Survey Report

Experience of Impact Funds with SFDR

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Lead Author:
Stephanie Brenda Smialowski | Policy and EU Partnerships Associate

Co-Authors:
Jana Bour | Head of Policy and EU Partnerships
Karolina Kolarova | Policy and EU Partnerships Analyst

EVPA becomes **Impact Europe**.

Impact Europe

About Impact Europe

Impact Europe (formerly EVPA) is *the* investing for impact network in Europe. We gather 350 capital providers (impact funds, foundations, corporate social investors, banks, public funders) to increase prosperity and social progress for all, fix inequalities and injustices and preserve the planet. Together, we rally people, capital and knowledge to accelerate, scale and safeguard impact.

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Introduction

The Sustainable Finance Disclosure Regulation (SFDR) is one of the building blocks of the European Union's efforts to achieve its international and European environmental commitments. In view of the Paris Agreement and the UN 2030 Agenda for Sustainable Development Goals (SDGs) adopted in 2015, the EU launched the European Green Deal to make Europe net zero by 2050. The Action Plan on Financing Sustainable Growth was introduced in 2018 and brought forward policy measures to finance the acceleration of the economy's green and just transition.

The SFDR is one of the proposed actions of the plan to enhance transparency in the financial markets about sustainability-related claims, prevent greenwashing and channel capital flows toward sustainable economic activities. Since March 2021, financial market participants and financial advisors have been required to inform investors about how they consider sustainability factors in their investment decision making process along with the investment impact on the environment and society. Market participants have to disclose this information respective to products and the firm as a whole.

Since the SFDR took effect, Impact Europe noticed growing concerns with the regulation among impact fund managers. At the end of 2022, the European Commission announced its intention to evaluate SFDR's implementation and collect stakeholder inputs through a public consultation in autumn 2023. With the goal of raising impact actors' voices in the consultation, Impact Europe collected the SFDR experience of impact fund managers through a survey that ran from mid-May to late August 2023. Moreover, Impact Europe conducted three structured interviews with members managing impact funds.

Part I: Who are the impact fund managers represented?

Impact Europe's survey collected insights from 21 impact fund managers from six European countries on their experience with SFDR (see Figure 1). Additionally, structured interviews were conducted with three Impact Europe members based in Germany and Spain. The three individuals were selected due to their funds' alignment with the pillars of impact investing, as outlined later in this report, and their extensive understanding of SFDR. This was done to offer a more thorough contextualisation of challenges and potential solutions in addition to the survey.

Survey respondents are collectively managing approximately €1.881 billion in Assets Under Management (AUM) and present a well-distributed spectrum of fund sizes. As a result, this report reflects the perspectives of the following fund profiles:

- 5 funds have AUM of less than or equal to €10 million.
- 5 funds have AUM greater than €10 million, but less than or equal to €32 million.
- 4 funds have AUM equal to or greater than €50 million, but less than or equal to €55 million.
- 5 funds have AUM equal to or greater than €220 million, but less than or equal to €650 million.
- 2 funds did not share their Assets Under Management (AUM).

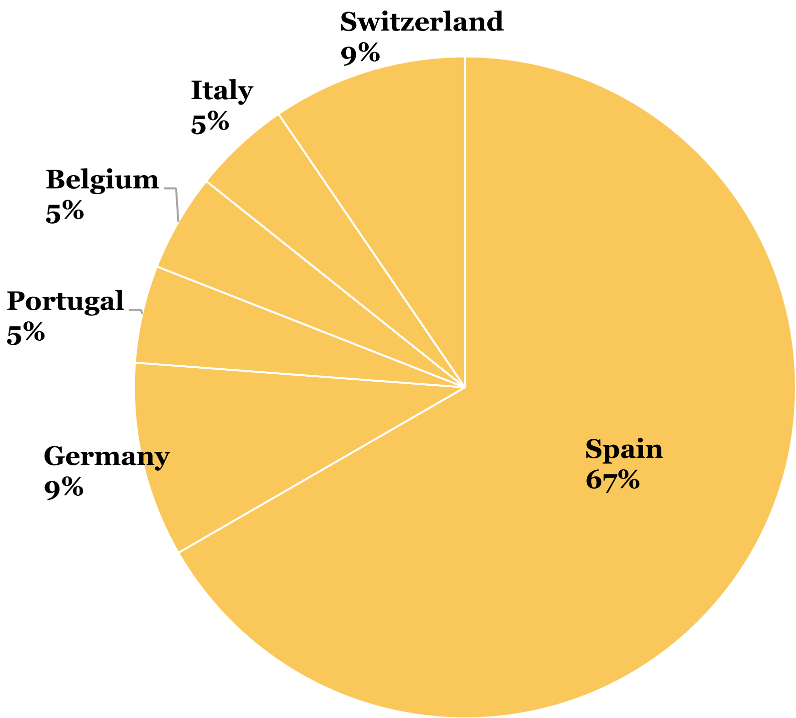

Figure 1 Countries of respondents

SFDR Fund Category

Under SFDR, financial market participants must report the integration of sustainability considerations at the entity and product levels. The funds disclose information according to their classification: Article 6 sets the disclosure rules of the integration of sustainability risks; Article 8 addresses transparency of the promotion of environmental or social characteristics in pre-contractual disclosures; and Article 9 pertains to funds with a sustainable investment objective.

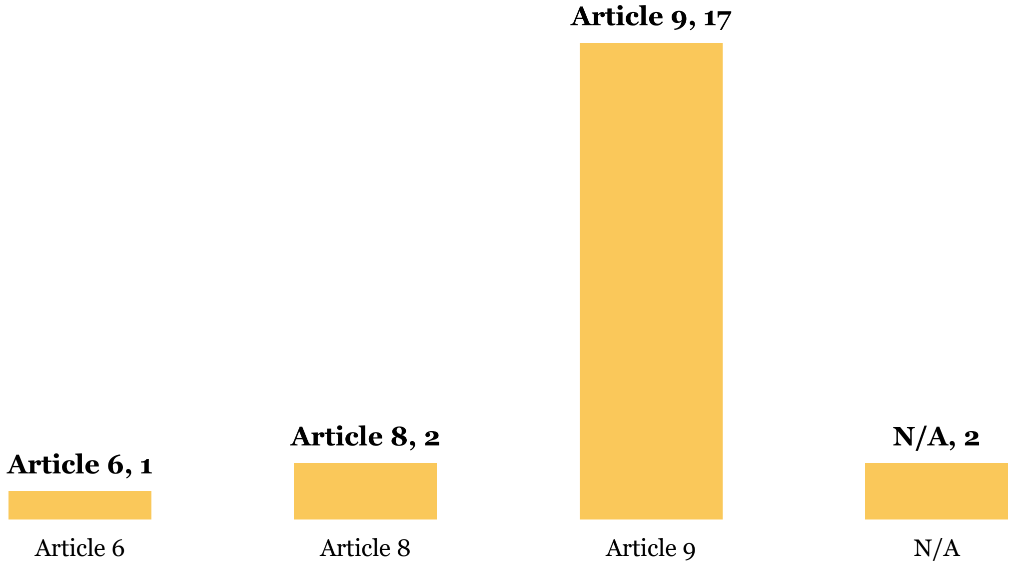

Figure 2 Classification of Impact funds under SFDR

The majority of the respondents, specifically 17 of the 21 impact fund managers, chose to report their products under Article 9, as illustrated in Figure 2. Ideally, all impact funds are sustainable products and could be categorised as Article 9. However, two impact funds were classified under Article 8, one under Article 6 and two did not respond. Upon closer examination of responses, these five fund managers revealed that they are in the process of transitioning towards Article 9 classification, while one fund continues to report under Article 8 due to challenges in meeting disclosure requirements.

The delay in reporting to Article 9 is frequently attributed to the adaptation period needed to conform with the extensive disclosure requirements. Firstly, they had to assess the capacity of their portfolio companies to report the necessary data, manage resources to support investees, and set up a data collection system before classifying to this article. Despite the intensive process and other challenges, which will be further explored in this report, some funds justified the need to conform to Article 9 due to demands from institutional and private investors who recognise SFDR categories as proxy labels.

The manager of the Article 8 fund clarified that even though the fund is more focused on impact objectives than sustainability variables, the demanding reporting requirements were a considerable challenge, especially for a fund of funds concentrating on Africa. The decision to report under Article 8 was driven by a desire to alleviate the reporting burden on its fund managers. Unlike others, this manager experienced that impact-minded LPs were increasingly accepting impact funds reporting under Article 8 as they understood SFDR is more about disclosure than labelling.

Impact investing criteria and SFDR compliance

Impact Europe, together with other stakeholders from the EIIC[1], identified three foundational pillars for impact investing: Intentionality, Measurability and Additionality (Impact Europe, p. 26-28).

While the three pillars are crucial for defining impact investing, intentionality is the primary criterion to meet in a checklist to assess if an investment is actively pursuing impact. **Impact intentionality underscores the importance of a deliberate pursuit of social and environmental impact, with the objective of delivering positive outcomes for specific communities** (Impact Europe, p.26). Figure 4 specifically looks at surveyed funds' intentionality, rather than the other pillars, by examining how the classification of their investee companies relates to their position within SFDR categories.

To meet impact intentionality criteria, investees must align with the **C asset classes**, indicating the enterprises' role in "**C**ontributing to solutions" within the ABC classification and Impact Classes methodology introduced by the Impact Management Project (IMP). This methodology is widely recognised and employed within the impact space, including in the EIIC's market sizing exercise. This framework distinguishes various impact investment strategies based on both the investee profile and investor contribution.

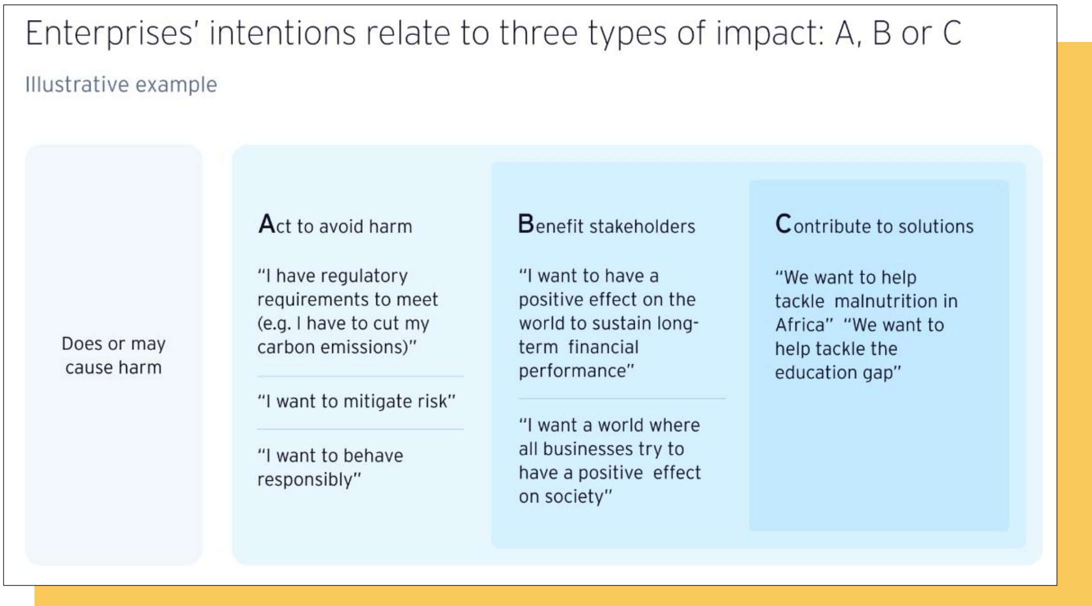

Figure 3: Source: Impact Management Project

[1] The European Impact Investing Consortium (EIIC) has joined forces to provide a clear and reliable picture of the impact investment market in Europe. The Consortium is composed of the Impact Europe (former EVPA), the Global Steering Group for Impact Investment (GSG), as well as several of its National Advisory Boards and academic partners, including SpainNAB, Esade Center for Social Impact, Social Impact Agenda per l'Italia, Tiresia, Politecnico di Milano – Department of Management, Economics and Industrial Engineering, FAIR, the Netherlands Advisory Board on Impact Investing, the Bundesinitiative Impact Investing, Solifin, King Baudouin Foundation, the Impact Investing Institute, and Big Society Capital.

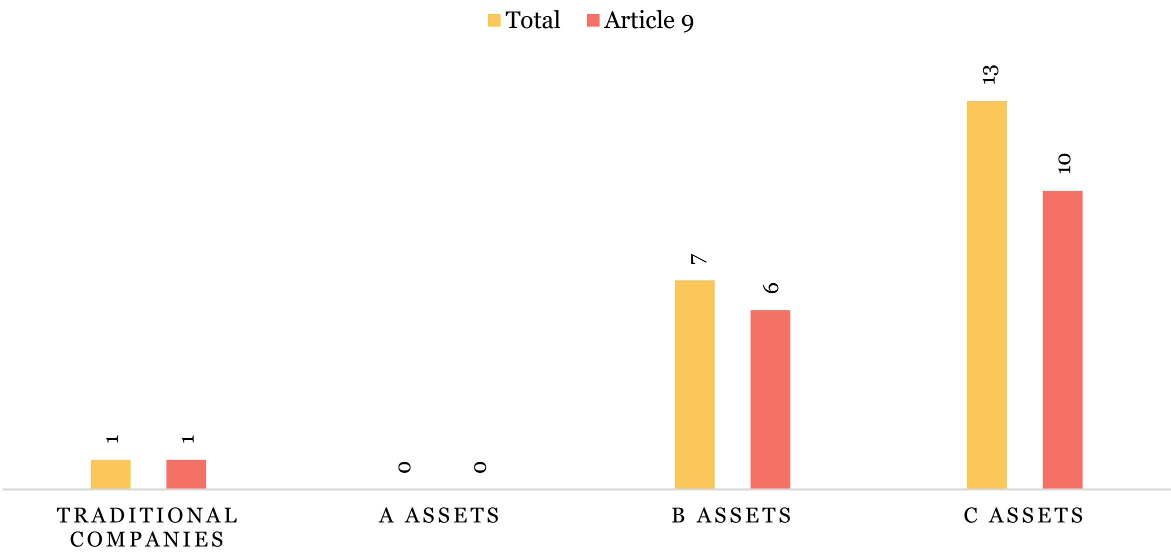

Figure 4 Investee profile of impact funds

Notably, Figure 4 reveals that none of the respondents opted for A asset class, characterised by investees that exclude activities with negative effects on people and the planet. Seven investors, representing 33% of the total respondents, favour the B asset class, focused on generating positive effects for individuals and the planet. In contrast, a majority of thirteen individuals, representing 62% of the total, directed their investments towards C asset classes, specifically designed to tackle unique social and environmental challenges faced by underserved communities and the planet.

The majority of respondents selecting B and C assets are already actively reporting under the Article 9 regime, as demonstrated in Figure 4. Indeed, these funds would align with the SFDR definition of sustainable investment. Surprisingly, one Article 9 fund allocates investments to conventional enterprises, using ESG criteria primarily for risk management and financial stability. This fund not only fails to meet the requirements of Article 9 but also does not qualify as an impact fund.

Figure 4 sheds light on the diverse interpretations of impact investing. It reveals instances where self-identified impact funds invest in B asset classes or even traditional enterprises, deviating from the impact investing criteria abovementioned. Additionally, it illustrates how the broad definition of sustainable investing within Article 9 allows for the interpretation that enables such different products to self-classify under it. This poses challenges for investors in differentiating between sustainable investment and impact investment strategies under the Article 9 framework.

Part II: SFDR implementation challenges

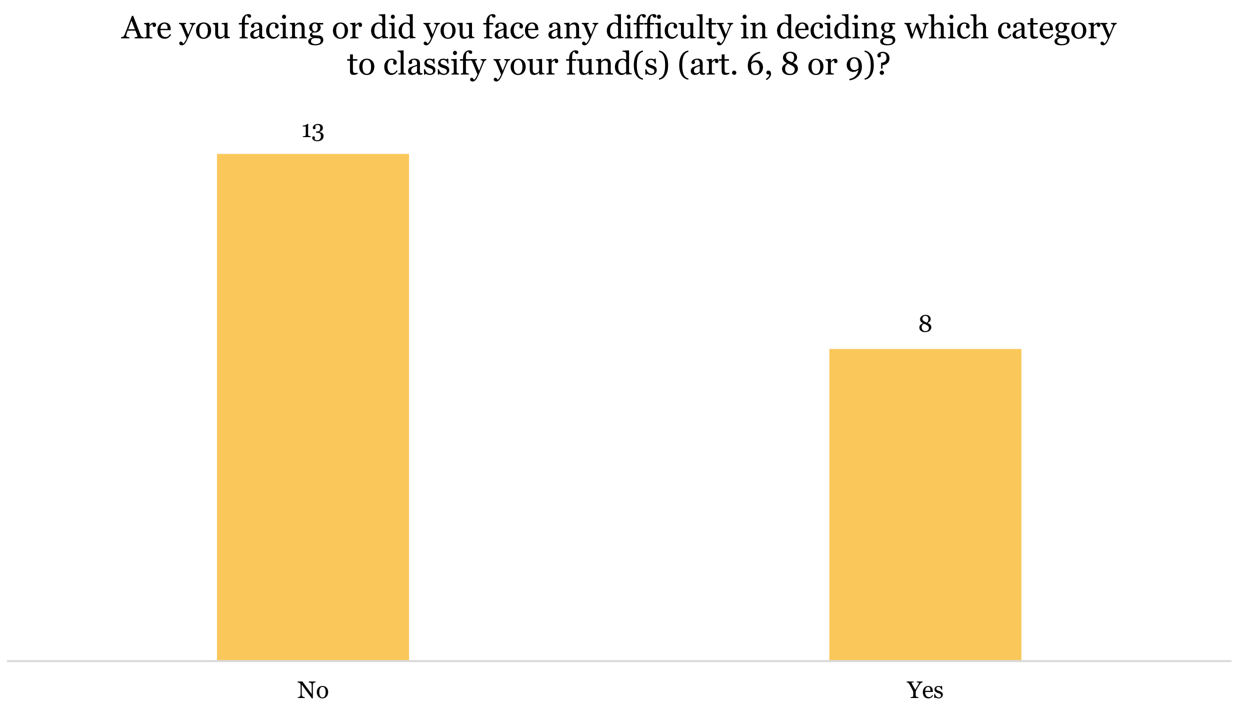

Figure 5

Challenges to deciding on a product category

Given that SFDR product categories are often used as label proxies by the market, some respondents have experienced pressure to conform to Article 9 to gain credibility as impact funds and access funding from institutional investors. However, 38% of respondents encountered significant challenges in determining the appropriate product category for reporting their funds.

This group pointed out that SFDR was designed with larger funds investing in listed assets in mind. As a result, it is considered ill-suited for the reporting of impact funds, especially those dedicated to investments in emerging markets and small- to medium-sized, unlisted and illiquid enterprises, often at their early stages of development.

Most impact investors who struggle with category selection refer to the burdensome reporting requirements necessary for Article 9 compliance. These funds' portfolios typically comprise small enterprises that lack the resources, including time, capital and personnel, required to collect the extensive data, especially concerning the mandatory Principal Adverse Impacts (PAIs).

Challenges to report under the chosen category

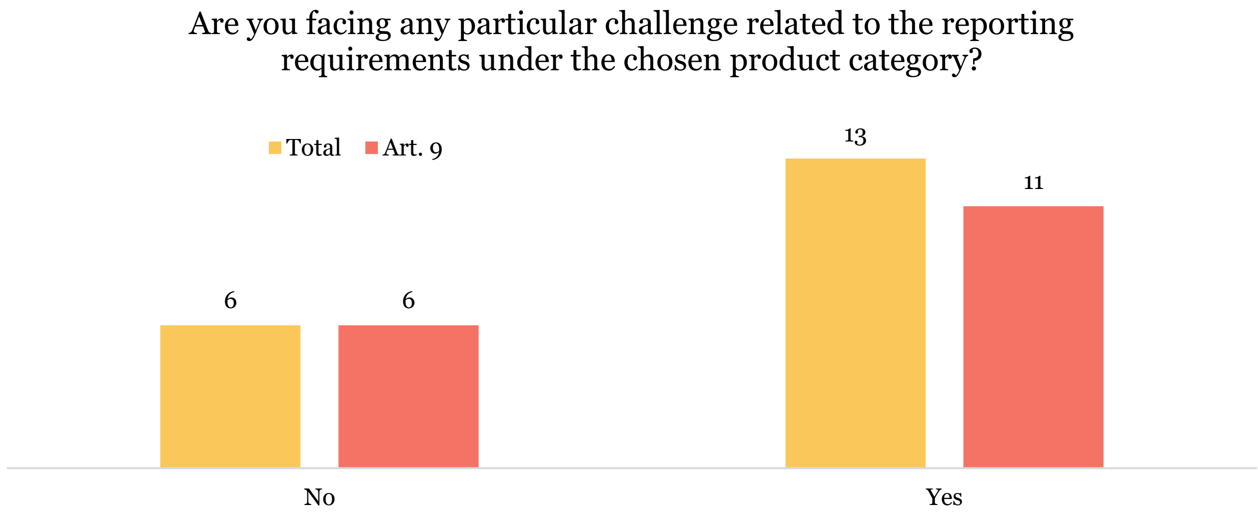

Figure 6

65% of respondents encountered difficulties when reporting under the Article 9 category. Upon examining the data regarding fund size, it becomes evident that, contrary to expectations, all larger funds (those with AUM equal or greater than €220 million, but less than or equal to €650 million) also acknowledge encountering challenges when reporting under Article 9. This observation highlights that the impact of these challenges extends beyond smaller funds with more limited resources to conform with reporting requirements.

Respondents encountering challenges in reporting under Article 9 reiterated the concerns mentioned earlier. They unanimously emphasised the lack of data from investees regarding PAIs or indexes for private and impact markets. Some respondents underscored the challenges associated with mandatory PAI indicators for small social enterprises, such as GHG emissions and carbon footprint. They stressed that such disclosure requirements place a substantial burden on SMEs without delivering meaningful information to stakeholders, given their minimal or irrelevant adverse impact. This results in a financial strain on investees and impact funds disproportionate to the added value of this information.

Impact investors also noted that the lack of legal clarity in Article 9 creates a sense of uncertainty in terms of interpretation and compliance with the regulation. In this context, one of the key issues refers to the absence of differentiation between sustainable and impact products, as well as the absence of guidelines or exceptions for PAI reporting when investing in unlisted SMEs. Additionally, one respondent pointed out that the regulation places a prominent focus on negative environmental impacts without further guidance on positive/social disclosures.

SFDR potential risks to impact funds

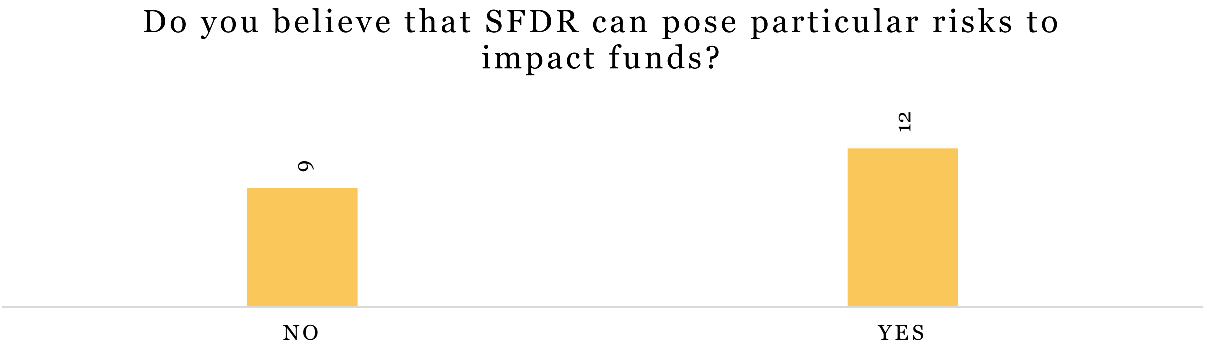

Figure 7

As illustrated in the figure above, 57% of respondents expressed concerns about SFDR posing a distinct risk to impact funds. This apprehension stems from the common use of SFDR product categories as labels in the market, while the regulation itself fails to differentiate between impact and sustainable products. Multiple investors pointed out that the market identifies impact funds with Article 9, even if not all of Art. 9 funds automatically align with the impact investing pillars' principles mentioned above.

Additionally, the broad definition of sustainable investment, the lack of clarity regarding the distinction between Articles 8 and 9, and the absence of explicit consideration of impact investment strategies within SFDR, all contribute to an environment that presents an increased risk of potential greenwashing, sustainable washing or impact washing.

Impact investors further highlighted that the pressure to obtain the 'Article 9 label' compels them to adhere to its requirements, even though the associated burdens outweigh the benefits. Unlike the European Social Entrepreneurship Funds (EuSEF) Regulation, Article 9 is not suited for impact funds as it neither mandates nor facilitates disclosure of positive impact in addressing specific social or environmental issues. As a result, it cannot be considered a gold standard for impact funds, either as a label or disclosure tool.

To make this issue even more compelling, impact funds find themselves in competition with Article 9 sustainable funds that are characterised by higher liquidity, reduced risk, established track records and investments in listed assets that offer the potential for higher returns. These funds have typically more resources and internal capacity to meet reporting obligations, but they do not necessarily generate the same/higher positive impact. This situation places impact funds at a significant competitive disadvantage during fundraising periods, and can discourage the set-up of smaller, illiquid/patient funds with large positive contributions in favour of larger ESG funds.

Additional risks were also raised, including the concern of disseminating misleading information, stemming from the challenges of accurately measuring PAI and other Key Performance Indicators, as well as the potential for misclassification (e.g., Article 6, 8, and 9) and misrepresentation of ESG product performance. Failure to comply with the regulation can potentially result in reputational damage and legal breaches.

SFDR consultation and revision

Figure 8

Figure 9

The graphs above may seem hard to reconcile at first glance. In the first graph, respondents are nearly evenly split in their opinions on whether SFDR is suitable for its intended purpose. The second graph paints a contrasting picture, indicating a significant preference for revising SFDR, with the majority of individuals (17/81%) in favour of revision and only 4 opposing the idea (19%).

Upon examining the responses by fund size, a similar result emerges. Contrary to expectations, larger funds (those with AUM greater than €220 million, but less than €650 million) and mid-size funds (those with AUM greater than €50 million, but less than €55 million) unanimously agree with the need to revise SFDR, while responses diverge among smaller funds.

In response to SFDR fitness, a few critical viewpoints emerge. Impact investors emphasised the complexity of SFDR, particularly when applied to products operating in private markets, where data availability, reliability and comparability are constrained. Moreover, some raised the risk of impact washing, which arises from the regulation's inability to provide an unambiguous distinction between sustainable and impact products, further indicating its inadequacy. Moreover, the legal ambiguities pose significant obstacles to the overarching objective of channelling capital toward companies that genuinely embody sustainability and impactful practices.

Contrary to these views, one respondent was uncertain about whether the regulation is fit for purpose and expressed the need for additional time to gauge its success: *"A lot depends on how much asset owners will in the future read into the SFDR disclosure documents of asset managers, reward those who credibly integrate sustainability into their management procedures and sanction those who don't."*

Respondents supporting the revision of SFDR have suggested improvements that converge on several key points. The primary focus is a clear differentiation of impact funds and the incorporation of unequivocal legal text.

Some respondents emphasised the importance of introducing impact investing as a new category within SFDR, often referred to as "Article 9 plus". This article should enable impact funds to distinguish themselves from ESG and sustainable products, based on binding investment strategy and organisational framework criteria (such as pre-defined intentionality, binding impact targets, impact measurement and management, reporting, impact-linked carried interest, impact audits, etc.).

Another respondent advocated for affording certain advantages to European Social Entrepreneurship Funds (EuSEF) by automatically conforming to Article 9. This recommendation is based on the argument that EuSEFs already comply with rigorous registration and reporting requirements outlined in Regulation (EU) No 346/2013.

Respondents also suggest revising SFDR reporting requirements to better reflect impact products. A commonly highlighted recommendation involves the need for proportional and tailored reporting obligations for the different financial market participants, especially concerning mandatory PAI indicators. Some respondents also called for clearer guidance on reporting positive social impact and potential environmental trade-offs. In this regard, a respondent provided additional insights into the importance of establishing rules for transparent reporting of impact objective attainment in the form of pre- and post-contractual reporting. This includes presenting evidence of no significant harm to other sustainability objectives through a Do No Significant Harm (DNSH) test. Lastly, respondents are calling for enhanced clarity regarding SFDR alignment with other EU legislations (e.g. Taxonomy, CSRD etc).

Key takeaways

1. Impact Europe gathered insights from 21 impact fund managers across six European countries, collectively managing €1.881 billion in Assets Under Management (AUM). The surveyed funds exhibit a diverse range of sizes, with a particular emphasis on perspectives from small- to mid-size impact funds in this report.
2. The majority of surveyed impact fund managers (17 out of 21) chose to classify their products under SFDR Article 9. Remaining funds are in the process of transitioning to Article 9, while one fund opted to retain Article 8 classification to reduce reporting burdens.
3. The survey reveals diverse interpretations of impact investing, with instances of self-identified impact funds investing in B asset classes or traditional enterprises, deviating from the intentionality criteria agreed by impact stakeholders in the context of the European Impact Investing Consortium (EIIC).
4. A majority of respondents (65%) faced difficulties in reporting under Article 9. Contrary to expectations, all larger funds classified as Article 9 acknowledged challenges, indicating that these difficulties are not exclusive to smaller funds.
5. Respondents reported a disproportionate reporting burden for unlisted assets, small enterprises, and emerging markets, regarding mandatory Principal Adverse Impacts (PAI), and the emphasis on negative impact reporting, lacking a requirement for substantiating claims of positive social contribution.
6. Respondents expressed concern that SFDR poses specific risks to impact funds. The current market use of SFDR categories as proxy labels, the broad definition of Article 9, and the absence of explicit consideration for impact investment strategies, all contribute to an increased risk for social/greenwashing and impact washing.
7. Respondents are nearly evenly split in their opinions on whether SFDR is fit for purpose. However, there is a significant preference for revising SFDR, with 17 in favour and 4 opposed.
8. Key recommendations from impact fund managers:
    a) Clear differentiation of impact funds and implementation of unequivocal legal text – deemed crucial.
    b) Enhanced focus on reporting on claims of positive impact, especially on social aspects.
    c) Emphasis on tailored and proportional reporting requirements, especially minimum PAI indicators for unlisted SMEs.
    d) Calls for enhanced clarity on the alignment of SFDR with other legislations (e.g. EuSEF).

Resources

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

Regulation (EU) No 346/2013 on European social entrepreneurship funds

Gianluca Gaggiotti, Alessia Gianoncelli, Raffaella De Felice (2022), Accelerating Impact, European Impact Investment Consortium.

Impact Management Project (2018), A Guide to Classifying the Impact of an Investment, April.

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