ESG Insights

SFDR and Taxonomy: Transparency and Protecting the ESG Investor

June 2022

Protecting the investor is embedded in our culture and investment philosophy at Coho Partners. We are actively engaging in research and education to do our part as investors and as an organization to make a positive and lasting impact on the community around us. The evolution of Environmental, Social, and Governance (ESG) investing continues to challenge market participants across multiple levels. As part of our ongoing ESG communications, we will share some of our thoughts on an emerging regulatory framework within the global ESG investment landscape and how it may impact investors and their decision-making process.

Protecting the ESG Investor

Protecting the common investor has been at the heart of regulatory legislation ever since the enactment of the Securities Act of 1933 in response to the stock market crash of 1929. For decades, we have watched the global investment community navigate countless market cycles, investment trends, and the evolving regulatory landscape that governs the rules by which investors must abide. Acts such as Sarbanes-Oxley and Dodd-Frank have been woven into our everyday vernacular yet many of us may still struggle to understand all the implications that result from such sweeping legislative changes. The call for greater transparency in the public and private marketplace will only continue as it helps shape the investment opportunity set of the future. Investors should expect to be routinely challenged to think proactively about their investment decisions, fiduciary standards, and the priorities of their clients' best interests. Obtaining the transparency to make these decisions is a must, with ESG emerging as the next area of focus in the ever-evolving regulatory framework.

Many firms began their ESG journey in the context of relatively basic socially responsible investment (SRI) mandates that tended to be exclusionary in nature. It was a simple screening process to eliminate the so-called "sin stocks" such as gambling, tobacco, and/or alcohol. Over the years, investors have come to require stricter, more proactive, and more integrated objectives to fulfill their ESG demands, and many investment firms have struggled to keep pace. This catch-up process has been met with skepticism from investors and regulators that accuse firms of over-marketing their underlying ESG capabilities or "greenwashing" their investment objectives. Therefore, it is not surprising to see a demand for greater scrutiny, especially within the European Union (EU), where ESG investing is quickly becoming the standard. Protecting the integrity of ESG investing and those who seek it out has become a high priority in the global marketplace.

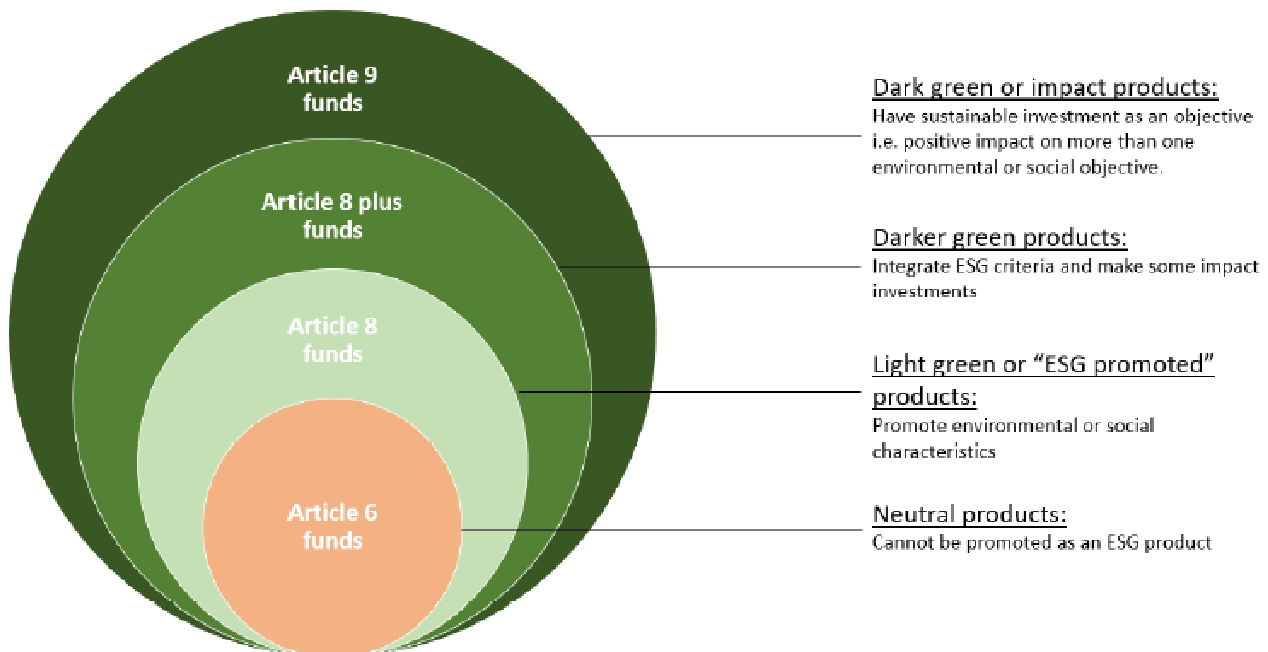
What does SFDR stand for and where did it come from?

Sustainable Finance Disclosure Regulation (SFDR) is a new EU regulatory framework designed to bring greater transparency and comparability to the market for ESG investment strategies and products. This regulation includes new disclosure requirements for investment managers and advisors which encourage firms to consider 1) sustainability risks to financial returns, and 2) the adverse impacts of investments on sustainability factors ("Do No Significant Harm"). In short, the SFDR framework demands that firms adopt a more thoughtful approach and strategy to their ESG investment discipline. Firms in the EU now have disclosure obligations at both the firm level and the product level.

Source: KPMG

The marketplace is translating this framework into a relative ranking system that illustrates the appropriate level of "greenness" of each investment strategy. The illustration below from Jefferies Equity Research demonstrates the ranking system which ranges from the lowest ranking of "Neutral Products" (Article 6) all the way up to the highest ranking of "Dark Green" (Article 9).

SFDR Disclosure Categories



Source: Jeffries

The various disclosure requirements for each category are beyond the scope of this commentary, but the more important takeaway is the EU's focus on improving the level of transparency for ESG investors and allowing for greater comparability across the ESG landscape of investment opportunities. Firms will be forced to take a hard and honest look at their ESG investment capabilities and accurately place their strategy within the proper category, thereby mitigating the ability to "greenwash" or potentially mislead investors. Within the European marketplace, the UCITS fund, to which Coho serves as adviser, is categorized as an Article 9 fund.

What is taxonomy regulation? How are the two frameworks, SFDR and taxonomy, related?

Taxonomy is simply a system of classification. ESG taxonomy would create a library of activities that will contribute to an entity's long-term environmental and social objectives. This framework is still evolving and remains a work in progress, but the EU is moving at a quicker pace to implementation than many across the global landscape. The EU hopes the combination of SFDR and taxonomy will direct capital flows to more environmentally sustainable activities and help mitigate "greenwashing" at both the firm level and the investment strategy level.

EU Environmental Taxonomy

Source: EU Commission

In practice, firms will be required to explain why certain investment strategies qualify for Article 8 or 9 classification under SFDR. The taxonomy framework will be the tool that firms utilize to make the appropriate disclosures and justify the category that was selected for its investment strategy. Individual portfolio companies will also be required to disclose how their business will map to the taxonomy objectives and any adverse impact that their business may have with respect to those objectives.

What are some of the long-term implications from this emerging EU regulatory framework?

Perhaps the most impactful element of SFDR and taxonomy regulation in the EU is the concept of "double materiality". This describes the combination effect of using sustainability factors to make an impact on company returns while also allowing companies to have a positive impact on sustainability factors. This concept of connecting financial outcomes to real-world impact is at the center of the EU's sustainability objectives.

The emerging regulatory framework in the EU is also sparking debate in the U.S. marketplace as investors begin to digest the Securities Exchange Commission's (SEC) plans to develop stronger ESG disclosure rules. Early indications are clearly pointing to stricter regulation and disclosure mandates for registered funds in the U.S. that use the letters "ESG" in their naming convention. The SEC's approach would encompass similar objectives to improving transparency, mitigating "greenwashing", and providing a level playing field for investors to evaluate and choose an ESG fund that meets their investment needs. Perhaps the only certainty investors can count on right now is the ongoing evolution of the ESG landscape and the regulatory framework that

accompanies it. At Coho Partners, we will continue to follow the developments closely and share our insights with you along the way.

The views, opinions and content presented are for informational purposes only. They are not intended to reflect a current or past recommendation; investment, legal, tax, or accounting advice of any kind; or a solicitation of an offer to buy or sell any securities or investment services. Nothing presented should be considered to be an offer to provide any Coho product or service in any jurisdiction that would be unlawful under the securities laws of that jurisdiction. Past performance is not indicative of future results.