

Engagement: A Method for Complying with the SFDR

Overview

In 2021, the European Commission introduced the Sustainable Finance Disclosure Regulation (“SFDR”), a regulation aimed at augmenting transparency for investors when weighing entities’ environmental, social, and governance (“ESG”) efforts.¹ Specifically, the SFDR set forth a standardized method for financial market participants to disclose information about their ESG practices.² This uniform disclosure framework allows investors to more easily compare sustainable investment options based on the degree to which the entity considers sustainability as part of its practices.³

The SFDR requires entities like asset managers and institutional investors to disclose their efforts to address ESG initiatives. Covered entities, like asset managers and institutional investors, are required to specify their method for considering adverse ESG protocols with reference to indicators related to climate, the environment, social, governance, and human rights issues. For example, an asset manager must report their methodology for assessing the sustainability impact of their investment with disclosure of any adverse impacts.

SDFR Funds

Under the SFDR, all funds are classified into one of three categories, which are defined by the regulation.⁴ Funds are classified based on their stated approach to sustainability. For this reason, funds are encouraged to memorialize their policies concerning sustainability efforts and must disclose such policies to investors.

There are three categories of funds: Article 6 funds, Article 8 funds, and Article 9 funds.

CATEGORY OF FUNDS	
Article 6 Funds	Funds determine that sustainability risk is relevant to their investment strategies and, as a result, must disclose their policy for sustainability risk assessment. ⁵

¹ European Parliament. 2019. “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 (Text with EEA Relevance).” Official Journal of the European Union 317 (1): 1–16.

² *Id.*

³ *Id.*

⁴ *What is SFDR?*, Nordea Funds.

⁵ See Brian Forrester, *et al.*, *Sustainable Finance Disclosure Regulation – Article 6 Funds or What to consider when integrating sustainability risk into the investment decision making process?*, Deloitte (2021)

CATEGORY OF FUNDS	
Article 8 Funds	Funds (referred to as “Light Green” funds) are aimed at promoting ESG goals. Article 8 funds should implement the SFDR’s principal adverse sustainability indicators to integrate into their investment strategy. ⁶
Article 9 Funds	Funds (referred to as “Dark Green” funds) are expressly intended to promote sustainable investments or reduce carbon emissions. Article 9 funds assess investment opportunities based on the SFDR’s principal sustainability indicators to carefully evaluate corporate governance and ensure that sustainability goals are being fulfilled by the target company. ⁷

Complying Through Engagement

Since the SFDR took effect, asset managers have considered options to take affirmative action and comply with the regulation. While there is no explicit framework for compliance, several options have emerged as best practices for compliance. One way asset managers may comply with the SFDR is through company engagement.

The regulation defines engagement as a strategic approach focused on purposeful, targeted communications with companies to address ESG issues and drive systemic change through active dialogue. This involves direct communication with companies to clearly express concerns and desired outcomes, setting the stage for constructive dialogue and establishing clear ESG objectives.

Section 220 – A Purposeful Method for Corporate Engagement

Many asset managers subject to the SFDR take large financial positions in publicly traded companies and thus, through ownership as investors, have the ability to effectuate change at the board level by engaging directly with board members to shape corporate policy. However, even large financial positions may not command the type of influence that would allow asset managers to demand the type of change that would, standing alone, further the goals of the SFDR. This is increasingly true in the face of competing political agendas for companies incorporated in the US.

Therefore, in some cases, it makes sense for asset managers to avail themselves of a set of investor protection laws that compel engagement versus simply encouraging it. Many Fortune 500 companies are incorporated in the jurisdiction of Delaware in the U.S. to take advantage of a robust set of laws that have

⁶ See Brian Forrester, et al., *Sustainable Finance Disclosure Regulation – Article 8 Funds or “Light Green Funds” What to consider for Article 8 Funds based on the draft regulatory technical standard issued by the European Supervisory Authorities (“ESAs”) on 4 February 2021*, Deloitte (2021).

⁷ See Brian Forrester, et al., *Sustainable Finance Disclosure Regulation – Article 9 Funds or “Dark Green Funds” What to consider for Article 9 Funds based on the draft regulatory technical standard issued by the European Supervisory Authorities (“ESAs”) on 4 February 2021?*, Deloitte (2021).



developed for corporate governance. Because these major companies are subject to Delaware law, investors, like asset managers subject to the SFDR, may initiate engagement with U.S. corporations by availing themselves of various jurisprudence in Delaware developed to effectuate good governance. Specifically, Delaware General Corporation Law Section 220 provides investors with the ability to access corporate books and records to, amongst other things, investigate breaches of fiduciary duty, suspected corporate wrongdoing, or mismanagement.⁸ In the context of the SFDR, this process provides another avenue for asset managers to engage with companies incorporated in Delaware to the extent that mere communications do not appear to be furthering the goals of the SFDR. With direct documentation provided by the company on the identified topic, this will allow the asset manager to better understand each company's ESG practices and sustainability efforts.

Indeed, under Section 220, investors may seek corporate books and records by establishing that they: (i) are stockholders of the corporation; (ii) complied with the demand requirements set forth by the statute; and (iii) have a "proper purpose" for conducting the inspection. Section 220 defines "proper purpose" broadly, including "a purpose reasonably related to such person's interest as a stockholder." The bar for demonstrating a "proper purpose" under Section 220 is low. Courts routinely find efforts to investigate possible corporate mismanagement or wrongdoing sufficient.⁹ Thus, efforts aligned with the SFDR's goals are almost certainly sufficient to establish a "proper purpose" under Section 220 – providing asset managers with an opportunity to investigate possible ESG issues and initiate contact with corporations to effectuate change.

Through a Section 220 demand, asset managers can directly investigate ESG practices and sustainability efforts, engage with companies on these issues, and then propose and negotiate specific corporate initiatives or reforms to address these issues. To the extent that these negotiations fail, litigation (or the threat thereof) to compel reforms may be another tool useful to asset managers to ensure they are complying with SFDR.

In any event, if preliminary dialogues do not result in corporate changes or if these communications are taking too long to manifest in real change, a Section 220 demand provides a meaningful way to obtain documents from the company to educate the asset manager and provide actionable information as to whether reforms are even needed. Therefore, a robust Section 220 program in and of itself is furthering the goals of the SFDR by taking the level of corporate dialogue and potential action to the next level.

Labaton Keller Sucharow's lawyers are available to address any questions you may have regarding these

⁸ See 8 Del. C. § 220.

⁹ See *AmerisourceBergen Corporation v. Lebanon County Employees' Retirement Fund*, 243 A.3d 417, 423 (Del. Supr. 2020).

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