The SFDR's Articles 8 and 9: The Funds Behind the Labels

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Executive Summary

Financial market participants (FMPs) in the European Union (EU) are already addressing aspects of the EU's Sustainable Finance Disclosure Regulation (SFDR)[1], which aims to enhance transparency on how sustainability risks are integrated or how adverse sustainability impacts are considered. Key aspects of the SFDR for investors and other market participants include the Article 8 and Article 9 classifications, which effectively set labels for funds that incorporate ESG considerations (Article 8) and impact-oriented funds (Article 9). We examined key elements of the two classifications and analyzed a set of the funds that already have been labeled by their fund managers as being either Article 8 or Article 9.

A Brief Overview of Articles 8 and 9 in the SFDR

Over the last seven years, we have witnessed a surge in sustainability-related investment products. It is estimated that if the ESG market continues to grow at this rate, by 2025 more than a third of the USD 140.5 trillion in projected total assets under management would be invested in ESG assets.[2] Amid this growth, the EU Commission's Action Plan: Financing Sustainable Growth[3] aims to harmonize the sustainability standards and disclosures used by much of the financial market ecosystem operating in the EU: companies, benchmark administrators, and FMPs and advisers.[4]

Part of this initiative includes the SFDR, which came into effect on March 10, 2021. The SFDR asks all FMPs and financial advisers to make pre-contractual and ongoing disclosures to their investors on whether and how they integrate sustainability risks into their investment decisions and investment or insurance advice. At the product level, FMPs are required to disclose whether they believe their funds fall under Article 8 or Article 9 of the SFDR, based on the funds' objectives (see below). This then informs the extent of sustainability disclosure they need to provide.

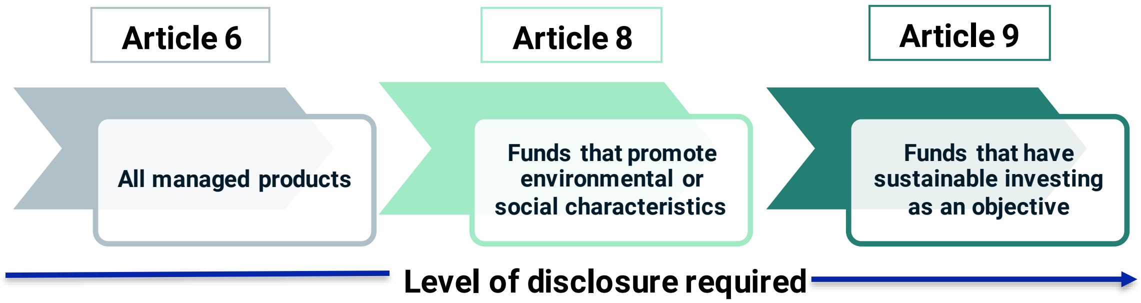
[1] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

[2] Head of ESG and Thematic Investing EMEA Adeline Diab and BI Chief Equity Strategist Gina Martin Adams. *ESG assets may hit USD 53 trillion by 2025, a third of global AUM*. Bloomberg Intelligence, Feb. 23, 2021.

[3] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions Action Plan: Financing Sustainable Growth

[4] As described by the EU Commission in the Action Plan: "1) reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth; 2) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and 3) foster transparency and long-termism in financial and economic activity."

Exhibit 1: Degrees of Disclosure Under the SFDR



Source: MSCI ESG Research

At MSCI, we have been continuously engaging with market participants about how they are interpreting the tenets of the SFDR since August 2020.[5] The list below lays out the basic definitions or requirements, as well as our interpretation of how Articles 6, 8 and 9 are currently viewed by those we have spoken with:

- FMPs, specifically, must disclose whether and how they consider sustainability risks, as well as the likely impacts of sustainability risks on the financial performance under **Article 6** of the SFDR.[6]
- **Article 8** funds promote, among other characteristics, environmental or social characteristics or a combination of both. FMPs and financial advisers of these funds must also assess good governance practices, as articulated in Article 2(17) of the SFDR, and must adhere to the "Do No Significant Harm" (DNSH) principle[7] if they make sustainable investments.[8] For many of our clients, this category encompasses funds that integrate environmental, social and governance (ESG) considerations in some fashion, including those more focused on the financial materiality of ESG factors.
- **Article 9** funds must have a sustainable investment as its objective, in addition to adhering to good governance practices and taking into account

[5] We conducted four workshops in August 2020 attended by 66 clients mostly based in EMEA, and an online survey was sent to 900 clients in late 2020. We have also had continuous one on one discussions with clients throughout 2020 and 2021. However, views are still evolving given new, parallel national and supranational regulations.
[6] Note that Article 6 lays out requirements that applies to all funds. Some clients view this to be an additional classification to Article 8 and 9. As per the ESA's Final Report on the draft RTS published in February 2021, funds that do not promote environmental or social characteristics (Article 8) or have a sustainable investment objective (Article 9) may apply some baseline environmental or social safeguards.
[7] Although the EU Taxonomy's Do No Significant Harm relates to harm on other environmental objectives not pursued, SFDR's DNSH is more in line with the minimum safeguards of the EU Taxonomy. As per the ESA's Final Report on the draft RTS, DNSH reporting must show whether investments are aligned with the OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Rights, Declaration of the International Labour Organization on Fundamental Principles and Rights at Work, and the International Bill of Human Rights.
[8] Based on Article 16 (3b) of the ESA's Final Report on the draft RTS, published in February 2021.

the DNSH principle and the principle adverse sustainable impact (PASI) indicators. Our clients considered Article 9 funds to be those more focused on sustainable economic activities/positive impact and/or aiming to reduce carbon emissions in line with the Paris Agreement.

In essence, the SFDR was created to combat "greenwashing" by fostering better transparency for investment vehicles that promote themselves as sustainable and to label those funds clearly and consistently for investors. In practice, it created a process to set consistent labels for funds — with asset managers showing on their websites and fund prospectuses which funds are *Article 8 funds* and which are *Article 9 funds*, based on managers' individual interpretation of the regulation. The intent of the SFDR is to focus on the importance of disclosure rather than as a labelling scheme;[9] so once an FMP has labeled a fund, it is still up to the investor to assess whether a particular Article 8 fund, for example, provides the ESG characteristics they are seeking.

For information on some of the MSCI and MSCI ESG Research solutions for addressing SFDR and other Sustainable Finance regulatory initiatives, please refer to our Sustainable Finance Solutions webpage.

Defining 'Good Governance Practices' for Article 8 and 9 Funds

As a baseline for both Articles 8 and 9, fund managers are required to ensure their fund's investee companies follow "good governance practices." Currently, the fund manager can interpret what constitutes good or bad governance practices. Many fund managers have pointed to using a signal in their SFDR disclosures that screens based on the UN Global Compact (UNGC) as an appropriate proxy for the principle of good governance.[10] This approach was echoed in our conversations with clients, although some have noted the need for a signal broader than the UNGC to align with Article 2(17) of the SFDR.[11,12] For this, we use MSCI ESG Controversies.

In the table below, we show the distribution of Article 8 and Article 9 funds in our analytical sample based on each fund's market value exposed to companies facing one or more Very Severe controversies (as defined by MSCI ESG Controversies and Global Norms methodology) related to the environment, customers, human rights, labor rights or governance principles.

[9] Head of Asset Management in the European Commission's financial services division Sven Gentner. *EC official reminds of SFDR intent amid 'label' tendency*. IPE, April 30, 2021.
[10] This comment is based on client engagement.
[11] Based on our Article 6/8/9 Proposed Mapping Framework built from client feedback. Note that this feedback was mostly based on the Level 1 text, prior to the ESA's Final Report on the draft RTS, published in February 2021.
[12] According to Article 2(17) of the SFDR, good governance practices include sound management structures, employee relations, remuneration of staff and tax compliance.

Table 1: Number of Article 8 Funds by Percentage of Market-Value Exposure to Companies Facing Very Severe Controversies

ESG Fund Rating	None (0%)	Low (0% to <=1%)	Moderate (>1% to <=5%)	High (>5% to <=10%)	Very High (>10%)
AAA	4	0	2	0	0
AA	50	13	17	1	0
A	38	21	15	3	0
BBB	15	8	7	3	0
BB	4	0	2	0	0
B	3	0	0	0	0
CCC	0	0	0	0	0

Chart shows the 207 funds of the top 15 asset managers by AUM that have been categorized as Article 8 funds by their managers and have been assigned an MSCI Fund ESG Rating (of the 217 Article 8 funds identified). Definition of how we assess controversies for companies and funds can be seen in our MSCI ESG Research Controversies and Global Norms methodology. Source: MSCI ESG Research, as of May 25, 2021; fund prospectuses and fund manager websites.

Table 2: Number of Article 9 Funds by Percentage of Market-Value Exposure to Companies Facing Very Severe Controversies

ESG Fund Rating	None (0%)	Low (0% to <=1%)	Moderate (>1% to <=5%)	High (>5% to <=10%)	Very High (>10%)
AAA	3	0	0	0	0
AA	17	1	1	0	0
A	11	4	1	1	0
BBB	1	0	0	0	0
BB	0	0	0	0	0
B	0	0	0	0	0
CCC	0	0	0	0	0

Chart shows the 40 funds of the top 15 asset managers by AUM that have been categorized as Article 9 funds by their managers and have been assigned an MSCI ESG Rating (of the 47 Article 9 funds identified). Definition of how we assess controversies for companies and funds can be seen in our MSCI ESG Research Controversies and Global Norms methodology. Source: MSCI ESG Research, as of May 25, 2021; fund prospectuses and fund manager websites.

Whether a fund has exposure to *any* companies with alleged UNGC violations may be as informative as looking at the market value exposed to such companies, as we did above for Very Severe controversies. Around 40% of the Article 8 funds we examined held at least one company flagged by MSCI ESG Research for potential UNGC violations, compared with only 17% of Article 9 funds. In total, of the 247 Article 8 and Article 9 funds we assessed, 90 funds (36%) held companies flagged for potential UNGC violations. That is significantly lower than the broader fund universe under our coverage, where around 73% of funds were invested in companies flagged for potential UNGC violations.

Examining the Current Landscape of Articles 8 and 9 Funds

For this paper, we examined the ESG characteristics of a universe of equity and mixed-asset funds that already have been labeled by their fund managers as either Article 8 or Article 9. We looked at the top 15 fund managers by assets under management to see which, if any, already had self-disclosed their funds. As expected, asset managers had many more funds categorized as Article 8 than Article 9.

Of the 247 funds examined, 207 were classified as Article 8 (83%) with only 40 classified as Article 9 (17%).[13] A majority of the reported funds for both categories were mutual funds (77% for Article 8 and 95% for Article 9), with the remainder being exchange-traded funds (ETFs). There was a slight difference in the geographical focus of the Article 8 and Article 9 funds that we examined, although the bulk of the investment strategies in both categories were focused on the securities of global companies:

Table 3: Geographic Focus of Funds' Investment Strategies

Geographic Focus	Article 8 (n=207)	Article 9 (n=40)
Asia	11%	3%
Europe (incl. UK)	26%	13%
Global	50%	83%
USA	13%	3%

Source: MSCI ESG Research LLC, as of June 2021.

[13] The top 15 asset managers by AUM had a total of 217 equity and mixed asset funds classified as Article 8 and 46 classified as Article 9. Of those classified as Article 8, 207 were under our coverage; and of those classified as Article 9, 40 were in our coverage. Our analysis was confined to the 247 funds in our coverage.

ESG Characteristics of Article 8 Funds

A majority of the self-labeled Article 8 funds used either a best-in-class ESG selection process or an exclusions-based strategy to promote ESG characteristics. We would consequently expect these funds to show stronger environmental and social characteristics than the average fund. The graph below shows the spectrum of MSCI Fund ESG Ratings for the Article 8 funds.[14] Most fell within the ESG leaders (AA to AAA) to average (BB to A) range, with only four funds considered ESG laggards (B to CCC). The distribution of ESG ratings by percentage (in green) for Article 8 funds is compared to the broader fund universe (gray) below:

Exhibit 2: ESG Ratings of Self-Disclosed Article 8 Funds

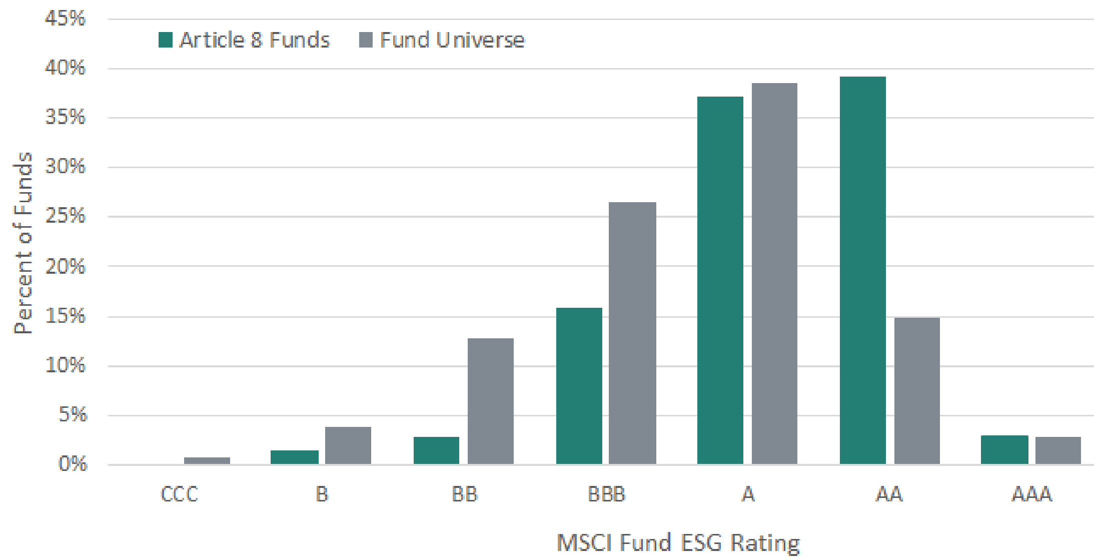


Chart shows MSCI Fund ESG Ratings distribution for the 207 funds of the top 15 asset managers by AUM that had been categorized as Article 8 funds by their managers as of March 2021. Our Fund ESG Ratings use a momentum-based model to rate funds under our coverage. More information on the ratings methodology can be found in the [MSCI ESG Fund Ratings Methodology](#) document. Sources: MSCI ESG Research, as of May 25, 2021; fund prospectuses and fund manager websites.

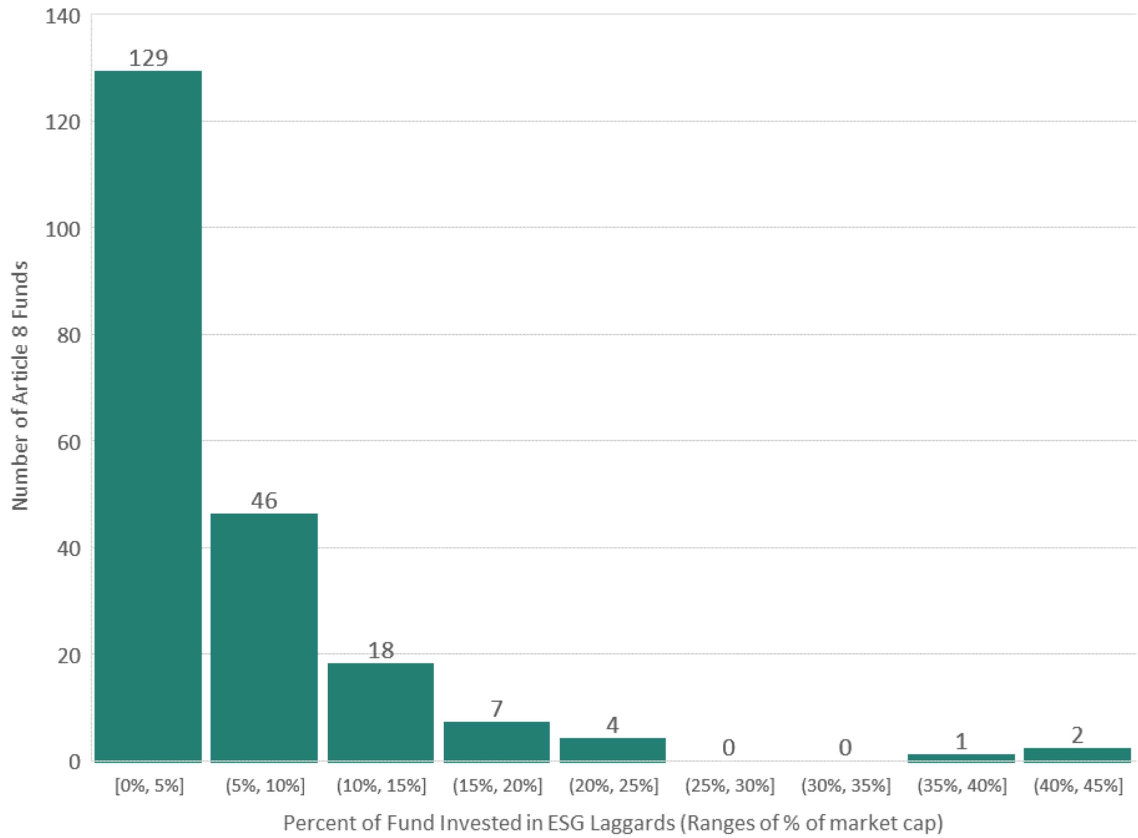
The three laggard funds (all rated B) invested in China A shares, stocks of mainland China-based companies that have typically been rated lower than the broader universe on ESG factors.

Our analysis found that these Article 8 funds generally exposed investors to few ESG laggard companies. The exhibit below shows that 62% of the funds had less than 5%

[14] To learn more about MSCI ESG Fund Ratings, please visit our fund rating website: https://www.msci.com/our-solutions/esg-investing/esg-ratings/esg-fund-ratings

of their portfolio's market value invested in companies with an ESG Rating of B or CCC (worst-in-class). For comparison, we looked all funds in our coverage with a rating of AA or higher (funds that are considered ESG leaders by our ratings methodology); of those, 93% had less than 5% of their portfolio's market value invested in companies with an ESG Rating of B or CCC.

Exhibit 3: Histogram of ESG Laggards in Article 8 Funds



The histogram shows the 207 funds of the top 15 asset managers by AUM that have been categorized Article 8 funds by their managers. The x-axis data labels are showing a range of information, e.g. the first bar is showing the range of 0% to 5%. The definition of how we provide an ESG rating for companies can be seen in our [ESG Rating Methodology document](). Source: MSCI ESG Research, as of May 25, 2021; fund prospectuses and fund manager websites.

One of the options for a fund seeking to adhere to Article 9 is to have a reduction in carbon emissions as an objective, aligned with the low-carbon objectives of the Paris Agreement. Yet we found only limited differences in the carbon intensity of the funds in each category.

Table 3: Weighted Average Carbon Intensity of Articles 8 and 9 Funds

SFDR Classification	Very Low (0 to <15)	Low (>=15 to <70)	Moderate (>=70 to <250)	High (>=250 to <525)	Very High (>=525)
Article 8 (n=207)	1%	22%	66%	8%	2%
Article 9 (n=40)	0%	25%	68%	8%	0%
Coverage Universe	4%	16%	55%	17%	7%

Weighted Average Carbon Intensity measures a fund's exposure to carbon-intensive companies. The figure is sum of security weight (normalized) multiplied by the security's Scope 1+2 Carbon Intensity, based on sales. Source: MSCI ESG Research, as of June 21, 2021.

A majority of funds labeled as Article 8 and Article 9 were in the moderate carbon-intensity range, in line with the broader market of fund offerings when compared with our entire fund coverage universe. But this analysis does not consider the decarbonization trajectory that some of the Article 9 funds have incorporated, which may widen the gap of carbon intensity for the different fund categories in the future.

ESG Characteristics of Article 9 Funds

In practice, funds that have been labeled as Article 9 have been viewed as "dark green" funds for impact-oriented investors.[15] Article 9 funds are supposed to invest in what the SFDR defines as "sustainable investments," which include any "economic activity that contributes to an environmental … or … social objective" (provided, as noted above, that those companies or activities do not also cause significant harm).[16] There are further details given, but the language makes the distinction both

[15] Though we are examining Article 8 and Article 9 funds as two separate categories, this was not the EU's explicit objective in setting up the SFDR. Head of Asset Management in the European Commission's financial services division Sven Gentner. *EC official reminds of SFDR intent amid 'label' tendency*. IPE, April 30, 2021.

[16] As per Article 2(17) of the 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."

broad enough to encompass all sustainable activities and specific enough to appear to highlight impact-oriented funds.

A more descriptive picture can be painted by looking at the level of exposure to environmental or social impact solutions provided by the funds that asset managers already have interpreted as being categorized as Article 9. In examining the 40 Article 9 funds that we identified from asset managers' disclosures, we narrowed the list to those with a stated investment objective that included an intention to invest in companies that provide solutions to environment challenges. (We excluded those that mentioned the environment only as part of a broader ESG consideration). Then, we examined the breakdown of the funds' exposure to investee companies deriving revenue from environmental impact products or services.[17]

The breakdown is compared with two MSCI indexes for context: the broader market (MSCI ACWI Index) and a very impact-focused index (MSCI ACWI Sustainable Impact Index). These indexes are used strictly for reference, as they are not subject to SFDR classification and requirements.

[17] An index or portfolio's Environmental Impact exposure is determined by its market value invested in companies that derive any revenue from Environmental Impact Solutions as defined by the MSCI ESG Sustainable Impact Metrics methodology and associated definitions.

Table 5: Environmental Impact Exposure of Article 9 Funds (average % of investee company revenue)

	BNPP Env. Abs Rtn Thematic	NN (L) Climate & Env.	BNPP Green Tigers	Amundi Funds Global Ecology ESG	BNPP Global Env.t	Allianz Positive Change	MSCI ACWI Sust. Impact*	MSCI ACWI Index*
Alternative Energy	20.4	7.9	5.4	4.8	2.0	2.9	7.6	0.5
Energy Efficiency	12.0	3.5	4.5	1.8	4.3	0.7	19.5	3.1
Green Building	0.0	0.0	0.1	0.0	0.0	0.0	4.3	0.4
Pollution Prevention	0.0	1.5	1.2	4.2	2.6	1.3	6.2	0.2
Sustainable Agriculture	0.0	4.0	0.0	1.1	0.1	0.6	1.9	0.1
Sustainable Water	0.0	1.7	1.9	0.4	2.9	1.6	2.2	0.1
Total Env. Impact Solutions	**Very high** **32.5**	**High** **18.6**	**High** **13.2**	**High** **12.4**	**High** **11.9**	**Moderate** **7.1**	**Very High** **41.7**	**Low** **4.4**

Indexes are not categorized as Article 8 or 9 under the SFDR and this comparison is for illustrative purposes only. In examining the 40 Article 9 funds that we identified from asset managers' disclosures, we narrowed the list to those with a stated investment objective that included an intention to invest in companies that provide solutions to environment challenges (including those that only mention the environment as part of a broader ESG consideration). Allianz Positive Change fund also noted an objective to create positive outcomes for society, not just the environment. An index or portfolio's Environmental Impact exposure is the portfolio weighted average of each company's percent of revenue generated by Environmental Impact goods and services. Additionally, Environmental Impact revenue from companies with negative externalities is excluded. This is defined by the MSCI ESG Sustainable Impact Metrics methodology and associated definitions. For more information on the MSCI Indexes methodology, please read the MSCI Index Methodology disclosures. Source: MSCI ESG Research. Data as of May 2021.

The SFDR does not set minimum impact-related thresholds for Article 9 funds. A fund manager does not have to have a certain level of investee company revenue from impact solutions, nor does the manager need to ensure that a minimum share of impact-related investments be met for the fund to fall under Article 9 of the SFDR. If the fund manager believes that it meets the Article 2(17) definition of sustainable investment and has appropriate disclosures to adhere to Article 9, then the manager may assert alignment even if, for example, the fund appears to have minimal to no exposure to companies with sustainable investment objectives.

The reason we analyzed environmental solutions exposure but not also social solutions among the Article 9 funds was the small number of funds with a stated social-impact-focused investment strategy (a sustainable investment activity covered under Article 9 can be either environmental or social). In our universe of 40 Article 9 funds, there were only two investment strategies focused on the furthering of some aspect of societal sustainability (outside of mentioning it as part of broader ESG principles): One was focused on gender equality and the other on SDG alignment.

What Happens Next?

Today, the SFDR disclosures are in their infancy. The first step toward adhering with Articles 8 or 9 was marked this year by a rush of FMPs editing the prospectuses of the funds they consider to be Article 8 or Article 9. These prospectuses potentially may be edited further before January 2022, depending on the EU's adoption of the Regulatory Technical Standards (RTS) and their publication in the Official Journal in coming months. It is also a time when FMPs are building their own views of their ESG funds, while keeping up to date with market consensus on the key definitions and classifications. The likely next step is for FMPs to start collating the data required (if they have not already started) to back up their prospectus statements. By January of next year, once the RTS is in place, there may be more clarity on whether a fund should be categorized as an Article 8 or Article 9 fund.

This formalization of ESG and sustainability in fund labels will likely provide more transparency for funds that promote sustainability objectives. Nonetheless, these efforts may be hampered if uncertainty around the disclosures creates more reluctance in the marketplace. Under SFDR, already there is much confusion over which investments can be labeled "ESG" or "sustainable."[18] For example, there is still room for interpretation on the extent to which Article 8 could accommodate exclusions-based approaches, or whether there should be a minimum threshold set for Article 9 funds. The hope remains that once the adjustment phase is over, there will be improved transparency for the ESG characteristics of investments, allowing the number and range of sustainable investment options to expand, and bringing greater choice for investors.

[18] As per the ESA's Final Report on the draft RTS, "To ensure comparability, where a financial product promotes environmental or social characteristics in a pre-contractual or periodic document, in its product name or in any marketing communication about its investment strategy, financial product standards, labels it adheres to or applicable conditions for automatic enrolment, the financial product should include the pre-contractual and periodic disclosures set out in this Regulation."

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