"Are you ready to comply?" asks a Dutch corporate management company of its clients, which include hedge funds and Fortune 500 companies operating in the EU, in March 2021. Perhaps the real question is "are you ready to comply or explain?"

The Road to SFDR: Recommendations, not Requirements

The much-anticipated Sustainable Finance Disclosure Regulation (SFDR) took effect on March 10, 2021, after years of consultations, white papers, and non-binding guidelines. Although the push for ESG disclosures may feel recent to an American investor or issuer, the EU has been feeling the pressure—and leading the charge—for much longer. In 2014, the European Parliament passed the Non-Financial Reporting Directive (NFRD), which required new reporting, starting in 2018, by some 6,000 covered entities. Defined public interest companies with over 500 employees, including banks, insurance companies, and exchange-listed public companies, were to begin reporting what policies they were implementing tackle "non-financial" issues such as environmental protection, human rights, and anti-corruption. Touted as providing "flexibility," the 2014 NFRD allowed covered entities to report information however they deemed most useful—there were no uniform standards (and thus, no reliable method of comparing companies' disclosures) and no real enforcement mechanisms. The European Commission provided updated Guidelines in 2017 and 2019 that were similarly non-binding, recommending but not requiring certain disclosure procedures and substance.

The SFDR, in theory at least, represents a new chapter in the EU's ESG-disclosure saga. Covered entities must provide detailed disclosures at both the entity level and product level and make them available to the investing public on their websites. Entity level disclosures include detailing the firm's sustainability risk policies, how the firm aligns its compensation policies with ESG objectives, and the principal adverse impacts (PAI) (qualitative and quantitative, physical and transitional) that climate change is expected to have on an issuer's operations, fund manager's strategy, or advisor's investment decisions. The PAI disclosure is the most important, and yet the one for which the regime is "comply or explain" instead of truly mandatory. Even those companies that choose to comply will still struggle to provide comparable data, at least until the Level II Regulatory Technical Standards (RTS) are released. Initially scheduled to coincide with the SFDR, they have been delayed until (likely) January 2022, leaving companies to "comply in principle" until then (whatever that means). Product-level disclosures will require sorting and accurately marketing investment products in one of three tiers (non-green funds, light green funds, and dark green funds), in an attempt to curb the growing practice of greenwashing everything from dish soap to derivatives.

Comply or Explain: A Monster without Teeth?

Do comply-or-explain standards undermine the SFDR? Do they render it just another set of guidelines that FMPs can follow or ignore? Or is this a necessary and temporary step on the path to moving material ESG issues from "non-financial" (2014) to another line item on the list of fundamental information that investors need to make informed decisions in an efficient market?

Professor Franz Werro, EU and comparative law specialist, worries about the efficacy of opt-in regulatory regimes in general. "Of course you can hope that the market will be there with its invisible hand [to] blame and shame those who don't comply," he says, but "unless there's some teeth in the system . . . I'm very skeptical." Chiara Pappalardo, Italian lawyer and S.J.D. candidate specializing in energy and environmental law, is more cautiously optimistic about the SFDR, although she agrees that naming and shaming cannot be "the only tool in the toolbox" when we consider the market failures. "Developing disclosure standards takes time, information, and resources" and covered entities need "enough lead time to develop the necessary expertise and [put the] infrastructure in place to respond adequately."

Member States, Market Participants, and (slow) Movement:

If the piecemeal approach to a fully mandatory framework does reflect some hesitancy, is it traceable to recalcitrant member state governments, or FMPs anxious about incurring a competitive disadvantage?

A little bit of both, it seems. The EU is no stranger to intra-union conflict; every regulatory move in an area of shared competence raises a risk of discord among the 27 member states. Obviously some states are better prepared for a shift to the SFDR era than others—just compare the size, productivity, diversification of economies and access to capital and technology of France and Malta. But experience with conflict means experience with compromise, and the EU has proven it can achieve harmonization in spite of the heterogeneity of its members.

FMPs have long been wary of any additional regulatory burdens, especially when their non-EU competitors will not be shouldering those burdens too. As the broader fight against climate change has accelerated, however, a climate-conscious regulatory landscape has gone from a potential handicap to a competitive advantage. "[G]reen financing and sustainable investment have now become part of a strategic race. When you are trying to lead the world on a particular issue, there can be several advantages in being the first mover," Ms. Pappalardo says.

EC in the Driver's Seat

Overall, according to Ms. Pappalardo, the new regulations show that the European Commission is finally "willing to take the driver's seat and demand that businesses get serious about taking responsibility for [the ESG impacts of and risks to] their operations." U.S. regulators and FMPs should look to the EU as a model to be followed, not a market to be avoided, and understand that it is in everyone's best interests (financial and otherwise) to move quickly to restructure our global securities markets for a sustainable future.