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Dividing Lines

Sustainability analysis of the largest SFDR Article 8 and 9 ETFs

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Table of Contents

Overview 3
Executive Summary 4
Key Findings 7
Introduction – SFDR 9
Methods 15
Findings and analysis 20
- Overall SDG Alignment 20
- Individual SDG Alignment 27
- Overall SDG Misalignment 30
- Principal Adverse Impacts 32
- Good Governance 35

SFDR moving forward 40
Conclusion 48
Appendix 52
- List of all PAIs included in the analysis 52
- Key Terms & Abbreviations 53

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Overview

Confusion around how to define and calculate sustainable investments under the EU SFDR triggered, in four months from October 2022 to January 2023, hundreds of ETFs, corresponding to approximately 270bn EUR in AUM, to downgrade from the Article 9 to Article 8 classification. These downgrades were driven by passive strategies tracking Paris-Aligned and Climate Transition Benchmarks. A Q&A published in April 2023 by the European Commission provides clarification and is likely to usher in a wave of reclassifications in the other direction. To understand the implications of these shifts in classifications, this report uses Matter's data and insights to analyse the largest Article 8 and 9 ETFs following the recent downgrades and unpacks what we can learn about the opportunities and challenges facing SFDR.

The analysis of Article 8 and 9 ETFs identifies clear sustainability differences between ETFs pursuing ESG, Paris-aligned and 'solutions-focussed' strategies. Recent regulatory guidelines – while providing important clarity for fund providers – do not account for these differences. As a classification system, SFDR should adapt to accommodate and delineate between these nuances in approaches, whilst maintaining minimum standards, in order to be an effective force for increased clarity and transparency in the European sustainable fund landscape.

Executive Summary

The introduction of Level 2 of the European Union's Sustainable Finance Disclosure Regulation (SFDR) has sent shockwaves through the European sustainable investment landscape. Suggestions around thresholds for what counts as 'sustainable investments', accompanied by a lack of clarity surrounding definitions triggered a mass downgrade of many funds, driven largely by ETFs tracking Paris-Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs) downgrading from Article 9 (supposedly 'dark green') to Article 8 (supposedly 'light green').

The purpose of this report is to examine the state of the EU sustainable ETF market, in the aftermath of the 'great reclassification', to better understand the impact that the introduction of the Level 2 RTS has had on the Article 8 and Article 9 classifications, and more broadly, the core challenges facing SFDR.

Until now, SFDR has been vulnerable to accusations of greenwashing, due to fund providers self-classifying as Article 8 or 9 with little oversight or disclosure. This analysis shows how the introduction of Level 2 of SFDR and the resulting downgrades has created a division between ETFs with different approaches to sustainability. Thematic, solutions-oriented strategies are falling under Article 9 classification, and more traditional approaches to ESG integration and Paris-aligned ETFs under the Article 8 classification.

With the introduction of Level 2, SFDR has shown its potential to distinguish between fund types, creating space for funds with different approaches to sustainability to stand apart from each other, thereby increasing transparency within the EU sustainable fund landscape and better defining different approaches to sustainable investment. This is reflected in the clear and meaningful differences in sustainability between the Article 8 and 9 products found in this analysis. It is an encouraging trend, but it is not currently systematic, as it was initiated by the introduction of a 100% sustainable investments threshold for inclusion as Article 9, without accompanying clarity on what was meant by 'sustainable investment'. This means that it was not possible to operationalise systematically.

Uncertainty around definitions also lies at the core of the current debate surrounding whether ETFs tracking PABs and CTBs should be defined as 'sustainable investments' under Article 9. The findings in this paper show that funds tracking PABs and CTBs, whilst offering marginally lower emissions today, have very similar sustainability profiles to Article 8 ETFs pursuing broad ESG strategies.

Paris-aligned funds do offer a distinct alternative to traditional ESG strategies, however, as they are bound by year on year Paris-Aligned emissions reductions targets, which are not captured in this analysis. SFDR Article 8 and 9 classifications, and their accompanying definitions and guidelines, are not yet sufficiently nuanced to effectively account for the differences between funds pursuing different sustainability strategies. At present, they are stuck trying to fit three complementary yet distinct approaches to sustainability – ESG, Paris-aligned, and thematic/solutions-focussed – into two classifications. Therefore, SFDR is, in its current form, neither systematic, nor sufficiently nuanced. This limits its ability to provide the necessary guidance for investors.

Of course, there is further complexity in the sustainability approaches employed by funds than the three highlighted in this analysis (Best-in-class vs. Exclusion vs. General Integration under the banner of 'ESG', for example), and these should also be addressed in the long-run. It is the fundamental differences between ESG, Paris-aligned and solutions-focussed, however, which must first be overcome in order for SFDR to progress beyond its current impasse.

A recent European Commission Q&A clarified that the definition of sustainable investment would be left up to the discretion of the fund providers and assured that PAB/CTB ETFs count as sustainable under Article 9. As our analysis shows, this will conflate Paris-aligned strategies with solutions-focussed strategies under Article 9, as opposed to conflating Paris-aligned strategies with ESG under Article 8, which was the state of play following the recent downgrades. The challenge is that these are, in some senses, contrasting approaches to sustainability. Paris-aligned strategies tend more towards low-impact sectors which meet emissions requirements (see p.42 for more), whilst solutions-focussed strategies can more freely (though not exclusively) expose investors to sectors which are transitioning or with inherent tradeoffs, therefore leading to comparatively higher negative impact. Both are necessary approaches which often target different segments of the economy. Our analysis shows that these different approaches result in distinct sustainability outcomes.

It is now clear to market participants that SFDR does not define what sustainability is, only what it is not. However, the different definitions of sustainability in investment strategies must be given space to stand out from each other, in order to provide investors who want to invest sustainably with clear guidance on where to find what they are looking for. Otherwise, the risk is either that Paris-aligned funds will struggle to stand out from ESG funds (if they remain under Article 8), or solutions-focussed funds will struggle to stand out from Paris-aligned funds (if they reclassify to Article 9, which would likely mean that the classification would once again be dominated by Paris-aligned ETFs). Each scenario has its own costs. Effective stratification between approaches is also necessary in order to

create appropriate definitions, thresholds and disclosure requirements which apply to them. If a classification is too broad, this limits how tailored and targeted the requirements placed upon them can be.

Each of these different approaches should naturally be accompanied by evidence-based, nuanced approaches for how to account for negative impacts and good governance principles in order to avoid exploitation. At present, however, the combination of muddied waters between funds employing different approaches to sustainability, along with a largely discretionary approach to what can be considered 'sustainable investments', means that SFDR remains limited in terms of the clarity it offers, and will remain vulnerable to the same accusations of greenwashing that have faced it to date.

There is a need for a middle ground which accounts for and delineates between the diverse routes necessary to reach a sustainable future, whilst employing realistic definitional guidance and thresholds in order to avoid greenwashing and ensure that SFDR remains rigorous. The current ongoing review of SFDR by the European Commission is crucial, therefore, if SFDR is to become the gold-standard sustainability disclosure framework that Europe needs it to be.

Key Findings

Paris-aligned downgraded funds are more similar to Article 8 ESG funds than the remaining Article 9 funds which largely pursue thematic strategies: The ETFs that were downgraded from Article 9 to 8 have strikingly similar sustainability characteristics to the largest ETFs that were already Article 8 labelled.

Downgraded and pre-existing Article 8 funds have similar environmental impacts: Downgraded Article 8 ETFs only expose investors to marginally reduced emissions in comparison to the pre-existing Article 8 ETFs, despite prevalence of Paris-Aligned and Climate Transition Benchmark trackers.

Remaining article 9 ETFs are considerably more SDG-aligned than downgraded and Article 8 funds: Article 9 ETFs expose investors to considerably more investments in companies whose revenue is aligned with the UN SDGs as a whole, compared to both downgraded (majority Paris-aligned) and pre-existing Article 8 funds (majority ESG). This suggests that Article 9 ETFs pursue a more 'solutions-focussed' approach.

Meeting Article 9 criteria depends hugely on calculation methodology: No Article 9 ETF manages to invest only in companies whose activities are 100% aligned with the UN SDGs according to Matter's revenue-weighted methodology. However, if we employ a revenue-threshold methodology (20% and above), 19/20 Article 9 ETFs meet the criteria.

Article 9 ETFs underperform on adverse impacts: Article 9 ETFs (majority thematic) perform worse on average on the majority of Principal Adverse Impact indicators (PAIs), which refer to disclosure requirements under SFDR on the negative effects on sustainability at both entity and product level, than either downgraded funds (majority Paris-aligned) or pre-existing Article 8 funds (majority ESG). Similarly, Article 9 ETFs expose investors to greater levels of SDG misalignment (revenue generated from activities misaligned with SDGs) than their counterparts.

Article 9 ETFs show wide variation in their sustainability profiles: Wide variation exists between the performance of Article 9 ETFs on all aspects of sustainability.

Article 8 and 9 funds are, in general, more sustainable than the market average: On average, pre-existing Article 8 funds, downgraded funds and Article 9 funds offer significant improvement on SDG alignment, SDG misalignment, PAIs (with the exception of Article 9 environmental PAIs) and good governance criteria, compared to a Global Market Benchmark, the Nasdaq Global Index.

The downgrades have clearly split the ETF landscape in two groups, between thematic, solutions-focussed funds (Article 9), and PAB/CTB and broad ESG funds (Article 8): Level 2 of SFDR and the resulting downgrades has largely divided Article 8 and 9 down strategy lines, with 18 out of 20 remaining Article 9 funds employing a 'Thematic' approach, 17 out of 20 downgraded ETFs employing 'Paris-Aligned' approaches, and 17 out of the 20 largest Article 8 ETFs employing broad-based ESG strategies (General Integration, Best-in-Class etc).

SFDR fails to account for differences between ESG and Paris-aligned approaches
Although displaying similar sustainability characteristics, this divide fails to account for the long-term difference in strategy between ESG and Paris-aligned approaches, which are currently conflated under the Article 8 classification.

Introduction – SFDR

Part of the EU Sustainable Finance Action Plan, the Sustainable Finance Disclosure Regulation (SFDR) was introduced to improve transparency in the market for sustainable investment products. Specifically, it aims to prevent greenwashing and increase transparency around sustainability claims made by financial market participants. On an ongoing staggered basis, SFDR introduces new rules on the incorporation of sustainability risks and characteristics, as well as the disclosures investors must make, including on the Principal Adverse Impacts (PAIs) of their investments.

The introduction of SFDR was widely welcomed by the financial industry as a mechanism to bring much needed clarity to the increasingly complex, crowded, and opaque world of sustainable finance. Since its inception, however, SFDR has faced a succession of teething problems which threaten its short-term usefulness and long-term credibility.

Most notably, although introduced to be a tool to eliminate greenwashing, it has faced accusations that it has actually facilitated a new form of greenwashing. This is due to the staggered manner in which the different levels of the regulation are introduced. The first step for financial market participants was to self classify their funds as one of three classifications under the SFDR:

Article 6 – Products which do not integrate any kind of sustainability into the investment process.
Article 8 – Products which promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.
Article 9 – Any financial product which has sustainable investment as its objective and where an index has been designated as a benchmark.[1]

The broadness of these criteria, combined with the requirement to self-classify led to a rush to market funds as either Article 8 or 9. After the inception of SFDR in March 2021, the sustainable fund universe grew by 65% between June and September 2021[2], and across 2021, 1,800 funds were reclassified by their managers from either Article 6 to Article 8 or 9, or from Article 8 to 9[3]. In some

[1] EU Commission delegated regulation (EU) 2022/1288
[2] Investment Week (2022): Responsible investors react as Morningstar strikes 1,200 funds from its sustainable universe.
[3] Responsible Investor (2022): SFDR reclassifications raise 'legitimate' greenwashing concerns, warns Morningstar.

cases, this may represent a genuine shift in the sustainability strategy in these funds, but in most cases, it represents a formalisation of light-touch ESG integration processes. This raised legitimate concerns that, in its early stages, without disclosure requirements, some asset managers were greenwashing their product ranges.

The issues of self-classification were made clear in Matter's white paper 'A House Built on Sand' which analysed the sustainability of the 45 largest (by AUM) sustainability-themed ETFs, that pursue a broad sustainability strategy and fall under EU regulation. All 45 of the ETFs fell under Article 8 classification, whilst their sustainability varied considerably. Four of the ETFs falling under Article 8 classification even performed worse on key sustainability metrics such as emissions and deforestation than their non-sustainability focussed parent indexes.

Level 2 of the SFDR adds further confusion

To address these allegations that SFDR has become an inadvertent labelling tool vulnerable to greenwashing, the EU introduced the SFDR Level 2 regulatory technical standards (RTS) on 1st January 2023. Now, fund providers will need to fulfil detailed sustainability-related disclosure obligations and complete reporting templates, including for Principal Adverse Impacts (PAIs).

In the lead up to the introduction of the Level 2 RTS, however, a sequence of communications from the EU led to confusion, especially around the definition of 'sustainable investment', and its implications for Article 9 funds. In June 2022, the European Securities and Markets Authority (ESMA) stated that "For the avoidance of doubt, as stated by the European Commission in its SFDR Q&A from July 2021, financial products that have sustainable investment as an objective should only make sustainable investments."[4]

This pronouncement that an Article 9 fund must have 100% sustainable investments triggered a mass downgrading of Article 9 funds in the latter months of 2022, continuing into 2023. According to Morningstar data, Q4 saw 307 Article 9 funds downgraded to the Article 8 classification, totalling €170 billion in AUM, with a further €99 billion downgraded in January 2023.[5]

The downgrades were not slowed by a new consultation from the ESMA in November 2022, which clarified that a fund with any ESG-related words in its name would have to have a minimum proportion of 80% of its investments being used to meet environmental or social characteristics.

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[4] ESMA (2022): "Clarifications on the ESAs' draft RTS under SFDR", item 19.
[5] Morningstar (2023): "ESG fund downgrade accelerates"

Further, a fund using the word "sustainable" or any other term derived from the word "sustainable" in its name would need to allocate 50% of that 80% towards sustainable investments as according to SFDR definitions.

The downgrades were driven by passive equity funds, the majority of which track the EU's flagship Paris Aligned and Climate Transition Benchmarks. This again is due to confusion around whether the use of these benchmarks qualified funds for an Article 9 classification or not. The result is that every passive fund previously in the top 20 largest Article 9 funds has been downgraded, and the proportion of passive Article 9 funds dropped 19 percentage points to 5.1% from September 2022 to January 2023.

The confusion surrounding what is considered a 'sustainable investment'[6] and therefore the requirements on fund providers attempting to meet the thresholds for Article 9 funds, has therefore led many investors to err on the side of caution, due to the potential reputational and legal risks should they be found to have misclassified their funds.

Confusion also remains around the definitions and thresholds surrounding the concept of 'Do No Significant Harm' (DNSH) – the idea that beyond showing contribution to an environmental or social objective, a 'sustainable investment' must ensure that it does not 'significantly harm' any stated objective. Fund providers know that PAIs must be considered, but do not seem to know to what extent this means simply disclosing PAIs, what level of "adverse impact" is deemed acceptable for a sustainable fund, or to what extent they are expected to address the adverse impacts. This means that different asset managers are currently approaching the concept of DNSH in different ways, with some considering all PAIs, whilst others consider only those most relevant for their strategies.

The picture was further muddied by the ESMA consultation in November 2022, which suggested that funds using either ESG or sustainability related words in their name must apply the same exclusions as the EU Paris-Aligned Benchmark. Many of these exclusions are environmental, leading to criticisms that the exclusions are not equally applicable to funds without an explicit environmental focus, or to those which invest the sustainability and transformation pioneers within high-emitting industries.

Most recently, the European Commission has issued a Q&A to clarify some of these confusions. In response to questions surrounding sustainable investment definitions, which was a key trigger for the

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[6] See Findings and Analysis

recent downgrades, the Commission wrote that the SFDR "does not set out minimum requirements that qualify concepts such as contribution, do no significant harm, or good governance, i.e. the key parameters of a 'sustainable investment'. Financial market participants must carry out their own assessment for each investment and disclose their underlying assumptions", emphasising that, "(t)his policy choice gives financial market participants an increased responsibility towards the investment community and means they should exercise caution when measuring the key parameters of a 'sustainable investment'".

In addition, the Commission has confirmed that the Article 2(17) sustainable investment definition "does not prescribe any specific approach to determine the contribution of an investment to environmental or social objectives. Financial market participants must disclose the methodology they have applied to carry out their assessment of sustainable investments" and that "the notion of sustainable investment can therefore also be measured at the level of a company and not only at the level of a specific activity".

This is, in its essence, not principally different from how the Securities and Exchange Commission (SEC) in the US has chosen to regulate sustainability claims in financial products, as it leaves both the definition of sustainable investment and the method to calculate contribution at the discretion of FMPs. This could be seen as a departure from the activity-based logic employed in the EU Taxonomy – at least for now.

Much of the confusion surrounding the downgrades specifically referred to whether PAB and CTB tracking ETFs should be classified as 'sustainable investments'. The Commission has also made clarifications here, stating that funds that passively track PABs and CTBs do indeed qualify as sustainable investments, as long as they abide by DNSH and good governance principles.

SFDR at a crossroads

The introduction of the Level 2 RTS represents a crucial moment for SFDR. Their introduction has triggered a mass response from financial markets in the form of the 'great reclassification'. This is being interpreted by some as an indication that SFDR is failing – adding further confusion for sustainable investors rather than increasing transparency. To others, it is a marker that SFDR is beginning to work by delineating between funds with different approaches to sustainability.

The recent Q&A from the European Commission adds further intrigue, as the reason why many funds downgraded in the first place now seems to be removed. This poses the question of whether these

downgraded funds will reclassify back up to Article 9, and whether this will provide the clarity that the market is requesting.

The purpose of this report is therefore to examine the state of the EU sustainable passive ETF market, in the aftermath of the 'great reclassification', to try and better understand the impact that the introduction of the Level 2 RTS has had on the Article 8 and Article 9 classifications, and more broadly, the core challenges facing SFDR.

This will be done by using Matter's sustainability data and insights to analyse:

1. The 20 largest Article 8 ETFs, by AUM
2. The 20 largest Article 9 ETFs, by AUM
3. The 20 largest ETFs which have downgraded from Article 9 to Article 8, by AUM , between 1st November 2022 and 31st January 2023

The analysis focuses on three key areas of fund performance.

1. Sustainable investments – Using Matter's SDG revenue alignment data solution, 'SDG Fundamentals', we analyse the proportion of these ETF's alignment with different sustainability objectives, as defined by the UN SDGs.
2. Do No Significant Harm – Using Matter's SFDR PAI solution, we analyse the negative impacts of the ETFs under each classification. In addition, we analyse the misalignment of the ETFs with the UN SDGs using SDG Fundamentals, to capture significant harm towards specific objectives.
3. Good governance – Using Matter's Thematic ESG Flags, we analyse how the ETFs are performing across a range of governance issues which serve as indicators for 'good governance'.

The aim of this report is to unpack the confusion that has characterised many of the discussions surrounding SFDR to date. By using SDG alignment, PAI analysis, and Governance metrics[7], our analysis zeros in on the key elements of what qualifies as a 'sustainable investment'.

The results highlight how the recent downgrades have split the European sustainable ETF landscape along strategy lines. This shows its potential as a meaningful force to realign investments and

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[7] See Methods for how these relate to definitions of 'sustainable investment' under SFDR.

increase the transparency of the European sustainable fund landscape. At the same time, it highlights the current limitations of the Article 8 and 9 classifications in accounting for the different nuanced approaches to sustainability employed by these ETFs. It also exposes the need for realistic and clear definitions and thresholds for SFDR to become a systematic, sophisticated and rules-based regulatory framework that can produce consistent outcomes in the EU sustainable finance ecosystem.

Methods

Object of study

In this report, we chose to analyse 60 ETFs which fall under UCITS regulation, and therefore fall under SFDR requirements. These ETFs can be split under three categorisations:

1. **Largest Article 8 ETFs pre-November 2022** – The 20 largest Article 8 ETFs by AUM, prior to the mass downgrade of ETFs from Article 9 to Article 8 between November 2022 and January 2023.
2. **Largest ETFs downgraded from Article 9 to Article 8** – The 20 largest ETFs by AUM which downgraded from Article 9 classification to Article 8 classification between November 1st 2022 and January 2023.
3. **Largest Article 9 ETFs post-January 2023** – The 20 largest remaining Article 9 ETFs by AUM, after the mass downgrade of ETFs from Article 9 to Article 8 between November 2022 and January 2023.

As such, ETFs downgraded between November 1st 2022 and January 31st 2023 will be referred to as 'downgraded' ETFs and should be viewed as distinct from 'Article 8' ETFs in the proceeding analysis. This also applies to those downgraded Article 9 ETFs that subsequently ended up in the top 20 of Article 8 ETFs – they are still referred to as 'downgraded' ETFs.[8]

We identified Article 8 and 9 ETFs and calculated their size based on AUM using data from ETF specialist TrackInsight[9]. We performed two separate analyses in November 2022 and February 2023 in order to accurately determine the largest funds which had been downgraded from Article 9 to 8 classification. The data on AUM and ETF holdings are accurate as of February 2023.

We chose to focus specifically on ETFs rather than active funds for this analysis because, as explained above, the recent downgrades have been driven by passive funds. This combined with the explosion in popularity of sustainability-themed ETFs in recent years, make them a highly relevant object of study in order to better understand the state of the sustainable finance landscape.

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[8] As of February 2023, 7 of the largest 20 Article 8 ETFs were previously Article 9 ETFs which downgraded as part of the 'Great Reclassification'. For the purposes of this analysis, they have been separated from the 'Article 8' classification, and included in the 'downgraded' classification, so as to better understand the implications of the introduction of Level 2 of SFDR and the resulting downgrades.
[9] www.trackinsight.com

In addition, we have chosen to include a global market index (Nasdaq Global Index) in the analysis, namely in order to provide a useful reference point and to analyse whether and to what extent the 60 ETFs in this analysis offer an improvement on sustainability, compared to a broad global index that covers large, mid and small cap issuers.

Level of analysis

All analyses compare fund performance but are based on an in-depth security-level analysis, where sustainability insights on issuers are adjusted according to each specific holding's respective weight in the funds. This allows us to better reflect the weighted impact that a given ETF exposes investors to.

Applying three SFDR-specific Matter datasets to analyse Article 8 and Article 9 ETFs

This analysis relies on three separate Matter datasets which can be used to qualify investments as sustainable under SFDR, informed by Article 2(17) of SFDR, which states:

> "'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."

The recent Q&A from the European Commission (EC) indicates that the way in which sustainable investment is to be defined in terms of contribution to environmental or social objectives, DNSH and good governance is to be left to the discretion of financial market participants (FMPs). In this paper, we will utilise Matter's SDG Fundamentals dataset (contribution and DNSH), SFDR PAIs (DNSH) and Thematic ESG Flags (good governance) to determine the extent to which the 60 ETFs in this analysis match up to Article 2(17)'s definition of sustainable investment.

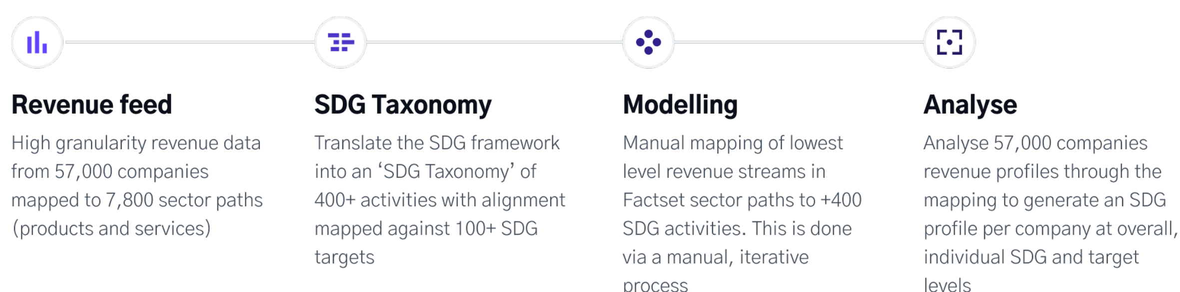
Dataset: SDG Fundamentals

SDG Fundamentals is a data solution that looks to the core of company impact by analysing how the different revenue streams generated by publicly traded companies are aligned or misaligned with the SDGs. Based on a thorough, manual classification of almost 8,000 different revenue streams towards a highly nuanced SDG Taxonomy, and with coverage on over 57,000 companies, SDG Fundamentals provides investors with a clear picture of how companies interact with the SDGs at both individual SDG and aggregate SDG level.

At its core, SDG Fundamentals is designed to be conservative, transparent and granular, resting on the principle of cautious recontextualisation. The intention is to help investors understand how the products and services a company produces impact the real world in the most realistic way possible, by conservatively mapping a company's revenue to the SDG framework. This means resisting the urge to overinflate or simplify both the alignment and misalignment of companies to the SDGs. This is especially important in light of the recent EC Q&A which places the responsibility for defining and calculating sustainable investment on the FMPs themselves, rather than outlining strict definitions and thresholds. The EC emphasises the need for caution and responsibility in this process. There is a need for an approach, therefore, which looks at both contribution (SDG alignment) and DNSH (misalignment), in a cautious and transparent fashion which can be traced back to the business activity they stem from.

SDG Fundamentals looks not only at the alignment of a company's products and services to the SDGs, but also the misalignment. To the same extent that companies can make a positive contribution to achieving the SDGs with their products and services, they can equally produce products and services which actively harm progress towards a given SDG, and are therefore misaligned. Methods that net alignment and misalignment create noise and keep managers from seeing the complexity needed to properly understand the sustainability profile of their investments.

The process



The 17 United Nations Sustainable Development Goals represent the closest thing humanity has to a roadmap for achieving a sustainable future for all. They are based upon universal underlying principles that are applicable across geography and context. It is because of this universality that the SDGs are becoming increasingly accepted as a benchmark against which to define and measure sustainability. This is reflected in the practices of several large asset managers, as well as in the guidelines form various regulators, including a recent decision[10] by the Swiss financial regulator to recommend that 'sustainable goals' be defined and measured against "the widest possible reference framework" such as the United Nations Sustainable Development Goals.

Therefore, in this paper, we use SDG alignment of ETFs to measure the proportion of investments pursuing and environmental or social objective contained in a fund.

Similarly, due to its universality, we also use SDG misalignment data as one of two datasets to assess the extent to which ETFs 'Do No Significant Harm', as it is a robust tool for assessing the Article 2 element, '*provided that such investments do not significantly harm any of those objectives',* because it offers directly comparable alignment and misalignment data at individual SDG level.

Dataset: SFDR PAIs

SFDR has introduced new rules on the consideration and disclosure of the Principal Adverse Impacts (PAIs) of their investments. There are a total of 64 PAIs by which the overall adverse impact of financial products should be reported under SFDR, including 18 mandatory PAIs (for equity investments) and 46 additional PAIs that can be reported on a voluntary basis. The mandatory PAIs cover a range of quantifiable environmental and social adverse impacts.

Matter's SFDR PAIs dataset measures portfolio PAIs utilising a wide range of data sources, from company-reported data to corporate insights from subject matter experts in the relevant field. The Matter PAIs have been designed to be as closely aligned to the EU-defined indicator as possible given available data. Where this is not possible, Matter uses either a proxy metric to infer the indicator or provides partial or estimated data on the metric.

Currently Matter's dataset contains PAI data on all mandatory PAIs for equities[11] and dozens of voluntary PAIs, although only mandatory PAIs are included here.

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[10] ETF Stream (2023): "Switzerland to implement sustainable fund label rules amid greenwashing concerns"
[11] The two PAIs excluded from this analysis cover real estate investments and are as such less relevant for the analysis of listed ETFs.

As such, we analyse the mandatory PAIs of each of the 60 ETFs in order to compare the adverse impacts between and within classifications and how these relate to the concept of 'Do No Significant Harm'.

Dataset: Thematic ESG Flags

Matter's Thematic ESG Flags comprise 380 company and sovereign ESG insights, combining analysis from independent, global subject matter experts and company-reported data.

Data from more than 40 different leading expert sources on sustainability is mapped to various ESG themes, including governance, human rights, the climate transition and more. The data is presented in a binary format as issuer-level flags. This method harnesses the power of collective intelligence, resulting in independent insights, covering more than 8,000 issuers, from external expert sources closest to a given theme.

For the purposes of this analysis, we have selected four governance-related flags that each lend insights into how well companies are governed in general, and specifically towards ensuring their transition to a more sustainable business model.

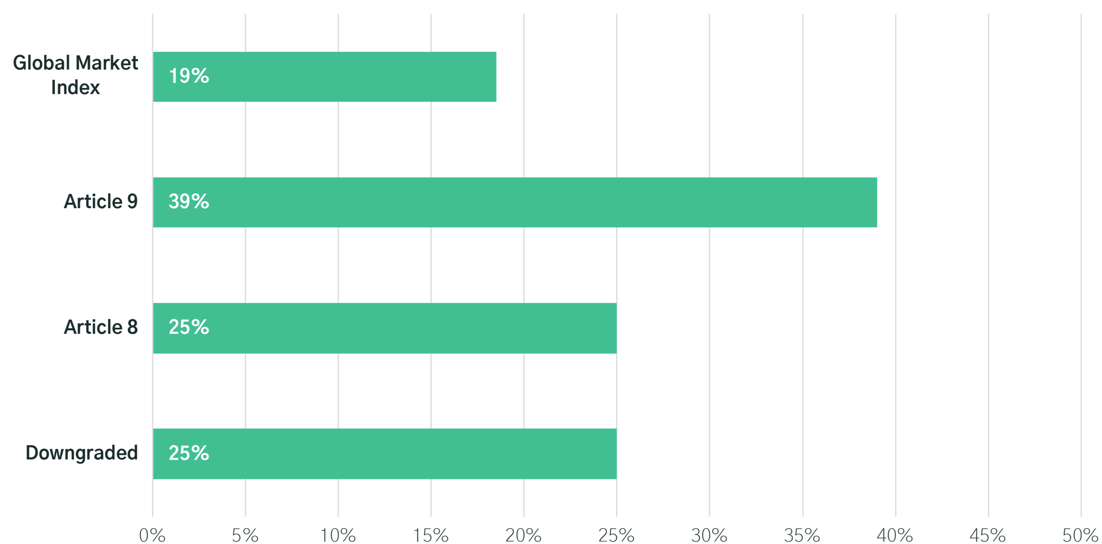
Findings and analysis

Overall SDG Alignment

Chart 1

Overall SDG alignment

Average ETF SDG alignment at aggregate SDG level, percentage average weighted revenue alignment



Article 9 ETFs offer a higher level of SDG aligned sustainable investments than the largest Article 8 ETFs and the largest downgraded ETFs

Chart 1 shows the average weighted proportion of each portfolio's revenue which is aligned to one or more of the 17 UN SDGs, for each type of ETF analysed in this analysis.

Worth noting is the similarity in SDG alignment profiles between the largest Article 8 funds, and the largest "downgraded funds" (Article 8 funds which have recently been downgraded from Article 9). On average, both groups of ETFs display the same degree of weighted revenue alignment towards the SDGs, even though the downgraded ETFs held Article 9 classifications just months ago. Furthermore, 19 of the 20 downgraded ETFs previously comprised the top 20 largest Article 9 ETFs, indicating that **the 'great reclassification' has created a meaningful delineation, on average, between funds**

The 'great reclassification' has created a meaningful delineation, on average, between funds with differing levels of SDG alignment

with differing levels of SDG alignment, with Article 9 funds on average containing considerably more investments in companies which produce products and service that address the SDGs.

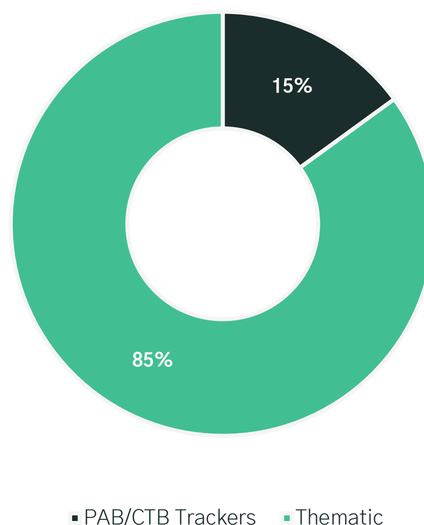
The increased alignment can in large part be explained by the strategies employed by Article 9 funds compared to the downgraded ETFs. 16 out of the 20 largest Article 9 funds employ a thematic strategy, focussing on either a sector (Hydrogen Economy, etc.) or impact area (biodiversity, etc.). In contrast, 17 of the 20 downgraded ETFs track either Climate Transition or Paris-Aligned Benchmarks. It makes sense that thematic strategies are more 'solution' focussed, and therefore derive more positive SDG alignment from revenue generation than those which track Paris-Aligned Benchmarks, as these are not necessarily solutions-focussed by design.

The strategies of the largest Article 8 funds are more fragmented, however, as they are split across Best in Class, General Integration, Thematic and Exclusion Screening. **This indicates that Paris-Aligned and Climate Transition strategies are more similar to broader ESG strategies than they are to thematic approaches when it comes to delivering sustainable outcomes, measured as alignment towards the SDGs.**

Chart 2

Article 9 ETFs by strategy

Share (%) of 20 largest Article 9 ETFs (by AUM), broken down by sustainability integration strategy



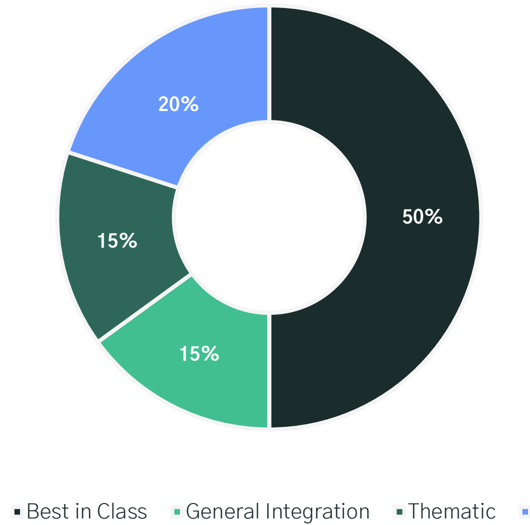
▪ PAB/CTB Trackers ▪ Thematic

Source: TrackInsight data & Matter analysis

Chart 3

Article 8 ETFs by strategy

Share (%) of 20 largest Article 8 ETFs (by AUM), broken down by sustainability integration strategy

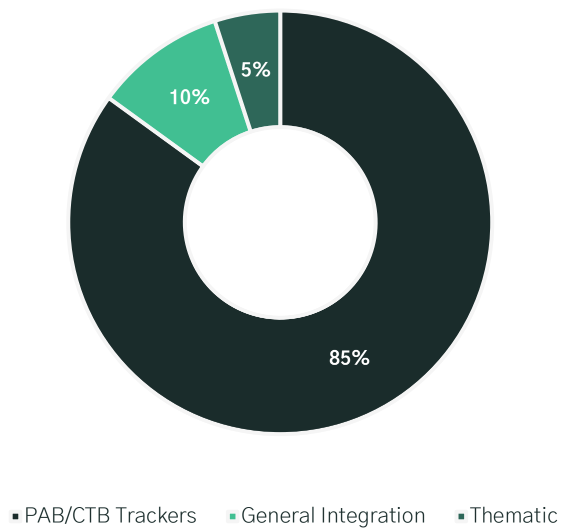


Source: TrackInsight data & Matter analysis

Chart 4

Downgraded ETFs by strategy

Share (%) of 20 largest ETFs which downgraded from Article 9 to Article 8 classification (by AUM), broken down by sustainability integration strategy



Source: TrackInsight data & Matter analysis

Unclear definitions mean that despite clear differences, a lack of consistency remains

This above analysis shows how the introduction of Level 2 of the RTS has demonstrated the potential of SFDR to stratify funds based on which type of sustainability strategy they employ. **The lack of clear definitions around what classifies as a 'sustainable investment', however, especially in terms of whether ETFs using Climate Transition or Paris-Aligned Benchmarks qualify under Article 9, means that this stratification is somewhat inadvertent, and is neither systematic nor consistent.**

For example, three funds tracking Paris Aligned or Climate Transition Benchmarks have remained under the Article 9 classification, whilst iShares Global Clean Energy, a thematic ETF with relatively clear alignment with the SDGs, was downgraded from Article 9 to Article 8. There are also three thematic funds in the 20 largest Article 8 funds. In this sense, despite the push provided by the introduction of Level 2, classification still depends on the interpretation of fund providers, with some choosing to be cautious, while others stick to their original classifications.

The strategy an ETF employs, although a useful suggestion of its SDG alignment, is not a consistent marker of sustainability, and large differences in SDG alignment exist between Article 9 funds employing thematic strategies. For instance, the least aligned Article 9 fund is only 12% aligned with the SDGs, with the most aligned achieving 67% alignment, indicating a huge variation which is not immediately visible if Article 9 were to be used as a guide for sustainability. Similarly, two of the 20 downgraded funds expose investors to over 50% SDG alignment. This inconsistency is indicative of a lack of clear guidance, with fund providers classifying differently depending on their interpretation of the 'only sustainable investments' stipulation by the ESMA, with all players awaiting further clarification in order to educate their classification decisions.

Article 8 and 9 classifications cannot be viewed as robust indicators of sustainability

Although an inadvertent rough guide, in the absence of clear definitions and minimum thresholds, **Article 8 and 9 classifications cannot be viewed as robust indicators of sustainability.**

Despite clarifications from the European Commission, definitional risks persist

In an attempt to address this uncertainty surrounding definitions which helped trigger the downgrades, in a recent European Commission Q&A, the EC states that it will not prescribe specific definitions around sustainable investing, nor on calculation methodologies for determining

environmental or social contribution. This opens up flexible new avenues for fund providers to argue their case for what constitutes "only sustainable investments". This has the benefit of making the Article 9 classification much more usable, as fund managers do not have to meet overly prescriptive and stringent definitions of 'environmental and social contribution'. It therefore recognises that there are many different routes to create a sustainable future and that these should not be unnecessarily constrained.

The guidance also comes with significant risks, however. A clear risk is that questionable definitions of sustainable investment may be employed in order to justify inclusion in the Article 9 classification. This analysis has shown the potential of SFDR to provide clarity between different fund types. **This can only happen, however, with some form of definitional standards and thresholds that must be met which are specific enough to formalise the divisions between ETFs pursuing different strategies.** This potential risks being unrealised if definitions are left purely to the discretion of fund managers, as it paves the way for funds employing wildly different conceptions of sustainability to be classified alongside each other under Article 9.

The Q&A also specifies that tracking PABs and CTBs will be sufficient in meeting the 'environmental or social contribution' element of Article 2(17)'s 'sustainable investment' definition. Our findings show the clear differences in SDG alignment between Paris-aligned ETFs and solutions-focussed ETFs. Under the new guidance from the EC, these funds may soon once again coexist under the Article 9 classification. This is not inherently negative, as they both pursue sustainability objectives. It will make differentiating between their objectives more challenging, however. **This speaks not to the limitation of PABs and CTBs, however, but to the current limitations of the Article 8 and 9 classifications to account for and clearly distinguish between the different sustainability approaches employed by ETFs.**[12]

The final risk is that the EC's guidance clears the way for creative accounting which, depending on the chosen method, can portray very different levels of sustainable investment, which we will now explore.

Does sustainability all add up?

The definitional issues surrounding 'sustainable investments' are not only difficult in terms of determining which objectives can count as 'sustainable' (Paris-aligned vs solutions-focussed, for example), but also in terms of how it is calculated.

[12] See "SFDR Moving Forward"

The downgrades have been driven by the EU's suggestion that in order to classify as Article 9, a fund must include only sustainable investments. This suggests that many have interpreted 'only sustainable investments' to mean '100% sustainable investments'. This was not accompanied by guidance on how to calculate sustainable investments, including in terms of contribution to an environmental or social objective.

A recent Morningstar report[13] laid out one element of this dilemma for fund providers trying to determine the environmental or social contribution of their product. For instance, "while one firm might count the entirety of a sustainable company (beyond a certain level of revenue derived from sustainable activities), another might count only the proportion of revenue attributed to those activities. These two approaches, broadly referred to as *revenue-weighted* and *pass-fail* approaches, would produce opposite results: high percentages of sustainable investments in the first case and much lower levels in the latter case."

Calculating 'Sustainable Investment Proportion'

Revenue-weighted approach	Pass-Fail approach
Only the % of revenue generated from sustainable activities	100 % of companies that generate a minimum level of revenue from sustainable activities
If 20% of a company's revenue contribute to the UN SDGs and the company is not involved in any business activities deemed significantly harmful, then the 20% of the investment in the company is considered	If 20% of a company's revenue contributes to the UN SDGs and the company's remaining business activities are not deemed significantly harmful, then an investment in the whole company is considered a sustainable one.
20-40%	60-80% (and in some cases 100%)

Source: Morningstar (2023): "SFDR Article 8 and Article 9 Funds: Q4 2022 in Review"[14]

Differences between providers of SDG data may also explain variance in outcomes. The available SDG datasets in the market often classify companies based on industry classifications, rather than in-depth revenue analysis, and also tend to map these broader categorisations to SDGs, and not their underlying targets. With cruder methods come cruder outcomes, and as with ESG ratings, it is not always easy for investors to understand exactly what the SDG scores they buy measure.

[13] Morningstar, SFDR Article 8 and 9 Funds: Q4 2022 in Review.
[14] Morningstar, SFDR Article 8 and 9 Funds: Q4 2022 in Review.

With cruder methods come cruder outcomes, and as with ESG ratings, it is not always easy for investors to understand exactly what the SDG scores they buy measure

This analysis, based on Matter's SDG Fundamentals, uses a revenue weighted approach, with only the percentage weighted revenue that is aligned across a portfolio to the SDGs – examined at SDG target level – being counted in the resulting figure. For example, In a model portfolio with only two equally weighted stocks, where each of the issuing companies have 30% and 40% of their respective revenue aligned with the SDGs, the resulting overall alignment via our method would be 35%. If we had applied the pass-fail approach with a threshold of 20%, 100% of the portfolio would be aligned. As such, the approach of this analysis represents a conservative perspective on the proportion of sustainable investments in these ETFs.

To illustrate the difference, no Article 9 ETF manages to only invest in companies whose activities are 100% aligned with the UN SDGs according to Matter's revenue-weighted methodology. However, if you employ a revenue-threshold methodology (20% and above), 19/20 Article 9 ETFs meet the criteria. The recent European Commission Q&A legitimises the 'Pass-Fail' approach, without offering guidelines on what a threshold would be to count as 'sustainable'. There is a risk, therefore, that providers could set the threshold lower, at 10%, for example, which would mean that all ETFs in this analysis could be classified as Article 9.

Best practice for how to count sustainable investments is not outlined in the Level 2 RTS, nor in the EC's recent guidance, meaning that simple methodological differences can add up to considerably different levels of 'sustainable investment' which do not represent a real world difference in sustainable outcomes of the economy.

Therefore, the EC has shifted from a position where classifying as Article 9 with any certainty is almost impossible, to one where discretionary calculation methodologies could mean the majority of the EU sustainable fund landscape could be argued to qualify as Article 9.

Just as an overly-prescriptive approach does not work, neither does an overly-discretionary approach. Further clarity surrounding how to define and count sustainability, as well as guidance on minimum thresholds is essential if SFDR is to provide transparency and correctly assign appropriate disclosure requirements based on fund characteristics.

Individual SDG Alignment

Looking at alignment towards each individual SDG, as opposed to overall alignment across the SDGs, can lend understanding into how focussed the SDG alignment (and therefore the sustainability profiles) of the ETFs under the different classifications are. The table below shows the number of ETFs, per group, with over 10% revenue alignment to each of the 17 individual SDGs.

Individual SDG alignment further demonstrates split between Paris-aligned, ESG and solutions-focused strategies

Table A

Individual SDG Alignment

ETFs by SFDR classification with over 10% alignment with an individual SDG, Number of ETFs with over 10% weighted revenue alignment, per SDG

SDG	Article 9 ETFs	Downgraded ETFs	Article 8 ETFs	Global Market Index
SDG 1: No Poverty	0	1	0	0
SDG 2: Zero Hunger	4	0	0	0
SDG 3: Good Health and Wellbeing	9	1	1	0
SDG 4: Quality Education	1	0	0	0
SDG 5: Gender Equality	1	0	0	0
SDG 6: Clean Water and Sanitation	4	0	1	0
SDG 7: Clean and Affordable Energy	7	1	1	0
SDG 8: Decent Work and Economic Growth	1	3	3	0
SDG 9: Industry, Innovation and Infrastructure	3	1	3	0
SDG 10: Reduced Inequalities	0	0	0	0
SDG 11: Sustainable Cities and Communities	5	0	0	0
SDG 12: Responsible Consumption and Production	3	0	1	0
SDG 13: Climate Action	0	0	0	0
SDG 14: Life Below Water	0	0	0	0
SDG 15: Life on Land	0	0	0	0
SDG 16: Peace, Justice and Strong Institutions	0	0	0	0
SDG 17: Partnerships for the Goals	0	0	0	0

It is clear that Article 9 funds, following the downgrades, not only offer a higher overall SDG alignment, but also a much more focussed SDG alignment. 18 of 20 Article 9 funds offer over 10% alignment to at least one SDG. Interestingly, and in line with our earlier findings, the two Article 9 ETFs which do not achieve 10% alignment apply PAB and Exclusion Screening approaches, whilst all thematic Article 9 ETFs offer over 10% focussed alignment to an individual SDG. Furthermore, only

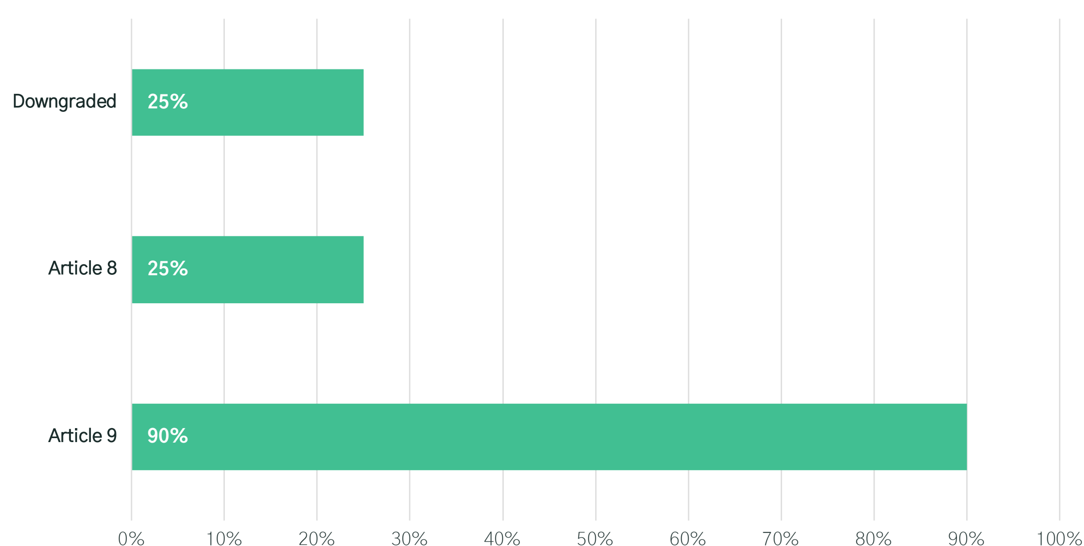
five of 20 Article 8 funds offer over 10% alignment to an individual SDG. Those five include all three thematic Article 8 ETFs. In the group of the 20 largest downgraded ETFs, the picture is the same: the only thematic ETF in this group also offers over 10% alignment to an individual SDG. In sum, all of the thematic ETFs we analysed offer over 10% alignment to an individual SDG.

Once again, on individual SDG alignment, the ETFs recently downgraded from Article 9 to Article 8 classification much more closely resemble Article 8 ETFs than the remaining Article 9 ETFs.

Chart 5

Individual SDG Alignment

ETFs with over 10% weighted revenue aligned with at least one individual SDG, percentage of ETFs, per classification



The difference between thematic strategies, Paris-aligned and ESG strategies is clear. **Alignment which is focussed on individual SDGs, rather than spread out in small percentages of revenue across multiple SDGs, indicates a deliberate thematic allocation towards pioneering companies that generate revenues from solutions that contribute to an environmental or social objective.**

Therefore, the introduction of Level 2 of SFDR has begun to split the EU sustainable ETF landscape along strategy lines, between solutions-focussed and broad-based ESG strategies. Interestingly, downgraded PAB and CTB benchmarks much more closely resemble classic ESG integration, rather than thematic SDG alignment profiles. This indicates that it is sensible to delineate between solutions-focussed strategies and those pursuing a different approach to sustainability. It would, however, be an oversimplification to say that because PAB and CTB ETFs more closely resemble ETFs

pursuing broader ESG strategies, then they belong in Article 8. They still pursue different strategies across different timescales. What it does show, however, is the potential for SFDR going forward to distinguish between funds with different approaches to sustainability which expose investors to different outcomes , even if it does not do so effectively across all different strategies yet. If it can do this, it will become a genuinely useful tool for fund managers to better understand the sustainability of ETFs.

Once again, however, we can see that the strategy split is not consistent, however, as thematic strategies with significant SDG alignment can be found in both pre-existing Article 8 and downgraded ETFs, while ETFs employing broad ESG strategies which do not offer focused SDG alignment can still be found in the Article 9 classification.

An overly discretionary approach to defining and calculating environmental/social objectives risks opening the Article 9 classification to funds which do not meaningfully pursue

Clear definitions and thresholds, combined with quality data, could help convert this stratification into a structured process for separating funds which pursue solutions-focussed impact, those which aim for Paris-alignment, and those which 'promote ESG characteristics'. An overly discretionary approach to defining and calculating environmental/social objectives, however, risks opening up the Article 9 classification to funds which do not meaningfully pursue sustainability objectives, and the potential risk of greenwashing that accompanies this. **Therefore, there is a need for evidence-led minimum thresholds which do not exclude funds that are making meaningful attempts to pursue sustainability objectives, whilst being stringent enough to successfully delineate between funds pursuing different sustainability strategies. Revenue-alignment thresholds are one way of doing this for solutions-focussed strategies, just as emissions reductions strategies are for Paris-aligned strategies.** Currently, however, SFDR Article 8 and 9 classifications are not sophisticated enough to account for these differences.

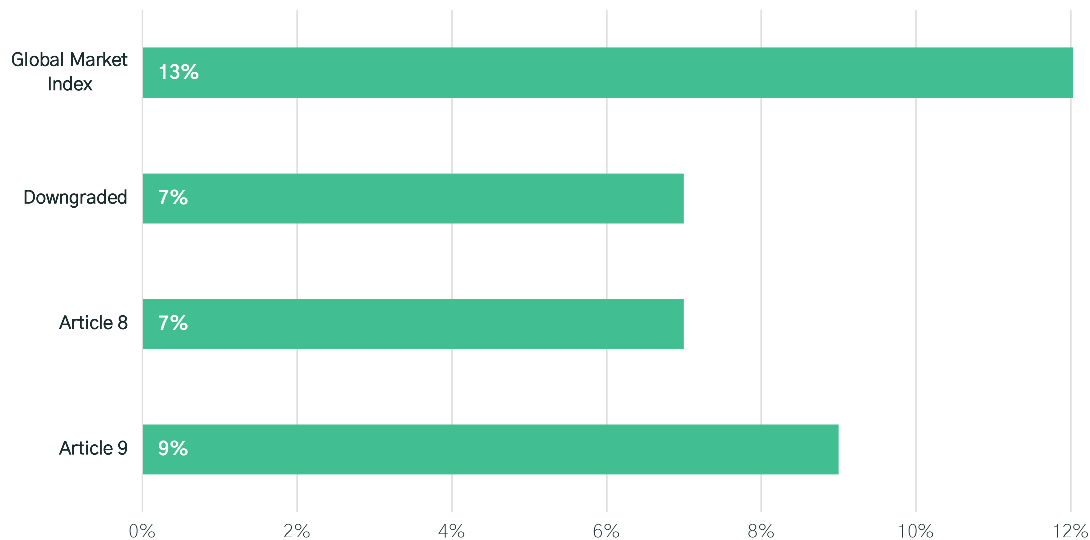
If SFDR were to adapt to this reality, **it would help investors in these funds to better understand what they are investing in from a sustainability perspective, whilst stopping short of being a label for sustainability. The impact on capital markets and the real economy could be substantial.**

Overall SDG Misalignment

Chart 6

Overall SDG Misalignment

Average ETF SDG misalignment at aggregate SDG level, percentage average weighted revenue misalignment



Greater Article 9 misalignment reveals 'Do No Significant Harm' complexity

The definition of 'sustainable investments' under SFDR states that an investment is sustainable so long as it contributes to an environmental or social objective, ***"provided that such investments do not significantly harm any of those objectives".***

Although Article 9 ETFs on average appear to expose investors to a higher level of SDG alignment than Article 8 ETFs, they also have slightly higher misalignment. This, similarly to both overall and individual SDG alignment, can be explained by the different characteristics of the three different strategy groups, namely solutions-focussed, Paris-aligned and broader ESG strategies. Pursuing a solutions-focussed approach often means investing in industries which are both part of the problem and the solution. For example, two of the 20 Article 9 ETFs focus on the Hydrogen Economy, meaning that they invest in energy companies that have significant alignment with SDG 7 – Affordable and Clean Energy, but also lower levels of misalignment with SDG 7 through assets which have not yet transitioned from fossil fuels. It is unclear, under SFDR, whether this would count as 'significantly harming' a sustainability objective, and therefore disqualify the ETF from classifying as Article 9.

The nuance of solutions-focussed investing should necessitate that 'Do No Significant Harm' definitions and thresholds take into account the different inherent characteristics that arise when

different approaches to sustainability are employed. It is for example easier to reduce harm from emissions if that core purpose of a fund is to do just that, whereas it might be much harder for a solutions-focussed ETF targeting the Materials industry, to avoid adverse impact in the same way.

In some cases, this report argues, higher levels of misalignment are likely to occur due to the thematic sustainable investment chosen. This is true only to an extent, however, and careful thresholds around misalignment still should be employed. For example, one of the twenty largest Article 9 ETFs, which focuses on food, exposes investors to 19% alignment with SDG 2, Zero Hunger, and 22% misalignment with the same SDG. Within this, there are SDG-aligned investments in a Nordic fish-farming business at the forefront of sustainable aquaculture, but also investments in a global fast food giant, which due to its nutrition profile is 100% misaligned with SDG 2. It is harder, in this case, to justify the harm in favour of the SDG alignment.

Similarly, to go back to the example of Hydrogen – investing in hydrogen is not just one thing. There are differences between 'green', 'brown' and 'blue' hydrogen which dictate whether the production of hydrogen is sustainable, or not, and therefore an approach which helps investors distinguish between solutions-focussed approaches which take all steps necessary to minimise harm, and those which do not, is important.

Essentially, funds with different approaches to sustainability require different treatment to account for their nuance

This again, indicates that there is a middle ground between a no tolerance approach to Do No Significant Harm with strict thresholds, and an approach which leaves the definition and calculation of DNSH up to fund providers, and therefore vulnerable to exploitation. **Essentially, funds with different approaches to sustainability require different treatment to account for their nuance.** The current debate over whether Paris-aligned funds should sit alongside broad ESG funds under Article 8 or solutions-focussed ETFs under Article 9, both of which would limit how tailored and targeted disclosure standards could be, indicates that SFDR must sophisticate in order to accommodate for the realities of sustainable investing. Only then will it become both an effective tool for disclosure, and a useful guide for investors looking to invest sustainably.

Is misalignment ever justified or inevitable? If yes, then how much and under which circumstances? How do you weigh misalignment against a chosen sustainability objective and broader misalignment? These are questions, in light of our findings, that regulators must provide a greater level of detail on. The development of the EU Taxonomy will provide some of these answers, but before it details both

environmental and social alignment criteria across all eligible industries, and companies report against these, more clarity in recommendations is needed. This also hinges upon whether EU Taxonomy activity alignment will be integrated into long term definitions of sustainable investment under SFDR, which the recent EC Q&A indicates a divergence from.

Principal Adverse Impacts

The previous section of this report highlighted the complexity underlying the 'Significant Contribution' and 'Do No Significant Harm' concepts under SFDR, depending on strategy and thematic focus employed by an ETF. In this section, this report further examines the concept of 'Significant Harm' by looking at the Principal Adverse Impacts of the 60 ETFs, utilising Matter's SFDR PAIs dataset.

Article 9 ETFs perform worse on majority of PAIs than Article 8 ETFs

Table B

SFDR PAIs

Average performance across 17 Mandatory SFDR Principal Adverse Impact indicators, per classification, varied units

PAI	Unit	Article 9	Downgraded	Article 8	Global Market Index
PAI 1.1 GHG emissions scope 1	Tonnes CO_2e / mEUR EVIC	44.8	18.0	21.8	46.1
PAI 1.2 GHG emissions scope 2	Tonnes CO_2e / mEUR EVIC	20.6	8.3	8.9	10.4
PAI 1.3 GHG emissions scope 3	Tonnes CO_2e / mEUR EVIC	721.6	293.1	319.4	444.0
PAI 1.4 Total GHG emissions	Tonnes CO_2e / mEUR EVIC	828.5	321.5	353.0	505.3
PAI 3 GHG emission intensity	Tonnes CO_2e / mEUR Revenue	1626.4	706.1	689.8	1237.9
PAI 4 Fossil fuel activities	Portfolio share	6%	6%	6%	12.4%
PAI 5.1 Non-renewable energy consumption	Share of non-renewable energy consumption	77%	73%	71%	70%
PAI 5.2 Non-renewable energy generation	Share of non-renewable energy production	43%	34%	36%	37.5%
PAI 6 Energy consumption intensity	Gigawatt hours annually / mEUR Revenue	0.4	0.3	0.1	0.3
PAI 7 Biodiversity risk	Portfolio share	9%	9%	8%	9%
PAI 8 Emissions to water	Tonnes / mEUR EVIC	0	0	0	0
PAI 9 Hazardous waste	Tonnes / mEUR EVIC	7.3	5.8	4.5	6.0
PAI 10 Human rights violations	Portfolio share	6%	10%	10%	13%
PAI 11 No human rights due diligence	Portfolio share	6%	11%	11%	12%
PAI 12 Gender pay gap	Difference between male and female average wages / male average wages	11%	18%	19%	16%
PAI 13 Board diversity (gender)	Share of non-male board members	28%	31%	30%	29%
PAI 14 Controversial weapons	Portfolio share	0%	0%	0%	1%

Surprisingly, but in line with our previous findings on misalignment, Article 9 funds, on average, have higher impacts on 12 of 17 PAIs than either the largest Article 8 funds, particularly when it comes to the environmental PAIs.

Again, the environmental underperformance of Article 9 funds can in large part be explained by the thematic focus of the ETFs. For example, the average Article 9 Total GHG emissions is more than double that of Article 8 ETFs, at 828.5 Tonnes CO2e, but within this, the ETF with the highest emissions generates 6614.5 tonnes, whilst the lowest emitter generates only 23.1 tonnes. Similarly to the example of misalignment, the highest emitter is a Hydrogen Economy ETF, with allocation in high emitting sectors which are also driving forward the hydrogen economy, whilst the lowest emitter focusses on Bionic Engineering. The deviation between emitters in downgraded ETFs is much less, with the lowest emitter generating 93.1 tonnes compared to the highest which generates 636.3.

Careful thought is required by regulators to account for differences in SFDR in a way that makes them clear and transparent for sustainable investors, whilst ensuring that avoidable harm does not occur

Similarly, the higher Hazardous Waste figure for Article 9 ETFs is almost entirely generated by one ETF, which is focussed on the circular economy.

Once again, this highlights how the sustainability strategy employed exposes investors to different sustainability outcomes. Careful thought is required by regulators to account for these differences in SFDR in a way that makes them clear and transparent for sustainable investors, whilst ensuring that avoidable harm does not occur.

Downgraded ETFs perform only marginally better on emissions, in comparison to pre-existing Article 8 funds, raising questions surrounding Paris-Aligned and Climate Transition Benchmarks

Funds which recently reclassified from Article 9 to Article 8 expose investors to considerably lower adverse impact PAIs which focus on emissions than Article 9 ETFs. This can be explained by the difference in strategy, with the 17 of the 20 downgraded ETFs tracking Paris-Aligned or Climate Transition Benchmark, which by definition can be expected to perform better on the PAIs focussed on emissions.

What is surprising is the minimal difference in environmental PAIs between the downgraded funds and the largest Article 8 funds. The downgraded funds have only marginally lower Scope 1, 2 and 3 emissions than ETFs pursuing broad ESG strategies under Article 8. This is the crucial area in which an outperformance might be expected between PAB/CTB funds and those pursuing a broad ESG strategy, and yet that big difference is not there. Additionally, downgraded funds expose investors to on average marginally higher GHG Emissions Intensity, Hazardous Waste and Emissions Consumption Intensity. From a high-level – albeit static – perspective, ETFs tracking PABs do not look considerably different when compared to conventional ESG strategies.

Overall, the average PAI performance across both environmental and social PAIs is very similar between the downgraded funds and the largest pre-existing Article 8 ETFs. This is interesting, because providers of Climate Transition and Paris-Aligned ETFs are among the voices calling for these to be classified as Article 9, but their sustainability characteristics, also on environmental metrics, hold a much closer resemblance to Article 8 ETFs which pursue broad sustainability characteristics. As such, Climate Transition and Paris-Aligned ETFs, although pursuing an important sustainability objective of decarbonizing the economy, deliver very different results when compared to solutions-focussed Article 9 ETFs.

Climate Transition and Paris-Aligned ETFs, although pursuing an important sustainability objective of decarbonizing the economy, deliver very different results when compared to solutions-focussed Article 9 ETFs

This indicates the need to delineate between them in the regulatory structure of SFDR. However, the recent guidelines from the European Commission pave the way for Paris-aligned ETFs to be classified as Article 9 alongside solutions-focussed ETFs, despite their considerable differences.[15]

Can all PAIs be applied equally?

Analysis of the PAIs of these 60 ETFs further demonstrates how the introduction of Level 2 of SFDR has, at the point of writing in April 2023, begun to create dividing lines between funds employing differing strategies, and with different sustainability characteristics.

[15] See 'SFDR moving forward' section for more

Solutions-focussed Article 9 funds generate greater overall alignment as well as focussed alignment on individual SDGs, but also in certain instances will expose investors to considerably higher adverse impact because of a thematic focus in areas where adverse impact is hard to avoid (although we cannot say for sure that the adverse impact we see in this analysis is unavoidable). Downgraded ETFs and the largest Article 8 ETFs both offer considerably lower environmental adverse impact than the average Article 9 ETF, **showing that the downgrades have clustered funds with similar static sustainability profiles together.** The downgrade however did not make a meaningful distinction between CTBs, PABs, and broader ESG strategies, which might look similar today, but are on different trajectories in terms of reducing emissions. The latest Q&A from the European Commission paves the way for the CTB and PAB funds to move to Article 9, but they risk carrying the confusion with them back into the Article 9 category, which will be harder for investors to understand.

These findings, in combination with findings on SDG misalignment, call for further iterations in setting a clear definition around what is considered as 'Do No Significant Harm', and relevant thresholds. **Similarly, nuance is required in considering thresholds for PAIs which take into account sustainability objectives and strategy, as different approaches hold inherently different PAI risks, which must be weighed against potential benefits involved.**

This poses complex problems for regulators as this complexity needs to be baked into disclosure and labelling rules to account for these realities, whilst also ensuring that funds are taking all possible measures to limit their PAIs. SFDR Article 8 and 9 classifications in their current form do not account for the material sustainability differences of the strategies analysed in this report.

Good Governance

The final element of qualifying as a 'sustainable investment' is ensuring that "*investee companies **follow good governance** practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.*"

Using Matter's Thematic ESG Flags, we have analysed Article 8, 9 and downgraded ETFs on four different areas of governance which, although not comprehensive, give an indicator as to whether the ETFs comply with SFDR's definition of 'good governance'. These four flags are:

1. **Controversial: Extreme Executive Pay –** For investors, extreme executive pay, especially in comparison to average employee compensation, can be an indicator of poor management structures.

2. **Controversial: High fines to revenue ratio** – This flags companies identified for having received a large amount of monetary sanctions. It can be an indicator of unsound governance, controversial business practice and increase investor risk.
3. **Controversial: Low Transparency – Tax Governance** – Tax governance is essential to good and compliant corporate governance. Companies that are transparent about their tax strategy can indicate lower reputational and regulatory risks by providing clear information on how and where they pay their taxes. Tax also plays a fundamental role in financing reduction of inequalities and sustainable initiatives. Therefore, tax governance transparency also reflects a company's commitment to societal responsibility and sustainable development.
4. **Beneficial: Overall Sustainability Linked Remuneration** – This flags companies with a mechanism in place to link compensation to the achievement of sustainability targets. This can increase long-term shareholder value, as well as sustainability, by rebalancing current emphasis on short-term targets in typical remuneration packages, and strengthen accountability on sustainability-related performance across management. For this reason, sustainability-linked remuneration is an indicator of how a company governs and assigns priority to sustainability issues.

Chart 7

High fines to revenue ratio

Average proportion of ETFs flagged for having high revenue to fines ratio, average percentage, weighted by portfolio allocation, per classification

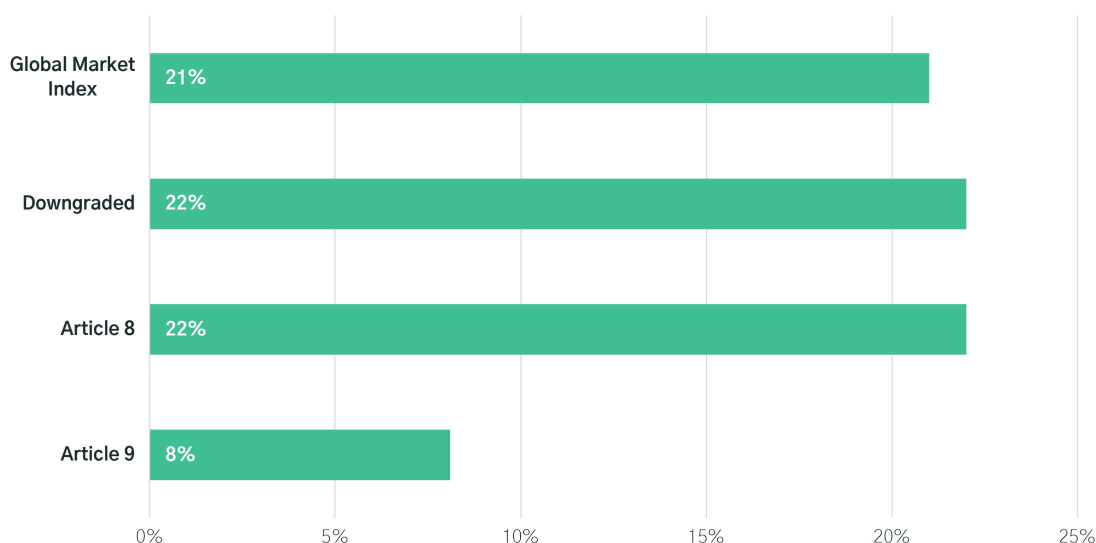


Chart 8

Extreme Executive Pay

Average proportion of ETFs flagged for having extreme executive pay, average percentage, weighted by portfolio allocation, per classification

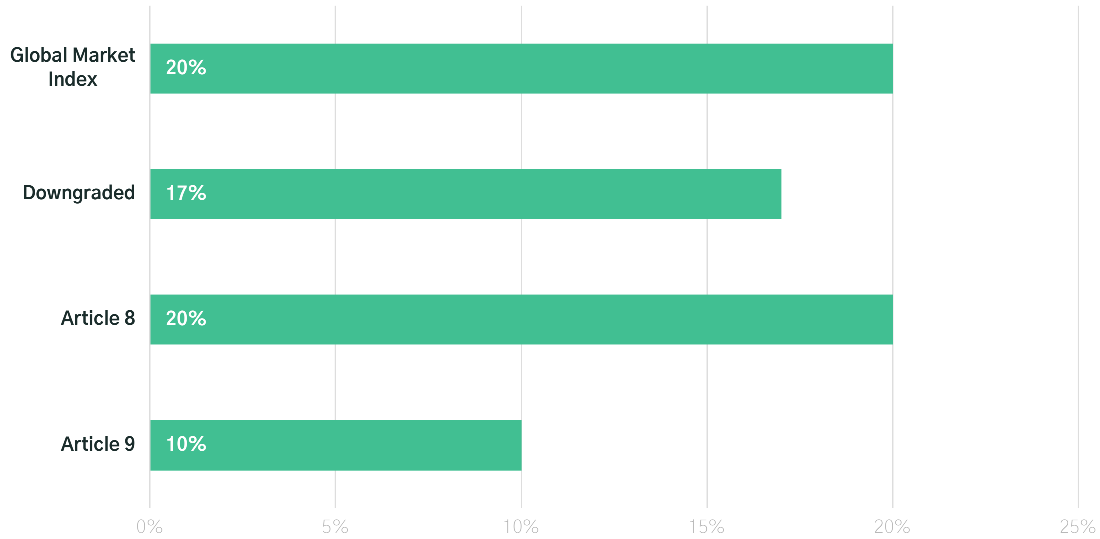


Chart 9

Low Transparency – Tax Governance

Average proportion of ETFs flagged for low transparency on tax governance, average percentage, weighted by portfolio allocation, per classification

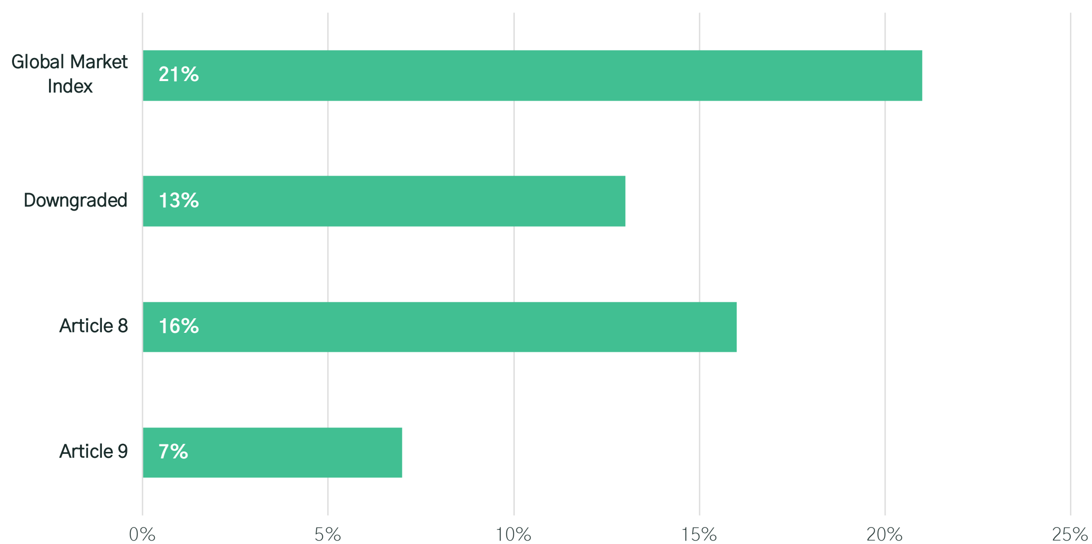
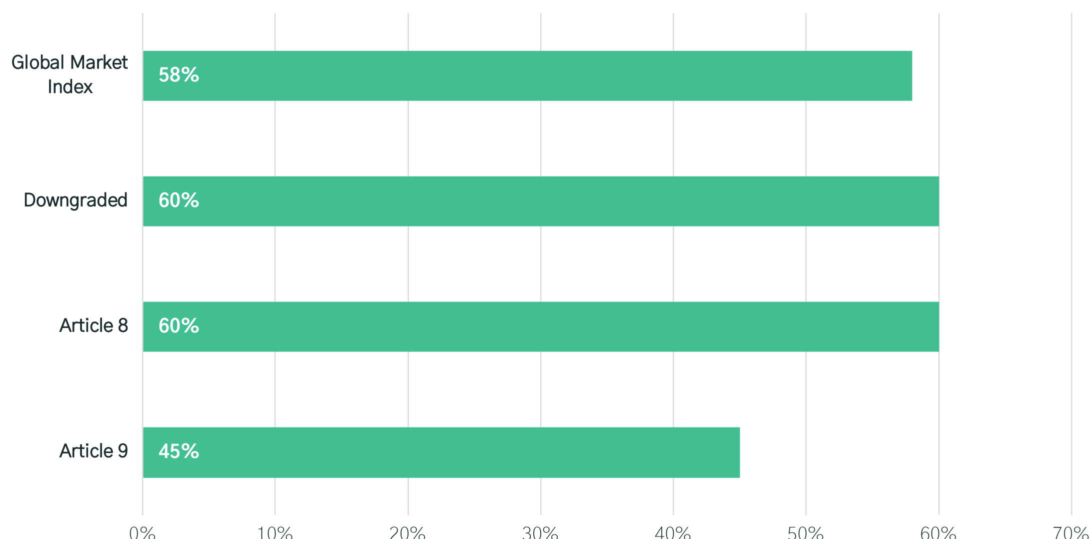


Chart 10

Overall Sustainability Linked Remuneration

Average proportion of ETFs flagged for having overall sustainability linked remuneration, average percentage, weighted by portfolio allocation, per classification



On the three ‘controversial’ governance flags, the pattern we have seen so far from analysing PAIs, SDG alignment and SDG misalignment continues, with Article 9 ETFs outperforming both downgraded and Article 8 ETFs, which expose investors to broadly similar governance risks.

This indicates that Article 9 funds are indeed more sustainable under the definition of sustainable investment outlined above, and is further evidence that SFDR Level 2 is, following the downgrades, demonstrating its potential to stratify funds with different sustainability profiles. The picture is complicated, however, when looking at Overall Sustainability Linked Remuneration, which shows both Article 8 and downgraded funds significantly outperforming Article 9 funds.

The definition is unclear on what exactly counts as ‘good governance’. Does it entail minimising the risks from poor governance, or actively taking steps to embed sustainability in governance structures? Similarly, 10% of the average Article 9 fund is flagged for Extreme Executive Pay. How much is too much? Once again, the pattern repeats. Article 9 ETFs, on the whole, appear more sustainable than Article 8 and downgraded ETFs. It is currently impossible for fund providers to know, however, whether their funds meet the definition of sustainable investment necessary to qualify as Article 9.

Suggestions by the EC that the definition of what counts as good governance and how to calculate it will be left to the discretion of FMPs is unlikely to help, as pick-and-choose definitions and thresholds can be applied to justify the classification of funds with considerably different performance on good governance issues as Article 9.

Once again, a middle ground needs to be found between overly-prescriptive, and overly-discretionary approaches, in order to systematise stratification into disclosure brackets based on differing approaches to sustainability.

SFDR moving forward

SFDR has the potential to formalise the difference between traditional investing, ESG investing and sustainable investing

The hope for SFDR was that it would lead sustainable finance out of a jungle of complexity, uncertainty and opacity into clarity and transparency. To an extent, the great reclassification demonstrates its potential to do just that. The recent Q&A from the European Commission risks diluting this potential, however.

The analysis in this paper shows that SFDR has created a successful divide between, in the first instance, financial products pursuing traditional investment logics (as indicated by the Global Market Index in this analysis), and Article 8 and 9 ETFs. ETFs under both classifications offer significant sustainability improvements,albeit in different ways, compared to a Global Market Index. This is to SFDR's credit.

Secondly, the introduction of Level 2 of the SFDR and the triggered reclassification of investment funds is a marker of its potential. By indicating that ambitious standards will need to be met in order to classify as Article 9, the Level 2 RTS has created rough dividing lines between funds which pursue a solutions-focussed sustainability objective under Article 9, and those with broader ESG characteristics and Paris-aligned ETFs under Article 8. Importantly, ETFs downgraded in the reclassification, many of which follow Paris-Aligned or Climate Transition Benchmarks, have strikingly similar sustainability characteristics (in terms of overall SDG alignment & misalignment, individual SDG alignment, and PAIs and good governance) to the largest Article 8 ETFs. This suggests an appropriate split between funds where the types of sustainability disclosures required are intuitively different.

We argue that it also speaks to a fundamental distinction between ESG investing and sustainable investing.

Simplistically, funds which 'promote ESG characteristics' employ a broader concept of sustainability which does not look to maximise positive impact, but instead prioritises responsible business practices which manage sustainability risks and harness sustainability opportunities relevant to a company's bottom line. This, on the whole, offers an improvement to the non-ESG status quo, but is not the same as 'sustainable investing'. Funds which 'sustainably

invest' pursue a specific sustainability objective as a core tenet of their strategy. Currently, SFDR has separated ETFs which allocate capital towards sustainable solutions, whilst taking all possible efforts to employ responsible practices and minimise harm across the operations of the companies they invest in.

PAB ETFs sit in an awkward middle-ground which SFDR currently does not adequately cater for, as the next section discusses. Their method of sustainable investment, when looked at from a static perspective, however, much more closely represents a rules-based, optimised ESG-integration process which prioritises the minimisation of adverse impacts, than it does a solutions-focussed approach, which in large part explains why their sustainability profiles, according to our data, are so similar.

In defence of PAB and CTB ETFs, it is important to note that they also pursue a crucially important sustainability objective, namely the overall decarbonisation and decoupling of emissions from growth. However, as discussed below, there is sometimes some distance between theory and practise for some PABs, and most of their sustainability credentials are based on an ability to deliver emission reductions in the future, although their vantage point does not look much different than a classic ESG-fund. The question is therefore whether or not SFDR Article 9 is the right classification for these products, or if SFDR needs to incorporate more nuances?

What the EU has begun to do with the introduction of Level 2 of SFDR is to formalise the divide between solutions-focussed funds and those with broader ESG characteristics. This shows its potential as a force for greater clarity in an industry where previously an absence of labelling, classification or disclosure rules meant that funds exposing investors to wildly different sustainability outcomes could present themselves as similar, or the same, and telling them apart was a laborious and uncertain process, even for sophisticated investors.

It is early days, and this split is simplistic, and does not yet account for the enormous complexity within both 'sustainable investing' and 'ESG', especially in terms of how to distinguish between Paris-aligned and solutions-focussed strategies. It is a good start, however, and a sorely needed grain of hope.

The recent Q&A from the European Commission, allowing for discretionary definitions and calculations of sustainability, seems to do more to help the fund managers (although indeed needed) than it does to help guide the end investor. The announcement that PAB and CTB tracking ETFs can qualify as sustainable under Article 9 of SFDR might have provided a meaningful expansion of what is

defined as a sustainability objective, but it has also stretched the Article 9 classification to include more approaches, whose differences will not be clear to the individual investor.

Paris-aligned benchmarks are the fly in the ointment

As described above, the issue of Paris-Aligned Benchmarks has caused some confusion in the market. PAB and CTB tracking ETFs drove the reclassifications amidst confusion surrounding SI definitions. Inadvertently, this separated them from thematic ETFs exposing investors to sustainable solutions, and aligned them with Article 8 ETFs with much more similar sustainability profiles. The recent clarifications posed by the European Commission, assumed to be in response to the downgrades and accompanying criticism, suggest that PABs can be defined as sustainable under Article 9 of SFDR, ushering in the possibility that many downgraded ETFs will now reclassify as Article 9 once again.

The potential inclusion of PABs and solution-focussed ETFs in the same classification poses some challenges as they have different roles in driving a sustainable transition. PAB Indexes are required, from the outset, to achieve 50% lower emissions than the baseline index, and then follow a 7% year on year reduction pathway from that point forward. To achieve this trajectory, Tom Steffen of Osmosis Investment Management argues that "Paris Aligned Benchmarks are currently forced to actively under-weight high impact sectors, such as Energy, Materials, and Utilities as a whole."[16]

As one index provider explained, "Today, 90% of the world's public companies have an Implied Temperature Rise of above 1.5°C, making it exceedingly difficult for a diversified index, including a Paris Aligned Benchmark, to have an ITR of 1.5°C or 2°C at this point in time." Steffen argues that this generates a "clear decoupling between the real economy and Paris Aligned Benchmarks… If we are to achieve the 1.5°C target, we need to incentivise the worst polluting sectors to change. This can only be achieved by penalising the environmental laggards in each sector. Divestment of whole sectors does not only remove the option to shift capital to transitioning companies, it also removes the ability to effect change through active engagement. We need to hold companies accountable across the economy, even if that requires renouncing the prescribed 7% year-on-year emissions reductions at times."

[16] Steffen, T - Osmosis Investment Management.: "Paris (mis) Aligned Benchmarks"; on https://www.osmosisim.com/paris-aligned-benchmarks/

The inverse of this, as we have seen, can be solutions-focussed ETFs. They consistently outperform on focussed SDG alignment, but at the same time risk exposing investors to higher adverse impacts both in terms of SDG misalignment and environmental PAIs. As this report has shown, this is often because they are exposing investors to high impact sectors which are transitioning, such as the hydrogen economy, or agriculture.

PABs therefore are an important tool for driving a Paris-aligned future, playing a crucial role inoverall decarbonisation and decoupling of emissions from growth. Given their limitations in terms of allocation, however, they are only a small part of what will make a long-term sustainable *real* economy. One could argue that this is unimportant in the context of Article 9 if SFDR's role is to place disclosure requirements on funds pursuing a sustainability objective of any kind, including decarbonisation.

However, given their popularity among ETF providers and investors, PABs risk once again dominating the Article 9 landscape, as they did before the Great Reclassification, where they made up the majority of the 20 largest Article 9 ETFs by AUM. The reclassification meant a net outflow of AUM from downgraded funds, and a net inflow of AUM to article 9 funds – including thematic, solutions-focussed funds. In other words, the SFDR classification of a fund matters, and until the reclassification, the majority of the AUM in the Article 9 classification flowed into the PAB and CTB ETFs.

> SFDR (...) must adapt to acknowledge that Paris-aligned and solutions-focussed approaches, whilst both pursuing valid sustainability objectives, do so in materially different ways

More PAB ETFs in Article 9 could make it difficult for thematic funds which prioritise investments in solution-focussed and transitioning industries to stand out, and potentially act as a disincentive for creating innovative sustainable ETFs moving forward. **Given the importance of ETFs that attempt to expose investors to high impact, high potential sectors and thematics, it is crucial that they have greater visibility and space to stand out, and not get lost at the bottom of a PAB-crowded Article 9 classification.**

Therefore, for SFDR to effectively formalise the distinction between traditional investing, ESG investing, and sustainable investing (described in the previous section), it must adapt to acknowledge that Paris-aligned and solutions-focussed approaches, whilst both pursuing valid sustainability objectives, do so in materially different ways, based on different theories of change, and therefore require different definitions and thresholds. Paris-aligned strategies pursue a

sustainability objective, and therefore should be distinguished from broad ESG strategies under Article 8. **However, treating them equally under the Article 9 classification equates to comparing apples and pears. Both are fruits, but very different fruits. In this scenario, their distinct contributions to a sustainable future cannot stand out to investors, and their contrasting approaches to sustainability dictate that focussed and tailored disclosure requirements cannot be effectively implemented.**

Usability vs. Usefulness

A repeated theme of this analysis is that different approaches to ESG and sustainable investing result in different sustainability outcomes, and therefore require different treatment in order to be useful for investors. This must be balanced, however, with a need to ensure that SFDR is easily understandable and usable from a fund manager perspective. A middle ground between an unattainable, overly-prescriptive approach to regulation, and an overly-discretionary approach is necessary in order to strike a balance between usability and usefulness.

Precision in what classifies as a 'sustainable investment' and standardised methods for calculation are required. Similarly, the data on SDG misalignment and PAIs shows that more clarity and nuance around the concept of Do No Significant Harm, and accompanying minimum standards, would also be beneficial. A simplistic 'higher is worse' approach to understand SDG misalignment and PAIs fails to account for the complexities of sustainable investment. Thematic investing, for instance, sometimes means investing in industries which are transitioning from being part of the problem to part of the solution, and in which there will often be unavoidable tradeoffs. The same applies to good governance principles, where overall trends in favour of Article 9 funds are detectable, but there is no way to determine when good governance is good enough.

> A middle ground is necessary in order to strike a balance between usability and usefulness

Essentially, up until now, it has been impossible for fund providers to know whether their funds comply with any of the three core elements of sustainable investing, 'sustainable contribution', 'Do No Significant Harm', and 'good governance'.

With the recent Q&A from the European Commission, the definition of 'contribution to environmental or social objective', 'DNSH' and 'good governance', as well as calculation methodologies, will all be, within reason, at the discretion of the fund providers. This risks moving too far in the other direction,

and prioritising usability of the Article 9 classification, whilst sacrificing clarity between different fund types.

The Commission's guidance means that achieving 'only sustainable investments' has gone from being completely unattainable to so broad and subjective as to undermine its quality and usefulness. This paper has shown how different calculation methodologies can make all the difference when meeting sustainability thresholds. **Similarly, opening definitions up to the discretion of fund providers means that claims of greenwashing that have plagued SFDR today are at serious risk of continuing.**

Definitions and thresholds must be consistent and clear for investors, but also usable for fund providers

The ongoing broad review of SFDR is critical to its long-term success. Definitions and thresholds must be consistent and clear for investors, but also usable for fund providers, taking into account different strategies and objectives in the short-term, whilst working towards further sophistication in the longer-term. This report has shown that the evidence is there to enable a balanced approach which maximises both usability and usefulness.

Balancing usability and usefulness is a hard task, especially in the face of data gaps, intangibles, and vested interests. These difficult questions must be considered proactively, however, to anticipate regulatory challenges before they arise – not long after. It was foreseeable, for example, that self-classification without clear guidelines would be used by some as a marketing tool.

The good news is that the EU has taken major steps in the right direction so far, and the market continues to demand more guidance, demonstrating good will and a desire for SFDR to provide direction and succeed.

The labelling vacuum

The analysis in this report suggests that SFDR *has the potential to* effectively stratify funds by sustainability profile and place appropriate disclosure requirements upon them.

In the best case, SFDR becomes a guide, pointing investors in the right direction of what to look for to determine sustainability. If tighter definitions and minimum thresholds for inclusion are introduced,

as the AMF in France is suggesting[17], then Article 8 and 9 will move towards being labels that offer some kind of sustainability judgement. These minimum thresholds, if implemented, will indicate exactly that, however – a minimum level of sustainability. Their role will be to facilitate an effective disclosure framework, ensuring that SFDR classifications are not exploited, by making sure that only companies demonstrably pursuing sustainable investments are included.

This case may be enough for sophisticated professional investors with the know-how and resources to follow the trail set out by SFDR to understand the sustainability of financial products, compare them against each other and so on. It will not be enough for the retail investment market, however, who cannot be expected to do this leg work, and therefore remain vulnerable to mistaking one sustainability objective with another.

There is a labelling vacuum therefore, where SFDR cannot and should not be the ultimate answer at this time, but where something else is needed.

The ESMA issued a new consultation on labelling in November 2022, which attempted to provide some insight on fund labelling. They clarified that a fund with any ESG-related words in its name would have to have a minimum proportion of 80% of its investments being used to meet environmental or social characteristics. Further, a fund using the word “sustainable” or any other term derived from the word “sustainable” in its name would need to allocate 50% of this 80% towards sustainable investments as according to SFDR definitions.

This has two central issues. Firstly, it falls foul of the same definitional issues as SFDR, as it is informed by the definition of sustainable investments under SFDR. This means that a ‘sustainable’ label could be informed by hugely different definitions of sustainability and calculation methodologies, exposing investors to different sustainability outcomes regardless of thresholds. Secondly, many funds pursuing sustainable objectives in this report do not use the term ‘sustainable’ or ‘ESG’ in their names, meaning that they would be excluded were ‘ESG’ and ‘Sustainable’ labels to be used as an indicator for sustainability.

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[17] AMF, The Sustainable Finance Disclosure Regulation – the AMF proposes a targeted review to include minimum environmental criteria. https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/sustainable-finance-disclosure-regulation-amf-proposes-targeted-review-include-minimum-environmental

Therefore, beyond the discussion surrounding SFDR, conversations must continue to be had at the regulatory level on how best to guide retail investors.

Quality data enables proactive and efficient regulation

Regulators depend on the industry to interpret regulation in transparent ways and disclose coherently, which requires that buy- and sell-side gain access to data that is more easily understood and communicated across the investment value chain.

Portfolio managers and ESG teams, for example, need more clearly defined evidence-led thresholds for 'contributions to sustainable objectives', as well as what level of 'harm' it might be reasonable to expect in Article 9 funds. And this must be provided by transparent data that can be thoroughly assessed and understood – not proprietary rating methodologies. At the end of the day, fund creators must be able to defend their decisions internally in their organisations, as well as towards clients and regulators, and this requires that they be equipped with better data to measure, for example, significant contribution in a transparent and easily-communicated way.

Rather than minimising the role of third-party insights providers, regulators and insights providers must have a mutually reinforcing relationship to support the regulatory requirements. Just as the EU regulates financial institutions and companies, whilst also consulting them as part of the process, so should they work with third-party insight providers to both ensure that they are operating responsibly, whilst also attempting to harness their unique insights. Quality data by itself is no replacement for regulation, and regulation is limited without quality data.

Conclusion

The ‘great reclassification’ of funds from Article 9 to Article 8, brought about by the introduction of Level 2 of SFDR, has exposed some interesting truths about the EU sustainable fund landscape.

By claiming that a fund needed to contain ‘only sustainable investments’ in order to be classified as Article 9, swathes of ETFs, driven by those tracking Paris-aligned and Climate-transition benchmarks, downgraded in response to regulatory risks stemming from a lack of clear definitions on how to define and calculate ‘sustainable investments’. This led to a significant reallocation of assets between funds.

The ‘great reclassification’, although somewhat inadvertently, shows SFDR’s potential. In this report we analysed 60 ETFs: the 20 largest Article 9 ETFs, the 20 largest Article 8 ETFs (before the ‘great reclassification’), and the 20 largest ETFs which were downgraded from Article 9 to Article 8. Using Matter’s data, we analysed them on the three core tenets of the Article 2(17) definition of sustainable investment under SFDR, environmental or social contribution (using SDG alignment as proxy), Do No Significant Harm (using SDG misalignment and SFDR PAIs), and good governance (using Matter’s Thematic ESG Flags).

The results of this analysis show that the downgrades have stratified the sustainable ETF landscape along strategy lines. The Article 9 classification, which at the time of writing was cleared of the majority of Paris-aligned ETFs, consists largely of thematic ETFs pursuing what we call a ‘solutions-focussed’ approach. These ETFs achieve high levels of overall SDG alignment, as well as focussed alignment with individual SDGs, indicating considerable contribution to environmental and social objectives. Interestingly, however, on average, Article 9 ETFs expose investors to higher levels of SDG misalignment and environmental PAIs than either downgraded or pre-existing Article 8 ETFs (and in some cases, even the Global Market Index), whilst outperforming on governance. This underperformance can largely be explained by a small proportion of Article 9 ETFs with a thematic focus on higher-impact, transitioning industries.

Funds downgraded from Article 9 to Article 8, in contrast, offer a striking resemblance to pre-existing Article 8 funds, compared to Article 9 funds. Downgraded and Article 8 funds on average expose investors to almost identical SDG alignment and SDG misalignment, both exposing investors to considerably lower SDG alignment than Article 9 funds, indicating that they do not pursue a ‘solutions-focussed’ approach in the same way.

Currently, the downgrades mean that SFDR divides between funds which pursue a solutions-focussed approach to sustainable investment (Article 9) and those which employ a broader approach to ESG, as well as ETFs pursuing Paris-aligned strategies (Article 8)), which from a static perspective, appear to offer a greater focus on emissions reduction and impact minimisation.

This, although an effective short-term division, overlooks the differences between ESG ETFs and Paris-aligned ETFs. Paris-aligned ETFs, unlike ESG ETFs, pursue an environmental or social objective as defined under Article 9 (in their case, decarbonisation and emissions reductions). This has led to widespread clamour that Paris-aligned ETFs should be legitimised for Article 9 classification. However, across all aspects of sustainability, this report has shown their differences from solutions-focussed funds.

Nonetheless, the recent downgrades, according to our analysis, highlights that SFDR can be a tool to formalise fundamental distinctions between traditional investing, ESG investing, and sustainable investing. SFDR in this sense has the potential to be a powerful force for increased clarity and transparency in the European sustainable fund landscape.

SFDR can be a tool to formalise fundamental distinctions between traditional investing, ESG investing, and sustainable investing

However, the stratification brought about by the downgrades, although demonstrative of SFDR's potential, was in reality a symptom of a lack of clear guidance within SFDR, resulting in inconsistent Article 8 and 9 classifications. Solutions-focussed ETFs exist in both downgraded and Article 8 categories and while Paris-aligned ETFs remain in the Article 9 category because the Level 2 RTS was introduced without clear definitions on what was meant by 'sustainable investing' and how to calculate it. In absence of this, the downgrades were the process of some fund providers deeming the regulatory risk of being deemed to not meet the 'only sustainable investments' assertion high enough to downgrade, with others holding out for further clarification.

A lot rests on the regulator's next moves, therefore. In one scenario, it can move to formalise this distinction between traditional investing, ESG investing, and sustainable investing by implementing clear but achievable definitions and minimum thresholds for 'sustainable investing'. This could be done whilst also working to nuance the regulation to account for the fact that Paris-aligned and solutions-focussed strategies, although both pursuing sustainability objectives under Article 9

definitions, do so in materially different ways that necessitate independent definitions, thresholds and disclosure requirements in order to allow them to stand apart from each other.

In reality, the recent Q&A issued by the European Commission suggests a move in the other direction. Under the new guidance, the definition and calculation of the three core tenets of 'sustainable investing' will be left to the discretion of fund providers. In addition, it also suggests that ETFs tracking PAB ETFs will be able to qualify under the definition of sustainable investment, but does not suggest adapting the Article 9 classification to account for their differences in strategies.

This approach, although correct in recognising that achieving a sustainable future requires many different approaches to sustainability, risks missing a golden opportunity for SFDR.

By pursuing an over-discretionary approach, SFDR risks entrenching many of the problems it has faced to date. The Article 9 classification, rather than being a tool for clarification between funds based on their approach to sustainability, by resting on discretionary definitions of sustainable investments, risks being diluted. Differing definitions and calculation methodologies, this paper has shown, risks Article 9 including funds which expose investors to wildly differing sustainability outcomes, without clear ways to distinguish between them. **This not only undermines consistency and comparability for investors, but also exposes the classification to the same risks of greenwashing it has faced in the past.**

The ongoing broad review of SFDR is a crucial opportunity to pursue a middle ground approach which strikes a balance between usability for fund managers and usefulness for investors looking to invest sustainably.

In addition, legitimising the inclusion of ETFs tracking PABs and CTBs under Article 9, without introducing clear mechanisms to define between them and highlight their different respective strengths and weaknesses, risks Paris-aligned ETFs once again dominating the Article 9 classification, as they did before the downgrades. This makes it difficult for solutions-focussed funds to stand out, and at worst acts as a disincentive for creating innovative sustainable ETFs moving forward.

It is not too late, however. The ongoing broad review of SFDR by the European Commission is a crucial opportunity to pursue a middle ground approach which strikes a balance between usability for fund managers and usefulness for investors looking to invest sustainably. This paper demonstrates that the data is there to facilitate such an approach. If this can be realised, SFDR has the potential to shape the sustainable finance market in a way that is

systematic and transparent, placing appropriate disclosure requirements on different funds types, whilst acting as a guide for investors who want to know where to look next to understand the sustainability of investments.

Appendix

List of all PAIs included in the analysis

PAI 1.1 GHG emissions scope 1: Tonnes Scope 1 CO_2e emissions / mEUR EVIC

PAI 1.2 GHG emissions scope 2: Tonnes Scope 2 CO_2e emissions / mEUR EVIC

PAI 1.3 GHG emissions scope 3: Tonnes Scope 3 CO_2e emissions / mEUR EVIC

PAI 1.4 Total GHG emissions: Tonnes CO_2e emissions / mEUR EVIC

PAI 2 Carbon footprint: *Excluded from analysis* [18]

PAI 3 GHG emission intensity: Tonnes CO_2e emissions / mEUR Revenue

PAI 4 Fossil fuel activities: Portfolio share of companies involved in Coal Activities, Oil & Gas Activities, Financiers of fossil Fuels, Natural Gas or Coal Utilities

PAI 5.1 Non-renewable energy consumption: The share of energy that portfolio companies consume from renewable energy sources compared to non-renewable energy sources, weighted against portfolio allocation.

PAI 5.2 Non-renewable energy generation: The share of energy a company generates from renewable energy sources compared to non-renewable energy sources, weighted against portfolio allocation.

PAI 6 Energy consumption intensity: The ratio of energy consumption relative to the revenue of companies per high impact climate sector. Gigawatt hours annually / mEUR Revenue

PAI 7 Biodiversity risk: Portfolio share of companies operating near or in biodiversity-sensitive areas which are negatively affected by their activities.

PAI 8 Emissions to water: Tonnes of emissions to water generated by companies, per million EUR invested, weighted against portfolio allocation. Tonnes / mEUR EVIC

PAI 9 Hazardous waste: Tonnes of hazardous waste and radioactive waste generated by companies, per million EUR invested. Tonnes / mEUR EVIC

PAI 10 UNCG principles or OECD guidelines violations: Portfolio share of companies involved in violations of the UNGC principles or OECD Guidelines for Multinational Enterprises.

PAI 11 No due diligence to comply with UNCG principles or OECD guidelines: Portfolio share of companies without policies to monitor compliance with the UNGC principles or OECD Guidelines for

[18] PAI 2 requires information about the current value of all investments and has therefore been excluded from the analysis. The numerator of the PAI equation is however the same as with PAI 1.4, as both measure greenhouse gas emissions.

Multinational Enterprises or grievance/complaints handling mechanisms to address violations of the UNGC principles or OECD Guidelines for Multinational Enterprises.

PAI 12 Gender pay gap: The average unadjusted gender pay gap of companies, weighted against portfolio allocation.

PAI 13 Board diversity (gender): The average ratio of female to male board members.

PAI 14 Controversial weapons: Companies involved in the manufacture or selling of controversial weapons, including anti-personnel mines, cluster munitions, chemical weapons, biological weapons and nuclear weapons.

Key Terms & Abbreviations

- **Article 8 (SFDR classification):** classification for investment products which promote (among other characteristics) environmental and/or social characteristics
- **Article 9 (SFDR classification):** classification for investment products which have a sustainable investment objective
- **AUM:** Assets Under Management.
- **CTB (Climate Transition Benchmark):** Market index based on companies that are aligned with the Paris Agreement. Does not necessarily exclude companies involved in Coal, Oil & Gas Exploration.
- **DNSH:** Do-no-significant-harm. Term used under SFDR article 2(17) to define sustainable investments, specifically their obligation to avoid doing significant harm to any sustainability objective.
- **EC:** The European Commission.
- **ESG:** Environmental, Social & Governance.
- **ESMA:** European Securities & Markets Authority.
- **ETF:** Exchange Traded Fund.
- **EU SFDR (SFDR):** The European Union Sustainable Finance Disclosure Regulation.
- **EU SFDR PAIs (PAI):** Principle Adverse Impact. Indicators of sustainability that e.g. fund managers must disclose against under SFDR.
- **EVIC:** Enterprise Value Including Cash (Market capitalisation + Issued Debt + Cash).
- **FMP:** Financial Market Participant.
- **GHG emissions:** Greenhouse Gas emissions.
- **Level 1 (SFDR Level 1):** SFDR Level 1 was implemented in March 2021 and required fund managers to classify their existing funds according to Articles 6, 8, or 9.

- **Level 2 (SFDR Level 2):** SFDR Level 2 was implemented in January 2023. It requires managers to disclose more detailed information and reinforce their initial classifications.
- **mEUR:** Million Euro.
- **PAB (Paris-Aligned Benchmark):** Market index based on companies that are aligned with the Paris Agreement. Excludes companies involved in Coal, Oil & Gas Exploration.
- **Q&A:** Question & Answers, in this context referring to guidance published by the European Commission in response to questions on how to interpret SFDR Level 2.
- **RTS (SFDR Level 2 RTS):** Regulatory Technical Standards – a first draft of the SFDR Level 2 disclosure requirements published in 2021. Has been followed up by several redrafts and Q&As.
- **Scope 1:** Greenhouse gas emitted directly from the operations of a company.
- **Scope 2:** Greenhouse gas emitted indirectly from the production of electricity consumed by a company.
- **Scope 3:** Greenhouse gas emitted up- and downstream in a company's value chain.
- **UCITS:** Undertakings for Collective Investment in Transferable Securities is the main European framework covering collective investment schemes.
- **UN SDGs (SDGs):** United Nations Sustainable Development Goals.

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Matter is a financial technology company specialising in the provision of sustainability insights to the financial industry, based in Copenhagen. Matter offers a wide range of data and solutions which enable some of the world's largest asset managers to better understand the sustainability of their investments, beyond ESG ratings. Matter uses the power of collective intelligence and pioneering technology to provide insights which are granular, transparent and accountable, representing the real-world impact of investments, aligned to leading regulatory and industry-led frameworks, including SFDR and the United Nations Sustainable Development Goals.

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