material thresholds. This exception is logically consistent, as SFDR’s procedural nature cannot supersede TR requirements for products claiming environmental sustainability under that regulation. Third, article 8 products not only must promote E/S characteristics, but also restrict investments to companies demonstrating good governance practices.¹⁹² Other than the disclosures pertaining to the E/S

187 Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 16.

188 Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 16.

189 Nagel, Lorenz & El-Qalqili relate this to the Commissions choice to not make the qualification of an article 8 or 9 SFDR product dependent on meeting a pre-determined percentage of Taxonomy-aligned investment, see: Nagel S., Lorenz L. & El-Qalqili J., “Nachhaltige Investitionen im System der Offenlegungs-VO und Taxonomie-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht*, 2022, Heft 5, p. 360, 364.

190 Steuer S., “Grüne Transparenz und nachhaltige Verwirrung – Die produktbezogenen Informationsvorschriften der SFDR”, *Zeitschrift für Bankrecht und Bankwirtschaft* 2022, vol. 34(1), p. 31, 32.

191 Steuer S., “Grüne Transparenz und nachhaltige Verwirrung – Die produktbezogenen Informationsvorschriften der SFDR”, *Zeitschrift für Bankrecht und Bankwirtschaft* 2022, vol. 34(1), p. 31, 32.

192 Article 8 (1) SFDR.

characteristics, this requirement seems to be of a substantive nature. Steuer convincingly argues that this criterion therefore does not align with the intent of the SFDR.¹⁹³ I agree with this assessment: given the SFDR's aim to enhance transparency on how sustainability is considered in investment decisions, a substantive requirement to limit investments to companies with good governance practices is misaligned to the general regulatory strategy pursued by the regulation. Additionally, it is incongruent to have this as a substantive requirement, while the disclosures under article 8 SFDR do not need to substantively meet the minimum safeguards from article 2 (17) SFDR.¹⁹⁴

3.6.4.2 Articles 8 and 9 SFDR as Product Labels

The product categorisation of the SFDR is in practice used – or at least perceived – as a labelling regime for light green (article 8) and dark green (article 9) products that refer to a certain degree of sustainability.¹⁹⁵ This use of the SFDR raises the question however whether articles 8 and 9 SFDR are suitable for this practice.

As mentioned before, the regulatory strategy of the SFDR is procedural transparency. This can be contrasted to labelling, which is aimed at reducing the complexity of data and providing a pre-defined normative affirmation of quality.¹⁹⁶ To achieve its aim, the label must be based on clear and pre-defined indicators.¹⁹⁷ It is clear that articles 8 and 9 SFDR do not meet this criterion. There are a number of factors that play a role. First of all, the core categorization criteria – promotion of E/S objectives, sustainable investment objective – are open-ended.¹⁹⁸ Second, the articles do not contain material thresholds: for example, there is no minimum percentage Taxonomy-alignment,

193 Steuer S., “Grüne Transparenz und nachhaltige Verwirrung – Die produktbezogenen Informationsvorschriften der SFDR”, *Zeitschrift für Bankrecht und Bankwirtschaft* 2022, vol. 34(1), p. 31–37.

194 Steuer S., “Grüne Transparenz und nachhaltige Verwirrung – Die produktbezogenen Informationsvorschriften der SFDR”, *Zeitschrift für Bankrecht und Bankwirtschaft* 2022, vol. 34(1), p. 31, 37.

195 Eurosif, “EU Sustainable Finance & SFDR: making the framework fit for purpose Eurosif Policy Recommendations for Article 8 & 9 product labels”, June 2022, p. 10. Ramos Muñoz D., Lamandini M. & Siri M., “The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)”, *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, *European Parliament* 2024, No. PE 754.212, p. 33–34. Even the ESAs have referred to these products as light green and dark green, in: Joint ESAs Consultation on Taxonomy-related sustainability disclosures, 15 March 2021, JC 2021 22, p. 5.

196 Steuer S. & Tröger T.H., “The Role of Disclosures in Green Finance”, *Journal of Financial Regulation* 2022, vol. 8(1), p. 1, 6.

197 Steuer S. & Tröger T.H., “The Role of Disclosures in Green Finance”, *Journal of Financial Regulation* 2022, vol. 8(1), p. 1, 6.

198 See paragraph 3.4.1 of this Chapter on the definition of “sustainable investment”.

nor mandatory PAI assessments.¹⁹⁹ Instead, articles 8 and 9 SFDR require transparency of methodologies and explaining the rationale for categorising the product under either article. Third, as articles 8 and 9 SFDR are product categories on an aggregated level, for example on portfolio level, there are significant challenges for data collection: sustainability information may be unavailable for certain investments, while available data may lack standardized formats, compromising the reliability of portfolio-level sustainability impact assessments that would be necessary for accurate labels.²⁰⁰

The use of articles 8 and 9 SFDR as labels thus is misaligned to the regulatory strategy that is employed under in those articles, namely comprehensive and neutral transparency. This gives rise to three specific problems: the label may not align to the investors preference; it may be hard to differentiate between article 8 and 9 as labels; there is an increased risk of greenwashing.

– *Mismatch with Investor Preference*

The use of article 8 and 9 SFDR as labels, increases the risk that investors may not understand that the classification as ‘article 8’ or ‘article 9’ does not correspond to a definite degree of sustainability. Consider, for example, the fact that an article 8 fund may have non-sustainable investments, a possibility explicitly acknowledged in Annexes I and II of CDR 2022/1288, which require disclosure of such investments.²⁰¹ After all, the idea of the SFDR is that FMP can justify their classification choice, without mandating investment exclusions.²⁰² An investor who is not aware of this may mistakenly believe that the label ‘article 8’ signifies predetermined sustainability thresholds or specific investment exclusions.

This is confirmed in a study done by Scheitza and Busch, in which more than 1000 ‘article 9’ funds were analysed.²⁰³ The authors found that the degree of sustainability ambition varied across the funds, with 60% of the funds focussing on positive sustainability impact, whereas 40% of the funds merely pursued a general ESG strategy.²⁰⁴ A similar study by Chesney and

199 Glander H., Kropf C. & Lühmann D., “Praktische Umsetzung der Pflichten aus der Offenlegungs-VO”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35. Colaert V., “On the Sustainability of the MiFID II and IDD Investor Protection Frameworks”, in: Alexander K., Gargantini M., & Siri M. (eds.), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press 2025, p. 323.

200 Steuer S. & Tröger T.H., “The Role of Disclosures in Green Finance”, *Journal of Financial Regulation* 2022, vol. 8(1), p. 1, 42

201 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 2)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 11, p. 545, 546.

202 See also recitals 19 and 20 CDR 2022/1288.

203 Scheitza L. & Busch T., “SFDR Article 9: Is it all about impact?”, *Finance Research Letters* 2024, vol. 62, part A, 105179.

204 Scheitza L. & Busch T., “SFDR Article 9: Is it all about impact?”, *Finance Research Letters* 2024, vol. 62, part A, 105179, p. 4.

Lambillon equally found that there is a great variety in article 9 SFDR funds.²⁰⁵ The problem that this causes, is that when investors who are unaware of this diversity may invest in financial products that do not reflect their sustainability preferences.²⁰⁶

In this context, it is also relevant to mention the under-examined risk of ‘grey-washing’ (also referred to as ‘green bleaching’).²⁰⁷ This phenomenon refers to the situation in which an FMP deliberately understates the positive sustainability impact of their product to avoid disclosure obligations or limit regulatory risks. In particular, the procedural transparency nature of the SFDR, with a lack of substantive criteria for product categorisation, may cause FMPs to err on the side of caution. One indicator for this is Badenhoop’s research, in which a significant reclassification from article 9 to article 8 funds was observed when CDR 2022/1288 entered into force.²⁰⁸ The research paper does not give a definite answer to why funds were reclassified after the CDR entered into force, hence the possibility cannot be excluded that some FMPs may have downgraded their funds to mitigate potential liability and regulatory risks, despite there being defensible justifications for maintaining the higher classification. When FMPs grey-wash their products, this results in less sustainability information being available to investors, undermining their ability to invest in products that reflect their sustainability preferences. Thereby, it also directly undermines the objective of the SFDR to enable investors to take sustainability information into account in their investment decision.²⁰⁹

– *Insufficient Distinction between Articles 8 and 9 as Labels*

Investors may not understand the distinction between article 8 and article 9 funds given the open-endedness of ‘E/S characteristics’ and ‘sustainable

205 Lambillon A.-P. & Chesney M., “How Green is ‘Dark Green’? An Analysis of SFDR Article 9 Funds”, 22 February 2023, available on: <http://dx.doi.org/10.2139/ssrn.4366889>.

206 Scheitza L. & Busch T., “SFDR Article 9: Is it all about impact?”, *Finance Research Letters* 2024, vol. 62, part A, 105179, p. 5; Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 95.

207 Colaert V., “On the Sustainability of the MiFID II and IDD Investor Protection Frameworks”, in: Alexander K., Gargantini M., & Siri M. (eds.), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press 2025, p. 335-336; ESMA, SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements, 3 May 2022, ESMA22-106-4032.

208 Badenhoop N., e.a., “Quo vadis sustainable funds? Sustainability and taxonomy-aligned disclosure in Germany under the SFDR”, *SAFE White Paper* 2023, no. 94, available at: <https://www.econstor.eu/handle/10419/273716>.

209 ESMA, SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements, 3 May 2022, ESMA22-106-4032, p. 1.

investment'.²¹⁰ This risk has partially been addressed by CDR 2022/1288, as is evidenced by Badenhoop's research, in which a significant reclassification from article 9 to article 8 funds was observed when CDR entered into force.²¹¹ However, the improved clarity for FMPs does not necessarily translate into better comprehension by investors. The potential inability of investors to distinguish between article 8 and 9 SFDR, undermines the usefulness of the classification system for informed investment decisions, which directly contradicts the aim of the SFDR to enable investors to make an informed investment decision.²¹²

– *Increased Greenwashing Risk*

The combination of ambiguous definitions and the absence of quantitative thresholds heightens greenwashing risks.²¹³ After all, there are clear incentives for FMP to market their financial products as sustainable as possible. For example, research demonstrates that investors are willing to pay more for products with positive non-pecuniary impacts, particularly sustainability outcomes.²¹⁴ More specifically, Scherer and Hasaj have found statistical evidence that article 9 funds attract more significant inflows than article 8 funds.²¹⁵ It is thus financially advantageous to exploit the discretion that the SFDR provides to FMP to strategically stretch the lower limits for the categorisation as article 9 (or 8) fund.

210 Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON), European Parliament* 2024, No. PE 754.212, p. 34; Martínez-Meyers S., Ferrero-Ferrero I. & Muñoz-Torres M.J., "The European sustainable finance disclosure regulation (SFDR) and its influence on ESG performance and risk in the fund industry from a multi-regional perspective", *Journal of Financial Reporting and Accounting* 2024, available at: <https://doi.org/10.1108/JFRA-03-2024-0150>, p. 2; Colaert V., "On the Sustainability of the MiFID II and IDD Investor Protection Frameworks", in: Alexander K., Gargantini M., & Siri M. (eds.), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press 2025, p. 323-325.

211 Badenhoop N., e.a., "Quo vadis sustainable funds? Sustainability and taxonomy-aligned disclosure in Germany under the SFDR", *SAFE White Paper* 2023, no. 94, available at: <https://www.econstor.eu/handle/10419/273716>; Macpherson M., "Meeting the EU's Sustainability Disclosure Rules – a mission (im)possible?" in: Rimmel G., e.a. (eds.), *Research Handbook on Sustainability Reporting*, Edgar Elgar 2024, p. 240-241.

212 Recital 10 SFDR.

213 Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 325; Lieverse C.W.M., "Transparantie en Sustainable Finance: Over greenwashing en door de bomen het bos niet meer zien", *Tijdschrift voor Financieel Recht* 2024, nr. 4, p. 15, 16-17.

214 Barber B.M., Morse A. & Yasuda A., "Impact investing", *Journal of Financial Economics* 2021, vol. 139(1), p. 162.

215 Scherer B. & Hasaj M., "Greenlabelling: How valuable is the SFDR Art 9 label?" *Journal of Asset Management* 2023, vol. 24, p. 541.

The SFDR's vulnerability to greenwashing has drawn regulatory attention. In 2022, the Commission requested the European Supervisory Authorities to evaluate greenwashing risks.²¹⁶ ESMA's subsequent Progress Report on Greenwashing identified several problems related to the SFDR that contribute to greenwashing risk, particularly the use of articles 8 and 9 as labels and the ambiguous definitions of 'sustainable investment' and DNSH criteria.²¹⁷ Also in its final report, ESMA noted that some NCAs find the unclear definition of 'sustainable investment' difficult to identify greenwashing.²¹⁸ It can therefore be concluded that the current use of articles 8 and 9 SFDR as labels enables greenwashing.²¹⁹

3.7 Ex Post Disclosures

3.7.1 Introduction

To mitigate the principal-agent problem, ex ante disclosures that precede the contract enable informed investment decisions, while ex post disclosures facilitate investors to monitor agent behaviour. The SFDR therefore also prescribes the latter type of disclosures, which I discuss in this paragraph.

3.7.2 Articles 3 and 4 – Sustainability Risk and Impact at Entity Level

The SFDR mandates ongoing website disclosures for the information that is disclosed under articles 3 and 4 SFDR – sustainability risk policies and impact at entity level. Article 12 SFDR requires that the sustainability risk policies that have to be disclosed under article 3, are kept up to date, while article 4 SFDR mandates that they be 'maintained' on the website.²²⁰ Article 2 CDR 2022/1288 reiterates that in general, information that is published on websites must be kept up to date. More specifically, the disclosure of sustainability

216 European Commission, Request for input to the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) related to greenwashing risks and supervision of sustainable finance policies, Ares(2022)3682962.

217 ESMA, Progress Report on Greenwashing, Response to the European Commission's request for input on "greenwashing risks and the supervision of sustainable finance policies", 31 May 2023, ESMA30-1668416927-2498, p. 45, 60-62; Lieverse C.W.M., "Transparantie en Sustainable Finance: Over greenwashing en door de bomen het bos niet meer zien", *Tijdschrift voor Financieel Recht* 2024, nr. 4, p. 15, 16-17.

218 ESMA, Final Report on Greenwashing, 4 June 2024, ESMA36-287652198-2699, p. 41.

219 Partiti E., "Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence", *European Business Organizational Law Review* 2024, vol. 25, p. 299, 325.

220 Article 4 (1) and (5) SFDR first sentence.

impact that has to be disclosed on the basis of article 4 SFDR, must cover the preceding year.²²¹ These ongoing disclosure requirements at entity level thus continue after the conclusion of a contract between the FMP or FA and the investor, and can therefore constitute *ex post* disclosures in the principal-agent paradigm.

3.7.3 Articles 6 and 7 – Sustainability Risk and (Negative) Sustainability Impact at Product Level

Articles 6 and 7 SFDR contain the obligation to disclose sustainability risk and (negative) sustainability impact at product level. As discussed in para. 3.6.2, how pre-contractual disclosures of sustainability risk at product level have to be made on the basis of article 6 SFDR depends on the sectoral legislation that applies to the FMP.²²² For example, investment firms providing portfolio management services must make the SFDR disclosures in accordance with Article 24 (4) of MiFID II. Article 24 (4) MiFID II explicitly prescribes that “[w]here applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment”.²²³ For portfolio management, the disclosures thus are contained within the framework of (pre-)contractual disclosures as article 24 (4) MiFID II does not distinguish those two phases.

In contrast, article 7 SFDR on the disclosure of sustainability impact contains a more explicit regime for ongoing disclosures, namely that periodic disclosures must be in line with article 11 (2) SFDR.²²⁴ How these disclosures have to be made, mirrors how the pre-contractual disclosures for sustainability risk on the basis of article 6 SFDR have to be made: according to the sectoral legislation that applies to the FMP.²²⁵ For example, for investment firms that provide portfolio management, the ongoing disclosures must be made in the form of a periodic report as referred to in Article 25 (6) MiFID II.²²⁶

3.7.4 Articles 8 and 9 – Products that Promote Environmental or Social Characteristics and Products that have Sustainable Investments as their Objective

Articles 8 and 9 SFDR contain, respectively, the disclosure obligations for financial products that promote E/S characteristics, and financial products

221 Article 4 (1) CDR 2022/1288 (information shall cover the period of 1 January until 31 December of the preceding year).

222 This follows from article 6 (3) SFDR.

223 Article 24 (4) MiFID II last sentence.

224 Article 7 (1) (b) SFDR; see also: recital 20 SFDR; Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 81.

225 Article 11 (2) SFDR.

226 Article 11 (2) (h) SFDR.

that have sustainable investments as their objective (see para. 3.6.4). The pre-contractual disclosures have to be made in line with article 6 (3) SFDR and depend on the type of FMP and should be made in the same manner that the FMP typically provides pre-contractual information.²²⁷ Additionally, pre-contractual disclosures have to be made on the website of the FMP.²²⁸

The ongoing disclosure requirements for articles 8 and 9 SFDR are contained in article 11 SFDR, which requires the FMP to publish periodic reports. This information must be made available in two manners.²²⁹ First, in line with the applicable sectoral legislation – for example, for investment firms that provide portfolio management, the ongoing disclosures must be made in the form of a periodic report as referred to in Article 25(6) MiFID II.²³⁰ Second, the information must be made available on the website of the FMP.²³¹ The content of the periodic reports is further outlined in articles 50 – 63 CDR 2022/1288. Most of these requirements are contained in the two templates for articles 8 and 9 respectively that are contained in Annexes IV and V of CDR 2022/1288.²³² The information to be disclosed using these templates follows the structure of the pre-contractual disclosure forms. In general terms, the periodic disclosures thus cover the pre-contractual disclosures of articles 8 and 9 SFDR.²³³

3.7.5 Conclusion

In general, it can be concluded that the ex post disclosures adequately cover the ex ante disclosure requirements. It is notable, however, that the mechanism for periodic disclosures differs significantly for articles 3, 4, 6, 7, and 8-9 SFDR. Only articles 8 and 9 SFDR have the same disclosure mechanism for ex post disclosures, namely periodic reports on the basis of article 11 SFDR, and further detailed in CDR 2022/1288. For articles 3, 4, 6, and 7 SFDR, the mechanisms

227 This follows from article 6 (3) SFDR. For example, investment firms providing portfolio management services must make the SFDR disclosures in accordance with Article 24 (4) of MiFID II.

228 Article 10 SFDR.

229 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 50.

230 Article 11 (2) (h) SFDR. Boogaard R.J., “Classificatie van financiële producten op grond van artikel 8 en 9 SFDR”, *Tijdschrift voor Financieel Recht* 2022, nr. 1, p. 13, 21.

231 Article 10 (1) (d) SFDR. Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 80-81.

232 Klerk J.E. de & Velden J.W.P.M. van der, “SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders” in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 80-81.

233 One significant difference is that for Taxonomy-alignment, the pre-contractual disclosures focus on what part of the investments is Taxonomy-aligned in total, whereas the periodic report splits this into turnover, CapEx, and OpEx and thereby follows the annual reporting requirements that stem from CDR 2021/2178, which supplements the Taxonomy Regulation on periodic reporting under the CSRD (see: paragraph 5.3.1 of Chapter 3).

vary from the obligation to keep information up to date (article 3 and 12 SFDR) to periodic reporting on the basis of rules contained in other legislation on pre-contractual disclosures, such as article 24 (4) MiFID II for investment firms providing portfolio management. This inconsistency makes it more complex to gain an understanding of the different periodic disclosure requirements.

An additional consequence is that the level of detailedness differs for the different areas that are covered in the SFDR. For example, periodic disclosure for sustainability risk at product level, namely to “provided to the client on a regular basis, at least annually, during the life of the investment” ex article 6 (3) SFDR and 24 (4) MiFID II is much less detailed than articles 50 – 63 and Annexes IV and V CDR 2022/1288 on the periodic reports for articles 8 and 9 products. A significant difference in detailedness may sometimes be justified when the areas of disclosure are also significantly different. For example, disclosures at entity level may not need to be as detailed as those at product level. However, there is no justification why periodic disclosures for the positive sustainability impact of products that promote environmental or social characteristics and products that have sustainable investments as their objective, should be so much more detailed than the periodic disclosures of sustainability risk at product level. After all, investors will not only want to monitor in detail the (positive) sustainability impact of their investments but also be well informed on the risks that they are exposed to.

3.8 OTHER REQUIREMENTS

3.8.1 Article 5 – Remuneration

Article 5 SFDR requires FMP and FA to disclose on their websites how their remuneration policies relate to the integration of sustainability risk.²³⁴ The focus of article 5 SFDR is on sustainability risk – financial risk that is due to environmental, social or governance events.²³⁵ Rather than establishing a link between positive sustainability impact and remuneration, article 5 SFDR thus aims to ensure transparency regarding risk management and incentives to limit excessive risk-taking.²³⁶ This could, for example, include policies in

234 Labeur R.E., “Vermogensbeheerders & duurzaamheidstransparantie”, in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022, p. 282; Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 492-493.

235 Article 2 (22) SFDR.

236 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 1)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 10, p. 485, 492-493; Klerk J.E. de & Velden J.W.P.M.

which variable parts of the remuneration of investment professionals are deferred for a few years and paid out pro-rata based on the performance of the investment.²³⁷

Given that the SFDR only demands the disclosure of how the remuneration policies relate to the integration of sustainability risk – but not sustainability impact, it could be expected that there is a weak link between remuneration and sustainability performance. Surprisingly, Cremasco and Boni have found that for both article 6 and article 9 funds, there is a positive relationship between on the one hand financial performance and on the other hand sustainability performance and management fees.²³⁸ This suggests that the SFDR stimulates FMP and FA to integrate both sustainability risk and impact in their remuneration policies, even though this is not required for the latter.²³⁹ Nonetheless, the lack of legislative guidance on linking both sustainability risk and sustainability impact to remuneration policies creates a fragmented disclosure framework and misses the opportunity to use this mechanism to decrease the divergence in interests between investors and intermediaries.

3.8.2 Article 13 – Marketing Communications

Article 13 SFDR requires that marketing communications by FMPs and FAs do not contradict the disclosures that must be made pursuant to the SFDR.²⁴⁰ This provision is essential for reaching the Regulations' aim "to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks."²⁴¹ While not explicitly stated, this alignment requirement inherently addresses greenwashing concerns, as I discuss in paragraph 2 of this Chapter.²⁴² The prohibition on contradicting SFDR

van der, "SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders" in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 86.

237 For example: Nordea Asset Management, "Sustainability risk integration in remuneration", 11 June 2024, available at: https://www.nordea.lu/documents/integration-of-sustainability-risks-in-remuneration/ISRR_N1_eng_INT.pdf/.

238 Cremasco C. & Boni L., "Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour", *Journal of Sustainable Finance & Investment* 2024, vol. 14(4), p. 1018.

239 Cremasco C. & Boni L., "Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour", *Journal of Sustainable Finance & Investment* 2024, vol. 14(4), p. 1018, 1032-1333.

240 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 51; Klerk J.E. de & Velden J.W.P.M. van der, "SFDR en ESG benchmark verordening: de impact op beleggingsondernemingen en beheerders" in: Strijbos F.P.C., e.a. (eds.), *Duurzaam bankieren*, Wolters Kluwer 2023, p. 86; Glander H., Lühmann D. & Jesch T.A., "Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 2)", *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 11, p. 545, 548.

241 Recital 10 SFDR.

242 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 51.

disclosures represents a significant anti-greenwashing measure, as it prevents FMPs and FAs from making unsubstantiated sustainability claims that exceed their disclosed information. However, as I discuss in paragraph 3.6.4, the SFDR framework itself may create new greenwashing opportunities that article 13 fails to address.²⁴³

3.8.2 Article 18a – European Single Access Point

The information that FMP and FA have to make available on the basis of articles 3, 4, 5, and 10 SFDR – sustainability risk and impact at entity level, remuneration policies, and website disclosures at product level – must also be made available on the European Single Access Point (ESAP) from 10 January 2028 onward.²⁴⁴ The ESAP, established by Regulation (EU) 2023/2859 and set to become operational by 10 July 2027, aims to facilitate easy access to information, enabling sound, informed, and environmentally responsible investment decisions that support efficient market functioning.²⁴⁵ This will increase the accessibility of information that has to be disclosed under the SFDR as all information that FMP and FA have to disclose on their websites will also be available in a centralised manner.²⁴⁶

3.9 Supervision

According to article 14 SFDR compliance with the Regulation is monitored by the national competent authorities that oversee sectoral disclosures referenced in article 6 (3) SFDR.²⁴⁷ Consequently, the supervision of FMPs and

243 Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 51.

244 Article 18a (1) SFDR.

245 Article 1 Regulation (EU) Regulation (EU) 2023/2859 of the European Parliament and of the Council of 13 December 2023 establishing a European single access point providing centralised access to publicly available information of relevance to financial services, capital markets and sustainability (ESAP Regulation); Recital 1 ESAP Regulation. See also: Russ A. & Schranz B.A. “European Single Access Point (ESAP) Das neue europäische Zugangsportal zu öffentlichen Informationen (Teil 1: Der Kommissionsvorschlag)”, *Österreichisches Bankarchiv Zeitschrift für das gesamt Bank- und Börsenwesen*, vol. 71(6), p. 437; Russ A. & Schranz B.A. “European Single Access Point (ESAP): Das neue europäische Zugangsportal zu öffentlichen Informationen (Teil 2: Die finalen ESAP-Rechtsakte samt Anmerkungen zur prospekt- und transparenzrechtlichen Umsetzung)”, *Österreichisches Bankarchiv Zeitschrift für das gesamt Bank- und Börsenwesen*, vol. 72(2), p. 110; Heldring M. & Horck M.F., “Een Wondermiddel in de Zoektocht naar ESG-Data?”, in: Loopik M.J. van & Palm-Steyerberg I.P. (eds.), *The Twin Transition: Digital & Sustainable Finance*, Wolters Kluwer 2022, p. 329-345.

246 Recital (1) ESAP Regulation.

247 Glander H., Lühmann D. & Jesch T.A., “Nachhaltigkeitsbezogene Offenlegungspflichten im Finanzdienstleistungssektor unter der Offenlegungsverordnung (Teil 2)”, *Zeitschrift für Bank- und Kapitalmarktrecht* 2020, Heft 11, p. 545, 549.

FAs aligns with existing sectoral oversight frameworks. This means that, for example, investment firms who have to disclose pre-contractual SFDR information according to the MiFID II framework, will be supervised by the competent authorities that supervise compliance with MiFID II.

4 CONCLUSION

4.1 Introduction

In this Chapter, I analyse the disclosure of sustainability information to investors by intermediaries on the basis of the SFDR. My analyses focus on the question: *how effective are the disclosure requirements from the Sustainable Finance Disclosure Regulation in reducing the principal-agent problem between intermediaries and investors?* The relationship between investors and intermediaries is characterised by a classical principal-agent problem, which can result in insufficient consideration of sustainability risk and potentially lead to greenwashing. This principal-agent problem manifests when the interests of investors and intermediaries diverge while information asymmetries persist between the parties. This undermines market efficiency and may impede the flow of capital toward sustainable investments. I evaluate the effectiveness of the SFDR by assessing whether the information that is disclosed in the basis of the Regulation meets the three criteria set out in the normative framework in paragraph 2: complete, standardized, and accurate.

Before this evaluation, I want to stress that in general, the SFDR has improved the flow of information to investors and has increased sustainable practices in financial markets. From the ESAs 2024 survey to NCA's in 2024 on SFDR disclosures, it follows that more than 1000 FMPs voluntarily disclosed their entity-level sustainability impact, in addition to those FMPs for whom the disclosures are mandatory.²⁴⁸ Moreover, the ESAs noted a general improvement in the quality of the disclosures compared to the previous two years.²⁴⁹ Additionally, there is evidence that the introduction of sustainability disclosures on the basis of the SFDR led to an increase in ESG performance and an increase in sustainable investing.²⁵⁰ This appears to be so not only

248 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 8. Article 4 and article 7 SFDR. Article 7 only applies to FMP that disclose information on the basis of article 4 SFDR, which only is mandatory for FMPs with more than 500 employees.

249 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 5.

250 Martinez-Meyers S., Ferrero-Ferrero I. & Muñoz-Torres M.J., "The European sustainable finance disclosure regulation (SFDR) and its influence on ESG performance and risk in the fund industry from a multi-regional perspective", *Journal of Financial reporting and Accounting* 2024, available at: <https://doi.org/10.1108/JFRA-03-2024-0150>, p. 14.

for FMP and FA that market article 8 and 9 products, but also for conventional article 6 funds.²⁵¹ At least two reasons can be identified for this. First, the SFDR has increased the harmonisation of sustainability disclosures in a market that was relying on self-regulation and fragmented legislation. Second, the mandatory disclosures may influence the FMP and FA to shift their policies on the integration of sustainability risk and impact, even though this is not explicitly mandated by the SFDR. This is for example evidenced by the positive relationship between sustainability performance and management fees, regardless of whether the product pursues sustainability objectives or not.²⁵² In general, the SFDR thus is a positive development as information asymmetries indeed have decreased between intermediaries and investors in comparison to the situation before the introduction of the Regulation.

4.2 Evaluation

4.2.1 Complete

As a procedural transparency regime, the SFDR aims to empower investors to make their own assessment of the sustainability risks, opportunities, and impact of an investment. For this, the SFDR aims to minimize information asymmetries by providing the investor with relevant and complete information. To evaluate whether the Regulation is successful at this, the double materiality principle serves as the indicator to assess whether the disclosed information covers all relevant areas.

In general, the double materiality principle is reflected throughout the SFDR, even though it is never explicitly acknowledged: entity level disclosures pertain to both the negative impact of the FMP or FA on sustainability factors, and the negative impact of sustainability risks on the FMP or FA. The positive dimension of the double materiality principle at entity level is excluded from the disclosure requirements in the SFDR. Similarly, the double materiality principle is also reflected in the product level disclosures, with article 6 focusing on sustainability risk, i.e. the (potential) negative impacts of sustainability on the product, article 7 focusing on the negative impact of the product on sustainability factors, and articles 8 and 9 focusing on the positive impact on sustainability. How the SFDR covers the double materiality principle is summarized in the table below:

251 Martinez-Meyers S., Ferrero-Ferrero I. & Muñoz-Torres M.J., "The European sustainable finance disclosure regulation (SFDR) and its influence on ESG performance and risk in the fund industry from a multi-regional perspective", *Journal of Financial reporting and Accounting* 2024, available at: <https://doi.org/10.1108/JFRA-03-2024-0150>, p. 14.

252 Cremasco C. & Boni L., "Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour", *Journal of Sustainable Finance & Investment* 2024, vol. 14(4), p. 1018.

Table 7: Double materiality throughout the SFDR. Source: Own image.

	Entity level	Product level
Sustainability risk	Article 3 All FMPs and FAs regardless of their size	Article 6 All FMPs and FAs regardless of their size
Sustainability opportunities		
Negative sustainability impact	Article 4 Mandatory for FMPs with more than 500 employees & voluntary for all other FMPs and FAs	Article 7 Mandatory for FMPs and FAs that apply article 4
Positive sustainability impact		Article 8 and 9 In principle voluntary, mandatory for FMPs and FAs that categorise their products to have E/S characteristics or sustainable investment as objective

Three issues put pressure on the completeness of the information that is disclosed under the SFDR: the scope of the disclosure obligations, the level of detailedness, and the content of the disclosures. These three issues imply that the information that is disclosed under the SFDR does not sufficiently match the needs of the investor who needs a complete overview of sustainability risks, opportunities and impacts.

The varying scopes of the disclosure obligations create gaps in the completeness of the information on entity and product level. For example, all FMPs and FAs have to disclose sustainability risk on entity level, but only FMPs with more than 500 employees have to disclose sustainability impact on entity level. Similarly, at product level, some FMPs will disclose the sustainability risk on the basis of article 6 SFDR, but not the sustainability impact of their products on the basis of articles 7 SFDR. This problem is most pronounced regarding articles 8 and 9 SFDR, for which the situation can arise that FMPs only disclose positive impact, without having to disclose negative impacts in line with article 7 SFDR.²⁵³

Another issue is the different levels of detailedness that apply to the disclosure obligations. For articles 4, 7, 8 and 9 SFDR there is elaborate guidance in CDR 2022/1288. For the disclosures under articles 3 and 5 SFDR, there is hardly any guidance at all. This inconsistency creates an unbalanced flow

253 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 48.

of information toward investors with some elaborate and some minimal disclosures.

Lastly, the content of the information may not sufficiently match the needs of investors. As has been touched upon several times in this chapter, disclosures on the basis of the SFDR focus on processes, policies and methodologies. However, investors may rather need straightforward information about the concrete sustainability risk or impact of a financial product. This type of information is for example provided on the basis of the TR and the EuGBR. Under those regulations, the disclosure, in essence, directly states that an investment qualifies as an environmentally sustainable economic activity. Contrarily, the disclosure on the basis of, for example, article 9 SFDR are more procedural, focussing on the reasons and methods for classifying the financial product as having sustainability as its objective according to the FMP.

4.2.2 *Standardised*

Sufficiently standardised information is necessary to enable investors to compare investment opportunities. To assess whether the information disclosed on the basis of the SFDR is standardized, I analyse (i) whether the information is harmonised between intermediaries and (ii) whether the information is standardized for financial products to enable comparisons.

4.2.2.1 *Harmonisation at Intermediary Level*

Before the introduction of the SFDR, there was no harmonisation of sustainability disclosures by intermediaries, as this area was left to national legislators and market-based initiatives. In that light, the SFDR obligation to disclose sustainability impact and risk at entity level (articles 4 and 3 SFDR), as well as the disclosure of the link between sustainability risk and remuneration policies (article 5 SFDR) represents a massive step toward the harmonisation of sustainability information at intermediary level. Additionally, the regulation contains extensive formats for some disclosures, in particular the PAI on sustainability factors (Annex I CDR 2022/1288) that apply at entity level. Moreover, the location of entity-level disclosures is harmonised, mandating that these disclosures be made on the website of the FMP or FA. In this light, the ESAs have also noted a significant improvement in the website disclosures, increasing the accessibility of the information.²⁵⁴ Additionally, disclosures on the basis of articles 3, 4 and 5 SFDR must also be made available on the European single access point (ESAP) from 10 January 2028 onward.

On the other hand, there are also significant challenges to the harmonisation of SFDR disclosures at intermediary level. This primarily has to do with the type of information that has to be disclosed under the SFDR: information on

²⁵⁴ Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68.

processes, methods, and policies. A consequence of this is that FMPs and FAs have a relatively wide margin of discretion in their disclosures. This discretion allows FMPs and FAs to finetune the disclosures to their specific situation and context, which can enhance the relevancy of the disclosed information for investors. Moreover, this flexibility aligns with the procedural transparency approach of the SFDR, which prioritises the disclosure of processes over mandatory substantive obligations. However, a consequence of context-specific disclosures can also cause significant differences across the entity-level disclosures of different FMPs and FAs. Indeed, the ESAs have noted as ‘bad practices’ in relation to article 4 disclosures on sustainability impact at entity level, the use of complex language, disclosing information in vague and unclear manners with ambiguous statements and the inclusion of technical information.²⁵⁵ This lack of substantive harmonisation is problematic for investors. Even though the SFDR has increased the availability of entity-level information, as well as the accessibility, there is a significant barrier to comparing FMPs and FAs as the information itself is not harmonized.

4.2.2.2 Harmonization at Product Level

The SFDR establishes four product-level disclosure obligations in articles 6-9 SFDR, addressing respectively: sustainability risk, adverse sustainability impacts, positive sustainability impacts for products with environmental/social characteristics, and positive sustainability impacts for products with sustainable investment objectives. However, these disclosures face similar challenges as observed for the intermediary-level disclosures discussed in the previous section. While format and location are harmonized by the SFDR, intermediaries retain a relatively wide margin of discretion on the content of the disclosures:

- Article 6 SFDR lacks guidance that streamlines the disclosure of sustainability risk at product level;
- For article 7 SFDR, FMPs have to disclose how they considered the PAI listed in Annex I CDR 2022/1288 in their investment decisions. However, significant variations have been observed in these disclosures.²⁵⁶ Some FMPs provide detailed disclosures of methodology and data, others indicate that a particular indicator is not applicable or that they possess no information.²⁵⁷
- For articles 8 and 9 SFDR products, despite the detailed disclosure templates provided in Annexes II and III CDR 2022/1288, the absence of clear thresholds and precise definitions undermines comparability between

255 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 20-21.

256 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 13-14.

257 Joint ESAs Annual Report on Principal Adverse Impact disclosures under the Sustainable Finance Disclosure Regulation, 30 October 2024, JC 2024 68, p. 13-14.

products. Furthermore, certain disclosures remain voluntary, such as the PAI template.

As with entity-level disclosures, a certain level of discretion is necessary for product-level disclosures. This allows for context-specific information, which increases the relevancy of information to investors and aligns with the procedural nature of the SFDR. However, there is an inherent tension in sufficient flexibility for and the availability of harmonised and comparable information, which creates a challenge for legislators. However, in balancing flexibility and harmonisation, the current level of harmonization between different products seems to leave considerable room for improvement without compromising the procedural transparency nature of the SFDR. In particular, the PAI template could be made mandatory for article 8 and 9 products. This would greatly enhance the ability of investors to compare the negative sustainability impact of those products, without subjecting FMPs to any substantive requirements.²⁵⁸ Nonetheless, the SFDR is a significant improvement to the situation before it entered into force, in which there was no harmonized disclosure framework to start with.

4.2.3 Accurate

To assess whether the information disclosed by intermediaries on the basis of the SFDR is accurate, I evaluate two criteria. First, whether the information at intermediary level is consistent with the information that is made available by issuers. Second, whether the information is sufficiently supported by scientific consensus.

4.2.3.1 Consistency between Issuers and Intermediaries

Intermediaries provide aggregated information on investments to investors. To ensure that this flow of information can be used in a meaningful way by investors, this aggregated information must reflect the information that is made available by issuers – in other words, the information chain must start with the primary source: the issuers.²⁵⁹

Within the EU SFF, this flow of information appears misaligned. Issuers have to disclose sustainability information on the basis of the CSRD and ESRS whilst intermediaries disclose under the SFDR. The CSRD explicitly aims to ensure that FMPs “have the information they need from investee undertakings

258 Partiti E., “Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence”, *European Business Organizational Law Review* 2024, vol. 25, p. 299, 327; Arriba-Sellier N. de & Caenegem A. van, “Sustainability-related Materiality in the SFDR”, *EUSFiL Research Working Paper Series* 2024, no. 15, available at: <http://dx.doi.org/10.2139/ssrn.4881034>, p. 24.

259 Zetzsche D.A. & Anker-Sørensen L., “Regulating Sustainable Finance in the Dark”, *European Business Organization Law Review* 2022, vol. 23, p. 47, 69.

to be able to comply with their own sustainability disclosure requirements” under the SFDR.²⁶⁰ In principle, this should thus ensure that FMPs and FAs have sufficient information about issuers to reflect this at intermediary level accurately. However, the disclosure framework of the SFDR is not always sufficiently aligned with the information disclosed by issuers. This misalignment creates challenges for intermediaries and investors. Intermediaries effectively have to convert information published under the CSRD at issuer level to aggregated information in the SFDR format.

The conversion problem exists regarding multiple disclosure requirements under the SFDR. For example, the disclosure of sustainability impact at entity and product level (articles 4 and 7 SFDR). For both, the FMPs and FAs have to disclose the PAI listed in Annex I of CDR 2022/1288. This list differs from the reporting topics that issuers comply with on the basis of the ESRS.²⁶¹ The challenge for intermediaries here is how to aggregate PAI information when the source information from the ESRS is contained in a fundamentally different disclosure framework. Similarly challenging are the disclosures for articles 8 and 9 products. For these products, FMPs and FAs must *inter alia* disclose the E/S characteristics and the sustainability objectives of the financial products. CSRD information may be available for the investments that are pooled together in these products. However, given the very different disclosure formats contained in CDR 2022/1288 for articles 8 and 9 SFDR products, the SFDR disclosures may fail to accurately reflect the CSRD information.

The implication of this is that disclosures under the SFDR are most challenging when the SFDR establishes elaborate disclosure frameworks with its own formats (articles 4, 7, 8, and 9 SFDR). In these instances, FMPs and FAs have to convert CSRD information at individual issuer level into aggregated SFDR information at entity or product level, whilst also navigating the structural and substantive differences between the disclosure frameworks. Conversely, disclosures that have relatively little guidance at the SFDR level, for example for the disclosure of sustainability risk at entity and product level (articles 3 and 6 SFDR), present fewer challenges as the intermediaries can directly use CSRD information without having to convert it into a different format. The conversion problems reveal the risk of inconsistency between information at issuer and intermediary level. This problem is not only challenging for intermediaries, who are faced with the challenge of navigating to misaligned disclosure frameworks. It also potentially undermines the SFDR’s aim to provide accurate and comparable information to investors.

The difficulties in aligning intermediary disclosures to issuer disclosures are exacerbated when financial products that are made available by FMPs

260 Recital 21 CSRD; Roelofsen E.P., “Wat is de toekomst van het IMVB-convenant voor pensioenfondsen in het licht van de verplichtingen uit hoofde van artikel 4 van de SFDR?”, *Tijdschrift voor Pensioenvraagstukken* 2021, afl. 4, p. 10, 14.

261 See: paragraph 4.2 of Chapter 3.

include investments in issuers that do not fall under the CSRD because they are located outside of the EU. In such cases, intermediaries face additional data collection and aggregation challenges: sustainability information may be entirely unavailable for certain investments, while available data may lack standardised formats. This fragmentation in the information chain ultimately compromises the integrity of sustainability disclosures throughout the information chain, from issuer to end investor.

Given the lack of guidance for this conversion, there is a substantial risk that the process may alter or obscure the original sustainability risks and impacts. On the one hand, it could be argued that this is less relevant in light of the procedural transparency approach of the SFDR. From that perspective, it can be argued that it is sufficient that intermediaries disclose their policies and methodologies on how they convert information from issuer to intermediary level. On the other hand, it can be assumed that investors also use the outcomes of those processes in their investment decisions. If these outcomes fail to accurately reflect the situation at issuer level, this is problematic for investors who do not receive sufficiently accurate information that they need for a well-informed investment decision.

4.2.3.2 Accuracy of Labels

To overcome information asymmetries, the disclosed information must naturally be accurate. This also means that when an investment is categorized as sustainable under the EU Sustainable Finance Framework (SFF), this qualification should be supported by scientific evidence.²⁶² As I explain in Chapter 3, assessing the scientific accuracy of the EU SFF is beyond the scope of this research. In that Chapter, I explain that for this research, the scientific correctness of the categorisation of ‘environmentally sustainable economic activity’ under the Taxonomy Regulation will be assumed. After all, the Taxonomy Regulation is based on scientific evidence that has been evaluated by experts and relevant stakeholders.²⁶³ However, the SFDR does not require information to meet a certain threshold of Taxonomy-alignment.

The question thus is whether the information disclosed by the SFDR is sufficiently accurate. There are two ways to approach this question, which lead to opposing answers. As I explain in this chapter, the regulatory strategy of the SFDR is procedural transparency on, in particular, policies and methodologies surrounding the incorporation of sustainability risk and impact in investment decisions. The type of information that is generated under the SFDR thus is not intended to meet a certain scientific threshold of ‘sustainable.’ Regardless of the various problems identified in this Chapter – such as the fragmented disclosure requirements, the lack of substantive harmonisation

262 See also: Financial Stability Board, “Report on Promoting Climate-Related Disclosures”, *Financial Stability Board* 7 July 2021, p. 39-40.

263 Recital 38 TR; article 19 (1) (f) and (5) TR.

of disclosures, and difficulties surrounding the collection and aggregation of issuer data to intermediary level – there is no fundamental reason to assume that the SFDR disclosures do not meet scientific thresholds because they are not predicated on thresholds to begin with.

This conclusion, however, shifts when recognizing that the SFDR functions beyond its intended role as a procedural disclosure framework, having effectively generated an informal labelling system, with financial products being marketed as articles 8 and 9 SFDR products.²⁶⁴ As investors may rely on these de facto labels, it becomes pivotal that such classifications accurately reflect the underlying sustainability ambition of the financial product. However, labelling is a fundamentally different regulatory strategy than procedural transparency. Whereas the latter requires the disclosure of comprehensive, relevant, and neutral information that enables investors to make their own assessment of the investment, labelling requires clear and pre-defined indicators that contain a normative judgement.²⁶⁵

It is clear that articles 8 and 9 SFDR do not meet this criterion. There are a number of factors that contribute to this. First, the core categorization criteria – promotion of E/S objectives and sustainable investment – are open-ended.²⁶⁶ Second, these articles lack material thresholds: there are no minimum Taxonomy-alignment percentages nor mandatory PAI assessments.²⁶⁷ This absence of thresholds blurs the category's boundaries, and consequently the meaning of the label.²⁶⁸ This in itself is already problematic for the accuracy of the labels. The problem is exacerbated by the fact that investors may not understand the difference between the article 8 and 9 categories – a difference hard to grasp in light of the blurred category boundaries.²⁶⁹ Instead, articles 8 and 9 SFDR require transparency of methodologies and explaining the rationale for categorising the product under either article, in

264 Paragraph 3.2 of this Chapter; Zukas T., *Regulating Sustainable Finance in Europe*, Duncker & Humblot 2024, p. 28-33; Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, European Parliament 2024, No. PE 754.212, p. 10, 33; Becker M.G., Martin F. & Walter A., "The power of ESG transparency: The effect of the new SFDR sustainability labels on mutual funds and individual investors", *Finance Research Letters* 2022, vol. 47, part B, 102708.

265 Steuer S. & Tröger T.H., "The Role of Disclosures in Green Finance", *Journal of Financial Regulation* 2022, vol. 8(1), p. 1, 6.

266 See paragraph 3.4.1 of this Chapter on the definition of "sustainable investment."

267 Glander H., Kropf C. & Lühmann D., "Praktische Umsetzung der Pflichten aus der Offenlegungs-VO", *Zeitschrift für Bank- und Kapitalmarktrecht* 2023, Heft 1, p. 28, 35.

268 Scheitza L. & Busch T., "SFDR Article 9: Is it all about impact?", *Finance Research Letters* 2024, vol. 62, part A, 105179, p. 4.

269 Ramos Muñoz D., Lamandini M. & Siri M., "The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR)", *Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON)*, European Parliament 2024, No. PE 754.212, p. 34.

line with the regulatory strategy of procedural transparency rather than labelling.

Paradoxically, the SFDR as a labelling system may exacerbate, instead of mitigating, the principal-agent problem.²⁷⁰ That is because the SFDR creates an opportunity to exploit the difference in interest between intermediary and investor. FMPs can use the SFDR to create ostensibly transparent and trustworthy sustainable products, such as article 8 or 9 products. Given the commercial incentive to categorize financial products as sustainable as possible, in combination with the opportunity to categorize products under the SFDR, there is a great risk for greenwashing, whereby investors are misled by sustainability claims that do not fairly reflect the sustainability profile of the product.²⁷¹ This truly undermines the ability of investors to rely on the information disclosed by intermediaries for informed investment decisions.

The answer to the question of whether the information disclosed under the SFDR is accurate, thus is nuanced. On the one hand, the CSRD/ESRS in principle should ensure that issuers provide the necessary information for intermediaries to fulfil their duties under the SFDR. However, the two regulations do not always align. Moreover, intermediaries might experience difficulties in collecting the necessary information as not all issuers report under the CSRD. This may lead to conversion problems from issuer to intermediary level. Arguably, this is less relevant in light of the procedural transparency nature of the SFDR, which focuses on the disclosure of policies and methodologies of how sustainability risk and impact have been considered in investment decisions instead of the material outcomes of those policies. However, given the fact that the market tends to treat, in particular articles 8 and 9 SFDR as labels instead of procedural transparency requirements, the accuracy of the material information that is disclosed does become highly relevant. Unfortunately, the SFDR is unfit to guarantee accuracy as labelling is a fundamentally different regulatory strategy than procedural transparency.

4.3 Conclusion

In this Chapter, I focus on the question: how effective are the disclosure requirements from the Sustainable Finance Disclosure Regulation in reducing the principal-agent problem between intermediaries and investors? The principal-agent problem has two prerequisites: information asymmetries and

270 Partiti E., “Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence”, *European Business Organizational Law Review* 2024, vol. 25, p. 299, 325.

271 ESMA, Progress Report on Greenwashing, Response to the European Commission’s request for input on “greenwashing risks and the supervision of sustainable finance policies”, 31 May 2023, ESMA30-1668416927-2498, p. 11.

diverging interests between principal and agent. Minimizing either of these will result in minimizing the principal-agent problem.

The SFDR is a disclosure framework, requiring the disclosure of the consideration of sustainability risk and impact at entity and product level. Whilst the regulation is not primarily aimed at better aligning the interests of investors and intermediaries, there is evidence that there may be a positive relationship between sustainability impact and managers' remuneration for the FMPs and FAs that have to disclose their remuneration policy pursuant to the SFDR. A side-effect of the SFDR may thus be an improvement of the alignment of investor and intermediary interests.

To evaluate whether the SFDR is successful in resolving the principal-agent problem, I focus on the question of whether it is effective in minimizing information asymmetries. For this, I have looked at three elements: completeness, standardisation, and accuracy of the disclosed information. Even though in general terms, the SFDR greatly enhances the flow of information to investors compared to the underregulated situation before the Regulation entered into force, I have identified three fundamental flaws that undermine the fulfilment of these elements.

First, the information provided on the basis of the SFDR is fragmented over several disclosure requirements that have different scopes of application. Consequently, disclosures often do not cover all four areas of the double materiality principle. It is particularly problematic that the disclosure of the PAI is only mandatory for 'regular' financial products under article 7 SFDR, but not for sustainable products under articles 8 and 9 SFDR. This may be a relatively easy shortcoming to remedy that would greatly enhance the completeness of the disclosures.

Second, intermediaries may find it challenging to collect and convert information on individual investments into aggregated financial product disclosures. Several factors complicate this process. First, the CSRD/ESRS disclosures that apply to issuers may not always be sufficiently aligned with the SFDR disclosures. Second, and more challenging, financial products may encompass a wider range of investments than those of EU-based issuers that have to comply with the CSRD. For those investments, no or unharmonized sustainability data may be available. Together, these factors potentially compromise the accurate flow of information to investors. This is problematic also through the lens of the principal-agent problem, as the information asymmetries between intermediary and investor persist.

Third, the unintended use of the SFDR as a labelling system in the absence of thresholds and clear definitions may paradoxically exacerbate the principal-agent problem as it creates an opportunity for intermediaries to exploit the difference in interests between them and the investors. In the absence of thresholds and definitions, intermediaries can create seemingly trustworthy labels whereas in reality, the financial products may not respond to the sustainability ambition of the investors. Moreover, the SFDR is fundamentally unfit

to be used as a labelling system as this necessitates a regulatory strategy that is focused on material thresholds and normative judgements, as opposed to the complete and neutral information that should be disclosed under a procedural transparency regime.

Despite these fundamental flaws, the positive impact of the SFDR should not be understated. Before the SFDR, the disclosure of sustainability information was entirely unharmonized and left to member states and commercially driven market practices. The SFDR thus is an enormous step forward in diminishing information asymmetries between investors and intermediaries on sustainability information. By establishing both pre-contractual and post-contractual disclosure obligations, the SFDR enables investors to make better investment decisions and to better monitor intermediaries after the conclusion of the contract. This in itself already is an important step in minimizing the principal-agent problem between investors and intermediaries.