Eurosif

EU Sustainable Finance & SFDR: making the framework fit for purpose

Eurosif Policy Recommendations for Article 8 & 9 product labels

June 2022

Eurosif Policy Recommendations
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Policymaker Summary

The purpose of this report is to account for developments in the EU market for investment products since the application of the Sustainable Finance Disclosure Regulation (SFDR) and recommend adjustments to ensure the framework can be adapted to the use the market has made of it.

Policy recommendations

- **Disclosure framework used as a standard – making it fit for this role** - If SFDR is used by market participants as a product classification system, it reflects a need for such a framework. SFDR should be adjusted accordingly to fulfil this need. To achieve this, a clearer delineation between product categories is required to ensure that Financial Markets Participants (FMPs) can classify their investment products appropriately and in a manner that clearly conveys the characteristics of the product. These recommendations should be interpreted as Eurosif's contribution to the development of minimum requirements for products complying with Article 8 and 9 SFDR, as foreseen in the European Commission Strategy "Financing the Transition to a Sustainable Economy".[1]

- **Introduce a new category of products focussing on sustainability risks and opportunities** - A clear distinction must be made between financial products taking into account sustainability-related risks and opportunities, focussing on financial materiality, and financial products integrating sustainability considerations at the heart of their investment process, either simply through some environmental or social characteristics, or taking a more holistic approach to sustainability through a Do No Significant Harm (DNSH) lens. This can be done by adding a new article to the legislation or amending the existing Article 6 SFDR on sustainability risks.

- **Clarify 'promoting Environmental and Social Characteristics'** - Amending Article 8 to clarify that this category applies to products which can state and demonstrate the presence of binding environmental or social factors at the heart of the investment process, applicable to the entire investment portfolio. This could be achieved by referencing a subset of relevant Principal Adverse Impact (PAI) indicators as binding environmental and social characteristics in pre-contractual documentation depending on the objective of the product or strategy.

- **Clarify or remove the definition of 'Sustainable Investment'** - The definition of sustainable investment (Article 2(17) SFDR) currently leads to complications because there is no clear way of identifying and calculating which company qualifies as a sustainable investment, leading to a lack of comparability due to diverging interpretations. Currently there are two frameworks, SFDR and the EU Taxonomy, to define the notion of sustainability. This creates a complex duplication which is hard to apply uniformly across FMPs and will make comparability across products challenging. We recommend two options:

    - **Option 1** - Developing in further details a methodology that would allow FMPs to calculate in a similar way their share of sustainable investments. The advantage is that it will further refine a meaningful KPI applicable to a large share of investments. The risk is that it may show some duplication with the EU Taxonomy and be difficult to properly articulate in a way that makes it fully comparable.

    - **Option 2** - Removing the definition or aligning it with the definition of sustainable economic activity (Article 3 Taxonomy Regulation). This would require modifying or clarifying existing Q&As on Article 9 SFDR and Article 6 Taxonomy Regulation in relation to the use of data. It may simplify operationally the application of regulation and remove a criterion which may be hard to compare. However, it carries the risk that FMPs will be left with reporting on their alignment with the Taxonomy which currently covers only a limited share of the economy and therefore of investment portfolios.

- **The MiFID Sustainability Preferences delegated regulation** - If the SFDR is updated with the above recommendations and Article 2(17) is removed or aligned with Article 3 Taxonomy (sustainable economic activity) in line with Option 2, the MiFID II delegated regulation could be modified to remove criteria (b) on the share of sustainable investments.

1 European Commission, Strategy for Financing the Transition to a Sustainable Economy, July 2021, Action 1(e) eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390

- **Develop a set of voluntary labels at European level** - In the longer-term, we would recommend looking at the possibility of creating a set of European voluntary labels for financial products, seeking to define different levels of ambition, and providing a framework for investment strategies focussed on transition rather than on already sustainable economic activities.

The new classification of products would be along the following lines:

Why adjusting SFDR is necessary

In the absence of policy intervention at EU level to adjust SFDR, the classification of products in a rigorous way under SFDR will remain a challenging exercise for FMPs. The ambiguity of current SFDR product categories may expose FMPs to allegations of mis-selling if clients or national supervisors do not share their interpretation of SFDR provisions. This brings a significant reputational risk which may discredit the sustainable investing community, to the ultimate detriment of the sustainable finance agenda. Moreover, in the absence of EU intervention, national supervisors may have to intervene and provide clarifications in the context of their national market. This could lead to market fragmentation, hampering the cross-border distribution of sustainable investment products and forcing FMPs to adapt to different national standards. This would clearly not be a welcome outcome for the Capital Markets Union agenda pushed by the EU.

From a positive perspective, clearly delineating different SFDR product categories will enable FMPs to classify their investment products correctly and more consistently. Introducing minimum sustainability criteria for the different product categories would guarantee that sustainability-related claims and commitments are in line with the reasonable expectations investors can have. It will make the complex landscape of products and investment strategies hopefully clearer for investors and their advisors. In the longer term, introducing a regime of voluntary labels applicable to a wide range of investment products with differing sustainability characteristics and ambition levels might enable an even more granular approach to different investment approaches.

Introduction

The European Commission adopted the first action plan on financing sustainable growth in March 2018. The first action plan reflected an extraordinary level of ambition on the part of European policymakers to establish a regulatory framework that would facilitate private investment in sustainable economic activities. The progress made towards realising the action plan over the course of previous years has been remarkable, with many of the fundamental building blocks of sustainable finance framework having been put in place.

The Sustainable Finance Disclosure Regulation (SFDR) is one of these building blocks. It was introduced to bring transparency to the market for investment products with sustainability-related claims, enhance the comparability of products, enable investors to better understand the impact of their investment decisions, and channel capital towards more sustainable companies and activities. Eurosif and its members fully support these policy objectives and recognise the tremendous impact SFDR has had in raising awareness in the financial industry of the growing importance sustainability considerations should have in investment decisions.

The detailed disclosure requirements introduced by the Regulation have applied as of March 2021. Although SFDR was conceived of as a disclosure-based regulation, **we have seen many product manufacturers, asset owners and distributors use the categories of products in SFDR as a quasi-standard or proxy to make sense of the complex landscape of ESG, responsible and sustainable investing.** In this context FMPs have faced a number of **difficulties in interpreting and applying its provisions consistently. The interim conclusion is that the SFDR has increasingly been perceived and used as a product standard although it is ill equipped to fulfil this function currently.**

In particular, when classifying their investment products, market participants have used SFDR product categories as a common point of reference. This has, however, placed many market participants in a challenging position. SFDR provisions do not make clear how to qualify a product as Article 6, 8 or 9, or where the boundary between these product categories lies, forcing many market participants to classify and self-certify their own products.

The purpose of this report is to account for these developments in the EU market for investment products since the application of SFDR, describe the challenges that financial market participants (FMPs) have encountered, and recommend adjustments to ensure the SFDR can evolve to match the market reality. We also hope the report will prove useful to EU policymakers as they prepare for the evaluation of SFDR by the European Commission due by 30th December 2022, as per Article 19 of the Regulation.

The report is divided into three sections. The first section will provide an overview of the market trends in complying under SFDR. The second section will describe the challenges faced by market participants in applying current SFDR provisions. The third section will set out a number of recommendations for how SFDR should be adjusted to address these challenges. The recommendations reflect the state of Eurosif's thinking at the time of publication of this report on a very specific sub part of SFDR. Our thinking on possible adjustments to SFDR may evolve in the future and may encompass other parts of the SFDR framework not considered in the scope of this report.

Chapter 1
Market Overview

In this section we will provide a detailed overview of the market for investment products classified under SFDR. This will provide context for our discussion of the challenges FMPs have encountered in classifying their products, and our subsequent recommendations.

The market in Article 8 and 9 products

According to Morningstar data, as of 31st March 2022, **31.5%** of funds available for sale in the EU (excluding money market funds, funds of funds and feeder funds) were classified as either Article 8 (**27.9%**) or Article 9 (**3.6%**). In terms of assets, the two fund groups account for an even larger share of the EU universe at **45.6%** of assets. Article 8 products alone account for **40.7%** of assets with Article 9 products accounting for an additional **4.9%**. In terms of monetary value, the combined assets amount to **EUR 4.18 trillion**.

To improve their product offerings since the application of SFDR, many asset managers have enhanced existing strategies, reclassified funds and launched new products consistent with their interpretation of Article 8 and 9 requirements. In Q1 2022, 47% of new funds were launched as either Article 8 or Article 9 funds, with funds labelled as Article 8 or 9 having represented a significant share of new fund launches during each of the last 4 consecutive quarters.

A review of the Article 8 and 9 products on offer quickly reveals that approaches towards the classification of products in accordance with SFDR differ significantly, with some FMPs applying more stringent criteria than others. This reveals inconsistency in the market when it comes to classifying products in accordance with Article 6, Article 8 and Article 9.

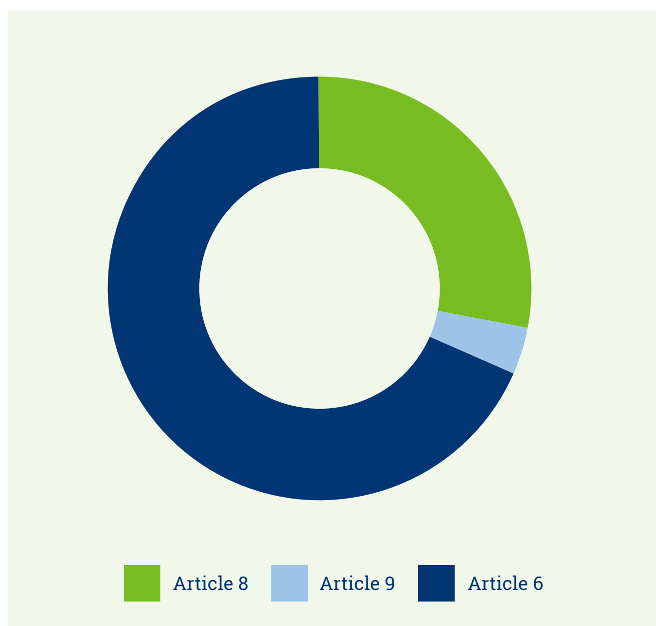

Figure 1 – Relative share of Article 8 and 9 products

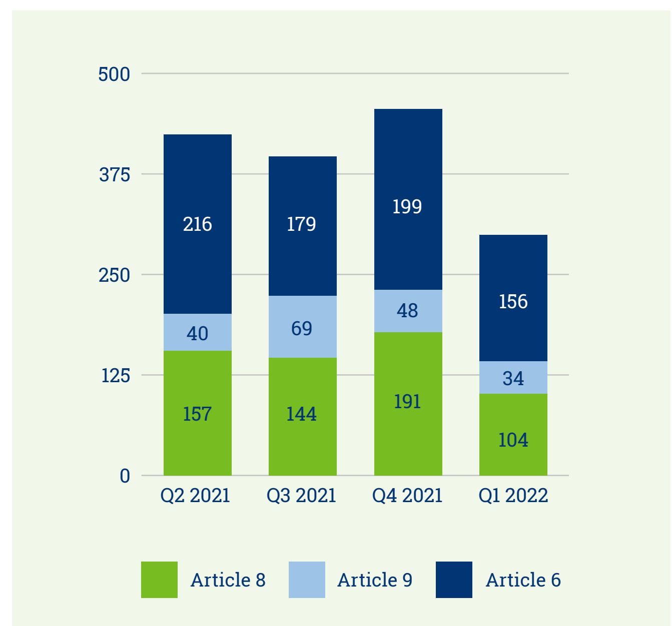

Figure 2 – Proportion of newly launched funds that are classified as Article 8 and 9

Source: Morningstar Direct. Data as of 31 March 2022. Based on SFDR data collected from prospectuses on 96% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

The full spectrum of Environmental, Social and Governance (ESG) strategies and approaches are applied, either solely or in various combinations, across Article 8 and 9 funds depending on their level of ambition and/or the prudence of the **FMP offering them. In many instances, FMPs have merely incorporated or (selectively) broadened the number of exclusions they apply to justify (re)classifying a product as Article 8 whereas for other FMPs such products limit themselves to disclosing on sustainability risks in line with Article 6 SFDR**. In other cases, a more rigorous approach combining exclusions, engagement and use of Principal Adverse Impact (PAI) indicators, ESG scores and other metrics have been used to qualify a product as Article 8.

With regard to Article 9 products, FMPs have tended to pursue more ambitious ESG strategies; such as 'Best-in-Class', 'Thematic' or 'Impact' investing, whereby capital is allocated to the companies with the strongest or improving ESG performance per sector. That said, the definition of 'sustainable investment' provided by Art. 2(17) has proven challenging for FMPs to apply in practice, with many FMPs developing internal framework to structure and evidence the process to determine whether a particular qualifies as a sustainable investment, effectively providing their own interpretation of a sustainable investment. Unsurprisingly, this has resulted in different interpretations, making it harder to compare products from different FMPs on this specific point.

Sectoral Exposures & fund holdings

In terms of fund holdings, over 17,230 companies are found in Article 8 and 9 portfolios. As many as 4,986 of these companies are present in both, representing an overlap of 29%. Despite this, there are important differences between the 'average' Article 8 and 9 products.

As shown, the product complying with Article 8 represents a significantly larger segment of the market than products complying with Article 9. They also tend to be more varied and heterogeneous in terms of their fund holdings. This is partly attributable to the broad spectrum of ESG approaches pursued by Article 8 products, from exclusions-only strategies to thematic investing. Consequently, Article 8 products have exposure to almost every company in the world's total market indices.

Stock	Sector	Number of Funds Owning the Stock	Average Portfolio Weight	% of Article 8 Funds Owning the Stock	Equity Style Box	ESG Risk Rating Assessment
Alphabet Inc	*Communication Services*	*485*	*2.8%*	*29%*	*Large Growth*	○○○
Microsoft Corp	*Technology*	*439*	*4.2%*	*26%*	*Large Growth*	○○○○
Novo Nordisk A/S	*Healthcare*	*384*	*2.5%*	*23%*	*Large Growth*	○○○
Roche Holding AG	*Healthcare*	*384*	*1.9%*	*23%*	*Large Blend*	○○○
ASML Holding NV	*Technology*	*377*	*3.0%*	*22%*	*Large Growth*	○○○○
Schneider Electric SE	*Industrials*	*358*	*1.7%*	*21%*	*Large Blend*	○○○○
Taiwan Semiconductor Manufacturing Co Ltd	*Technology*	*345*	*4.4%*	*20%*	*Large Blend*	○○○○
Alibaba Group Holding Ltd	*Consumer Cyclical*	*327*	*3.3%*	*19%*	*Large Blend*	○○○
SAP SE	*Technology*	*324*	*1.9%*	*19%*	*Large Blend*	○○○○
Sanofi SA	*Healthcare*	*313*	*1.9%*	*19%*	*Large Blend*	○○○
Astrazeneca PLC	*Healthcare*	*312*	*2.1%*	*18%*	*Large Growth*	○○○
Samsung Electronics Co Ltd	*Technology*	*310*	*3.2%*	*18%*	*Large Value*	○○○
Atlas Copco AB	*Industrials*	*301*	*1.8%*	*18%*	*Large Blend*	○○○○
Unilever PLC	*Consumer Defensive*	*300*	*1.7%*	*18%*	*Large Blend*	○○○
Tencent Holdings Ltd	*Communication Services*	*292*	*4.3%*	*17%*	*Large Growth*	○○○
Amazon.com Inc	*Consumer Cyclical*	*292*	*3.2%*	*17%*	*Large Growth*	○○
Allianz SE	*Financial Services*	*283*	*1.7%*	*17%*	*Large Value*	○○○○
L'Oreal SA	*Consumer Defensive*	*278*	*1.8%*	*16%*	*Large Blend*	○○○
Nestle SA	*Consumer Defensive*	*275*	*2.4%*	*16%*	*Large Blend*	○○○
LVMH Moet Hennessy Vuitton SE	*Consumer Cyclical*	*271*	*2.7%*	*16%*	*Large Growth*	○○○○

Figure 3 – Most commonly held in companies in Article 8 products

Source: MorningstarDirect. Data as of 30/06/2021

By comparison, the range of products complying with Article 9 is smaller and more homogenous. Accordingly, these products tend also to be more concentrated both in terms of their sectoral exposures and individual holdings.

For example, the most popular holding in products complying with Article 8 is Alphabet Inc., with approximately a third of such products having some exposure, with an average portfolio weight of 2.8%. By comparison, the most popular holding in Article 9 funds is Schneider Electric SE, with nearly half (45%) of Article 9 products having some degree of exposure to the industrial company.

Consistent with their sustainable investment objective, Article 9 products typically invest in companies that provide solutions or already exhibit strong ESG credentials. For example, 76% of Article 9 products have at least 5% exposure to companies providing carbon solutions.

Logically, this determines their holdings, which tend to be in the **industrial, technology and healthcare sectors** (see fig. 4).

Stock	Sector	Number of Funds Owning the Stock	Average Portfolio Weight	% of Article 9 funds owning the stock	Equity Style Box	ESG Risk Rating Assessment
Schneider Electric SE	*Industrials*	*123*	*2.3%*	*45%*	*Large Blend*	OOOO
ASML Holding NV	*Technology*	*100*	*2.9%*	*37%*	*Large Growth*	OOOO
Vestas Wind Systems A/S	*Industrials*	*99*	*1.8%*	*37%*	*Large Growth*	OOOO
Microsoft Corp	*Technology*	*80*	*3.6%*	*30%*	*Large Growth*	OOOO
Novo Nordisk A/S	*Healthcare*	*79*	*1.9%*	*29%*	*Large Growth*	OOO
Roche Holding AG	*Healthcare*	*74*	*1.8%*	*27%*	*Large Blend*	OOO
Unilever PLC	*Consumer Defensive*	*71*	*1.8%*	*26%*	*Large Blend*	OOO
Koninklijke DSM NV	*Basic Materials*	*71*	*1.6%*	*26%*	*Large Blend*	OOOO
SAP SE	*Technology*	*70*	*1.8%*	*26%*	*Large Blend*	OOOO
Thermo Fisher Scientific Inc	*Healthcare*	*67*	*2.1%*	*25%*	*Large Growth*	OOOO
Siemens Gamesa Renewable Energy SA	*Industrials*	*65*	*1.3%*	*24%*	*Large Growth*	OOOO
Koninklijke Philips NV	*Healthcare*	*65*	*1.7%*	*24%*	*Large Blend*	OOO
L'Oreal SA	*Consumer Defensive*	*64*	*1.9%*	*24%*	*Large Blend*	OOO
Xylem Inc	*Industrials*	*63*	*1.4%*	*23%*	*Mid Blend*	OOOO
Allianz SE	*Financial Services*	*63*	*1.8%*	*23%*	*Large Value*	OOOO
Alphabet Inc	*Communication Services*	*63*	*2.5%*	*23%*	*Large Growth*	OOO
Air Liquide SA	*Basic Materials*	*63*	*1.6%*	*23%*	*Large Blend*	OOOO
Umicore SA	*Industrials*	*62*	*1.1%*	*23%*	*Large Blend*	OOO
Siemens AG	*Industrials*	*62*	*1.7%*	*23%*	*Large Blend*	OOO
Infineon Technologies AG	*Technology*	*60*	*1.7%*	*22%*	*Large Growth*	OOOO

Figure 4– Most commonly held companies in Article 9 products*

Source: MorningstarDirect. Data as of 30/06/2021

While products complying with Article 8 and 9 have lower exposure to controversial activities (e.g. controversial weapons, tobacco and fossil fuel) when compared to conventional products, a significant proportion of SFDR products still have relatively **high and increasing exposures** to said activities, **fossil fuels in particular**.

This raises the question as to whether it is appropriate for such products to invest in certain sectors, companies and/or activities. The answer is likely to be different for Article 8 and 9 products depending on their objective or investment strategy and the interpretation of Article 2(17).

For example, as of December 2021, **39% of products applying Article 8 and 33% of products applying Article 9 have over 5% exposure to fossil fuel companies**, with the fossil fuel exposure of such products having increased overtime. Moreover, close to 22% of products applying Article 9 have **some exposure** to companies deriving more than 5% revenue from **thermal coal**, compared with 36% of products applying Article 8.

The extent of Article 8 and 9 exposures to thermal coal and fossil fuels is surprising – particularly in the case of Article 9 products where the SFDR's Do No Significant Harm principle (DNSH) requirement is meant to apply.

This raises the question of **whether exposure to fossil fuels or thermal coal is appropriate for products classified as Article 9 under any circumstances**. It is reasonable to consider such exposures incompatible with a sustainable investment objective and the DNSH requirement. Moreover, such exposures would **confound reasonable consumer expectations** and may come as a surprise to many retail investors, potentially **triggering greenwashing allegations**. On the other hand, it is necessary to recognise that some energy companies having started their transition and expanding their renewable energy capacity are likely to have legacy assets in fossil fuel activities.

Despite this, Article 9 products with fossil fuel exposures may not be in breach of SFDR, provided that FMPs comply fully with the applicable disclosure requirements. Currently, FMPs can interpret the definition of 'sustainable investment' as per Article 2(17) in a variety of ways, establishing their own criteria for assessing a 'contribution' and 'significant harm' to a sustainability objective.

Similarly, there is uncertainty on the part of FMPs as to what triggers application of Article 8 rendering product classification difficult. For some FMPs integrating consideration of ESG risks and opportunities constitutes promoting and environmental or social characteristics, whereas for others, consideration of sustainability impacts is also necessary to qualify a product as Article 8.

Chapter 2
Why are adjustments to SFDR needed?

2.1 The challenge of product classification

In this section we will describe some of the challenges encountered by FMPs since the application of SFDR and why they necessitate adjustments to certain aspects of the framework.

As shown in the previous section, in the 15 months since its application, SFDR has triggered a dramatic evolution in the market for investment products in the EU. SFDR's categories for financial products (Articles 6, 8 and 9) now provide a common language for the investment management industry when referring to responsible, sustainable and/or ESG products.

Strictly speaking, these provisions largely specify the scope, content and details of disclosure requirements applicable to financial products depending on the extent to which sustainability considerations are part of their investment process. They do not technically provide clear definitions for SFDR product categories.

Following the logic of a disclosure-based framework, the product categories in SFDR have a broad scope. They were deliberately left broad to capture as wide a range of products as possible. This is positive when viewed from the perspective of transparency as it ensures disclosures are applied to a wide segment of the market. However, significant risks emerge when a framework designed solely for transparency and disclosure starts being used to classify products.

A transparency framework by definition will seek to be as broad as possible in scope to capture as many financial products as possible with the aim of bringing as much transparency as possible. By contrast, a label will seek to define an ambitious standard to identify the best products available and create an incentive towards improvement. These two distinct logics can be at odds and require different approaches.

That said, SFDR is arguably, despite assertions to the contrary, **not purely disclosure based** as, in places, it shares features with a product standard or labelling regime. For example, Article 9 (read in conjunction with Article 2(17) and Article 9(3), plus the Q&As from July 2021 requiring exclusive exposure to Sustainable Investments (SIs)) clearly imposes standards that a product must satisfy in order to qualify as Article 9.

In this market context, the loose criteria to trigger Article 8 and 9 have resulted in two scenarios arising for existing funds. In the first, existing products have been found to fall in scope of Article 8 and 9 following an assessment by FMPs. In other instances, existing products have been 'upgraded' or reclassified through the application of additional exclusions or ESG elements with no material impact on the investment process or portfolio composition.

Prior to SFDR, the sustainable investment industry already found it challenging to demonstrate how most investment strategies translated into positive impacts and/or outcomes. SFDR has merely rendered this challenge more apparent and risks widening the gap between what many ESG products can actually achieve and the expectations of clients, particularly in cases where retail investors are involved. This creates significant reputational risks for individual FMPs and the financial industry as a whole. In this context, the practices displayed by some market participants around SFDR are likely to exacerbate this reputational risk further.

2.2 Real prospect of market fragmentation

A number of national supervisors have acknowledged the developments in the market since the application of SFDR and have initiated steps to mitigate the risks of mis-selling and greenwashing that invariably arise in a context where FMPs classify their products in accordance with SFDR without having clarity on how to do so. They have recognised that Article 8 and Article 9 are now used to classify products, and in some instances act as labels, thus playing a role in the marketing and distribution of funds, with implications for investor protection.

Examples of national supervisors signalling the need for action include the Q&A issued by the CNMV in Spain, the standards for sustainable investment products contemplated by BaFin in Germany, and recent statements by the AMF's chair, Robert Ophèle. At EU level, the European Supervisory Authorities (ESAs) and the European Commission have also made attempts to provide guidance on the application of the SFDR, however they have been severely constrained by provisions of the Level 1 text.

If this movement continues, it carries the risk of fragmentation that will compromise the cross-border distribution of ESG products in the EU and incur significant costs on FMPs as they navigate a patchwork of national regulatory regimes. This would run counter to the Capital Markets Union project of the EU to remove unnecessary market barriers.

Accordingly, the SFDR must be adapted to address the reality in the market. These adjustments can only be achieved through introducing targeted amendments to the Level 1 text of SFDR (potentially implying changes to other frameworks such as MiFID II). Changes should seek to better delineate between product categories and provide legal certainty to FMPs that currently struggle to classify their products. Policymakers should also seek to address the challenges associated with applying 'sustainable investment' as defined by Article 2(17). In the following section, Eurosif will outline policy recommendations and potential solutions that policymakers may wish to consider.

2.3 Why should we make the classification of products clearer?

Bearing in mind that FMPs will make many disclosures under SFDR to comply with the MiFID II sustainability preference criteria, a legitimate question is why it would be necessary to bring more clarity in the classification of products under SFDR. However, two factors are likely to limit the full effectiveness of a disclosure only based approach.

Currently it is clear that the quality of the data across all MiFID criteria for sustainability preferences remains sub-optimal. FMPs are struggling to collect reliable data on alignment with the EU Taxonomy either directly or from third-party data providers for the first criteria. The interpretation of the second criteria pertaining to the share of sustainable investment is contingent currently on the interpretation by each FMP and therefore not fully comparable. Finally, the data across PAI indicators remains of heterogenous quality making it hard to compare. The quality of data is likely to improve over the next few years, but it is unlikely to be ever fully perfect, building in an inherent limitation in the framework.

Moreover, any FMPs harbour strong doubts that the **extensive disclosures foreseen by the Level 1 and 2 of SFDR will be suitable for retail investors.** Many retail investors have difficulty understanding the disclosures, with the volume and technicality of information they contain often considered excessive and difficult to digest as demonstrated by consumer testing carried out by the Autoriteit Financiële Martken (AFM) & Warsaw School of Economics at the request of ESMA. In addition, the MiFID II requirements have imposed a framework reliant on complex and highly abstract legal terms (i.e. share of Taxonomy-aligned investments, sustainable investments within the meaning of Article 2(17), etc.) that are unlikely to resonate with retail investors.

This situation highlights the need for a deeper reflection on the right mix between disclosure requirements and product standards/labels to achieve effective investor protection and interaction with the market. From this perspective, we do believe that a clearer classification of products under SFDR still carries merits.

Chapter 3
Policy Recommendations

To correct some of the key challenges identified above on how the SFDR is currently applied, we make the following recommendations. Introducing these changes would significantly improve the applicability, readability, and transparency, particularly for retail investors, and therefore strengthen the legitimacy of the SFDR.

- **Disclosure framework used as a standard – making it fit for this role** - If SFDR is used by market participants as a product classification system, it reflects a need for such a framework. SFDR should be adjusted accordingly to fulfil this need. To achieve this, a clearer delineation between product categories is required to ensure that FMPs can classify their investment products appropriately and in a manner that clearly conveys the characteristics of the product.
- **Introduce a new category of products focussing on sustainability risks and opportunities** - A clear distinction must be made between financial products taking into account sustainability-related risks and opportunities, focussing on financial materiality, and financial products integrating sustainability considerations at the heart of their investment process, either simply through some environmental or social characteristics, or taking a more holistic approach to sustainability through a Do No Significant Harm (DNSH) lens. This can be done by adding a new article to the legislation or amending the existing Article 6 SFDR on sustainability risks.
- **Clarify 'promoting Environmental and Social Characteristics'** - Amending Article 8 to clarify that this category applies to products which can state and demonstrate the presence of binding environmental or social factors at the heart of the investment process, applicable to the entire investment portfolio. This could be achieved by referencing a subset of relevant PAI indicators as binding environmental and social characteristics in pre-contractual documentation depending on the objective of the product or strategy.
- **Clarify or remove the definition of 'Sustainable Investment'** - The definition of sustainable investment (Article 2(17) SFDR) currently leads to complications because there is no clear way of identifying and calculating which company qualifies as a sustainable investment, leading to a lack of comparability due to diverging interpretations. Currently there are two frameworks, SFDR and the EU Taxonomy, to define the notion of sustainability. This creates a complex duplication which is hard to apply uniformly across FMPs and will make comparability across products challenging. We recommend two options:
    - **Option 1** - Developing in further details a methodology that would allow FMPs to calculate in a similar way their share of sustainable investments. The advantage is that it will further refine a meaningful KPI applicable to a large share of investments. The risk is that it may show some duplication with the EU Taxonomy and be difficult to properly articulate in a way that makes it fully comparable.
    - **Option 2** - Removing the definition or aligning it with the definition of sustainable economic activity (Article 3 Taxonomy). This would require modifying or clarifying existing Q&As on Article 9 SFDR and Article 6 Taxonomy Regulation in relation to the use of data. It may simplify operationally the application of regulation and remove a criterion which may be hard to compare. However, it carries the risk that FMPs will be left with reporting on their alignment with the Taxonomy which currently covers only a limited share of the economy and therefore of investment portfolios.
- **Consider amending the MiFID Sustainability Preferences delegated regulation** - If the SFDR is updated with the above recommendations and Article 2(17) is removed or aligned with Article 3 Taxonomy (sustainable economic activity) in line with Option 2, the MiFID II delegated regulation could be modified to remove criteria (b) on the share of sustainable investments.
- **Develop a set of voluntary labels at European longer-term** - In the longer-term, we would recommend looking at the possibility of creating a set of European voluntary labels for financial products, seeking to define different levels of ambition, and providing a framework for investment strategies focussed on transition rather than on already sustainable economic activities.

In the section below we will explain in more details the rationale for the recommendations and how these could be concretely implemented in the current SFDR framework.

3.1 Products and investment strategies focussing on sustainability risk and opportunities from sustainability factors

As outlined in the previous section, since the SFDR is designed as a disclosure framework, it is naturally meant to have a wide scope, capturing as many financial products as possible. This is particularly the case in drafting Article 8 SFDR. Currently, products labelled as Article 8 that promote, amongst other characteristics, environmental or social characteristics are highly varied and heterogenous both in terms of the investment approaches and tools they apply and their sectoral exposures.

Significant interpretative doubts persist among sustainable investment practitioners as to what precisely constitutes promotion of environmental or social characteristics. In some instances, FMPs have qualified products merely applying (statutory) exclusions and/or performing ESG integration with a clear financial focus as subject to Article 8. Other FMPs have considered such product as merely looking at sustainability risks (Article 6 SFDR), but not as sufficiently ambitious to incur the disclosure obligations attached to Article 8 SFDR, as they would have difficulty demonstrating a clear and binding environmental or social characteristic integrated into the investment process. Therefore, it is important this distinction is made more explicit in the SFDR as it carries important investor protection implications, particularly for retail investors: is the investor seeking to improve their returns for a given level of risk? Or also seeking to integrate sustainability factors in their investment portfolio?

Investment strategies/products focussed on risks and opportunities from sustainability factors

This category would cover products whose **sole objective is financial**, seeking to generate returns while managing risks. This would cover all products that perform ESG integration seeking to manage sustainability related risks or financial opportunities, and apply exclusions, driven by risk or statutory considerations.

ESG factors are considered only to the extent that they might have a financially material impact on the value of the financial product or its underlying investments. The impact of investee companies on sustainability factors is not considered or does not have a bearing on the investment process.

This category could be built on the existing Article 6 SFDR and expanded to cover also financial opportunities emanating from sustainability factors in the investment process. Or a new article could be inserted in SFDR.

It would be advisable to make clear that these types of products should refrain from using terminology linked to 'sustainable', 'sustainability', 'environmental' or 'impact' in their communication or name.

3.2 Products and investment strategies integrating binding, transparent and material environmental and social characteristics in the investment process

By comparison, Article 8 products would be distinguishable from Article 6 products by virtue of pursuing **both financial and sustainability objectives**. The Article 8 product category would continue to encompass a broad and diverse spectrum of ESG investment strategies and products while establishing common criteria for all.

Article 8

Investment strategies/products taking into account environment and social characteristics in the investment process

Financial products in the scope of Article 8 SFDR seek to deliver a financial return and conduct sound risk management **while also pursuing clearly articulated and binding non-financial objective(s)**. The non-financial objectives should focus on reducing or minimising some or all negative environmental and social externalities. To measure the binding, it could be considered to clarify that the binding criteria to apply to at least 90% of the investment portfolio, measured by market value of the instruments.

The financial product would be required to have **one or more of the PAI indicators relevant to the environmental and/or social objective(s) pursued that is binding on the entire investment portfolio**. The PAI indicator(s) would be used to measure the progress of the product towards attaining its objective(s) and may be used for setting engagement targets with investee companies. This could be attained through a combination of absolute value (i.e. total GHG emissions) and relative (i.e. emission intensity) PAI indicators. The onus would be on the product and FMP to demonstrate the appropriate selections of PAI indicators in light of the investment objective or product name.

Financial products in this category would have to comply with the disclosure requirements as products focussed on risks and opportunities of sustainability factors (see above).

Additionally, the expectation would be for products in this category that invest in companies/equity instruments to have a transparent and strong engagement strategy at product or entity level towards investee companies to reduce the PAI indicators over time. The engagement policy could be subject to the following requirements:

- Clear, measurable and, in the case of climate and environment-related objectives, relevant science-based and time-bound targets communicated to investee companies
- Engagement plan with companies/sector most material to achieving the objectives, including tangible planned actions
- A transparent escalation strategy if the objectives are not met, with divestment as the ultimate escalation step
- Reporting on the implementation of the engagement plan and outcomes achieved

Finally, the expectation would be for at least products promoting environmental characteristics that they report on their alignment with the Taxonomy in line with Article 6 Taxonomy Regulation. This is in line with the latest Q&A of the European Commission.

The minimum sustainability criteria outlined above would be common to all Article 8 products while still allowing for significant variation in terms of investment process or strategy pursued and the fund's overall ESG performance.

The Article 8 product category would thus continue to represent a broad and diverse spectrum of ESG investment strategies. Flexibility and innovation would still be possible while ensuring a solid distinction between products managing risks and opportunities from sustainability factors and products integrating clear, transparent and binding environmental or social (or both) characteristics in their investment process.

Taking a longer-term perspective and in line with its Strategy for financing the transition to a sustainable economy of July 2021, the European Commission should consider developing a general framework of voluntary labels for financial instruments financing the transition of the economy. In these deliberations it could consider whether a more granular distinction between different types of investment strategies meeting the description of amended Article 8 (Best-in-Class, Thematic, Best-in-Progress, etc...) could be developed.

The mandate from the European Commission to the ESAs of April 2022[2] to review the PAI indicators will be the opportunity to assess and ensure that these are fully fit to be applied as binding environmental and social characteristics in products complying with Article 8 SFDR. Further work can still be done to refine the methodologies and ensure a diversity of absolute metrics and intensity metrics across the broad spectrum of sustainability topics. Furthermore, it will be important to develop robust governance indicators that are not based merely on the presence of certain company policies, but also seek to understand the effective application of these policies.

3.3 Products with a sustainable investment objective and the definition of sustainable investment (Article 2(17) – improving or removing the definition

Products complying with Article 9 SFDR are required to have a sustainable investment objective and evidence this by investing in sustainable investments as defined by Article 2(17) of the SFDR. In order to qualify as a 'sustainable investment', an investment must make a 'contribution' to an environmental or social objective while avoiding 'significant harm' to other objectives. These are considered the most ambitious products as they are expected to take a holistic view on sustainability in their investment process, pondering the broad range of environmental, social and governance factors.

SFDR is already evolving from a disclosure framework towards a standard

It is important to note that in this part, the SFDR should not be considered as a framework focussed only on transparency. Subsequent interpretative guidance from the European Commission and the ESAs is evolving the SFDR into a standard as the two following examples can illustrate. First, the Q&As from the European Commission and the ESAs of July 2021[3] indicate that *"may invest in a wide range of underlying assets, provided these underlying assets qualify as 'sustainable investments', as defined in point 17 of Article 2"*. This has been interpreted by many FMPs as requiring a high level of sustainable investments (80% at least), with the remainder of the assets being predominantly held for hedging and liquidity purposes. Second, the same Q&A indicates that a product complying with Article 9 SFDR that has carbon emissions reductions as its objective, must track an EU Climate Transition Benchmark or EU Paris-aligned Benchmark when these exist. The SFDR is therefore expressing a view on the assets or investments to be held in the product. Accordingly, the Guidance provided in Q&A is already changing the nature of the SFDR.

Comparability made difficult by challenges with the application of Article 2(17)

The definition of sustainable investment has proven extremely challenging for FMPs to operationalise. This is largely due to the lack of any framework or screening criteria for assessing a 'contribution' to a sustainability objective, and/or 'significant harm' to the others.

FMPs have thus had to provide their own interpretation and criteria for 'sustainable investment' often through the development of internal frameworks to evidence their analysis. As a result, it will be challenging to compare the definition and share of sustainable investments across Article 9 products from different FMPs. This is far from ideal if we bear in mind that the share of sustainable investment is one of the criteria under MiFID II for clients to express their sustainability preferences.

If the definition is not adjusted, we are left with a situation where each FMP, possibly with the help of data vendors, will have to decide which companies or bonds are considered to meet the definition. We may also face situations where the same company or bond is considered a sustainable investment by one FMP and not by another. This is likely to result in outcomes which may sometimes be hard to explain to investors, particularly retail investors, and may lead to greenwashing allegations and carry significant reputational risks. This is particularly the case as these allegations will likely focus on FMPs that have taken the most creative interpretation.

Therefore, it is clear to us that the definition of sustainable investment in Article 2(17) SFDR needs to be adjusted to remedy this. We have outlined in our recommendations two options: 1) adjusting the definition to improve the likelihood that it is applied in a comparable, consistent way by FMPs or 2) removing the definition and aligning with the definition of sustainable economic activity (Article 3 Taxonomy). This latter option is only possible if other adjustments are made simultaneously to existing Q&As and the MiFID Delegated Act on sustainability preferences.[4]

2 Letter from European Commission to ESAs on SFDR and Principal Adverse Impact Indicators, April 2022 www.esma.europa.eu/sites/default/files/library/mandate_to_esas_on_pai_product.pdf

3 ESA Q&A July 2021 https://www.esma.europa.eu/system/files_force/library/sfdr_ec_qa_1313978.pdf?download=1

4 Precise reference to the MiFID II DA.

3.3.1 Option 1 – Enhance the definition of 'sustainable investment' as per Article 2(17)

The first option would involve providing for a more precise and granular definition of 'sustainable investment' to guarantee greater consistency in how it is interpreted, ensure and enhance the comparability of products across the market. The latter point will prove particularly important in the context of MiFID II requirements on assessing client sustainability preferences.

As outlined above, in order for the definition of 'sustainable investment' to be practicable, a robust framework would need to be developed to; (i) clearly identify eligible environmental and social objectives, (ii) provide performance criteria against which to assess a 'contribution' to said objectives, and (iii) define what constitutes significant harm to said objectives. The following suggestion should be seen as a first attempt at the direction that needs to be explored to improve the functioning of the definition of Article 2(17).

Article 2(17)

Article 2(17) SFDR could be amended as follows: 'sustainable investment' means an investment in assets that contribute to the achievement of one or more international and/or European sustainability goals, namely the UN Sustainable Development Goals, through their products, services and/or processes. This can translate into an economic activity that contributes to an environmental objective or that contributes to a social objective, or both, either through:

1. Compliance with the EU list of environmentally sustainable activities as defined by Regulation (EU) 2020/852;
2. Demonstration of a positive contribution to the achievement of one or more of those objectives through their products and processes provided, that such investments do not significantly harm any of those objectives due to their CSR strategy, policies and practices 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.

Contribution to the achievement of EU objectives and UN SDGs outside of the scope of EU regulations (taxonomies, the EU Green Bond Standard) should be documented and justified by the investment manager and externally audited, detailing:

a) the SDG concerned

b) the analysis performed demonstrating that the asset (company, project) is contributing

In order for this amended definition of 'sustainable investment' to be practicable, **performance criteria would have to be developed to qualify a 'contribution' and to define 'significant harm' to each of the UN SDGs.** Developing such a framework would imply a substantial volume of technical work for policymakers. It may also take time for policymakers to fully elaborate and therefore is unlikely to be an immediate solution to the problem of comparability identified above.

3.3.2 Option 2 – Align the definition of sustainable investment with the EU Taxonomy

An alternative approach to Option 1 above is to remove the definition and concept of sustainable investment in SFDR and align it with that of a sustainable economic activity as defined in Article 3 Taxonomy.

This option stems from the acknowledgment that it may be complicated to craft a perfect solution that allows for uniform application and comparability across FMPs. That need for comparability comes from the fact that the share of sustainable investment is one of the MiFID criteria to determine sustainability preferences and it features prominently with a percentage in the first section of the pre-contractual templates for products disclosing under Article 8 and 9 SFDR. Furthermore, it may end up being duplicative of the work undertaken in the context of the EU Taxonomy on the environmental objectives 1 to 6.

Aligning the concept of sustainable investment in SFDR with the notion of sustainable economic activity in the EU Taxonomy will have the advantage of ensuring that FMPs will have to apply only one DNSH principle to their investments and will have to apply the same notion of substantial contribution. We certainly do not want to minimise the challenges of applying precisely the Technical Screening Criteria (TSC), the DNSH principle or the Minimum Social Safeguards (MSS). However, this option has the merit of ensuring that all FMPs will apply similar criteria to the data they have to report, coming with a criterion which over time will improve in comparability. It will minimise reputational risks that may emerge from the current heterogenous application of the definition of sustainable investment.

If this option is chosen, it can only work in practice for FMPs if other adjustments are made to existing guidance.

Option 2 however is not free of risks. The SFDR and the Taxonomy currently do not contain a reporting framework for FMPs to identify intermediary levels of sustainability performances. At one end of the spectrum, PAI indicators are at this stage only a reporting tool with no minimum performance level required. At the other end of the spectrum, the EU Taxonomy articulated a very high level of ambition, seeking to identify the most sustainable economic activities in each sector that are, for the climate mitigation objective, aligned with the objective of the Paris Agreement and the EU Climate Law. Data analyses show that this remains a very small share of the European and global economy. Therefore, removing or aligning the definition of a sustainable investment (Article 2(17) SFDR) with the definition of a sustainable economic activity does imply a reliance on reporting with the EU Taxonomy which will provide comparability on only a relatively small part of investment portfolios. It makes it operationally easier to operate, with less reputational risks associated with an unclear definition. But it may leave a gap when it comes to defining an intermediate level of sustainability performance that is meaningful enough as applicable to a broader part of the investable universe.

Amending MiFID II delegated act on sustainability preferences

If the definition of sustainable investment is removed or aligned with that of a sustainable economic activity, this will require amending the MiFID delegated act on sustainability preferences to remove the criteria identified as the share of sustainable investments.

Modification of Q&A on sustainable investment

A first adjustment concerns the composition of investment portfolio for products complying with Article 9 SFDR. The Q&A of the European Commission and the ESAs of July 2021 made clear that products complying with Article 9 SFDR should only contain investments meeting the definition of sustainable investment (Article 2(17) SFDR). As explained earlier, this has been interpreted by many FMPs as requiring a high level of sustainable investments (80% at least), with the remainder of the assets being predominantly held for hedging and liquidity purposes.

If the definition of sustainable investment is removed or aligned with that of a sustainable economic activity, the current investment landscape would render it impossible for FMPs to deliver products with such a high level of investments in companies whose economic activities are aligned with the Taxonomy Regulation. Therefore, if this option were to be chosen, it would require editing this Q&A. In general, we would at this stage still be reluctant to mandate a minimum mandatory level of alignment with the Taxonomy for products complying with Article 9 SFDR. Since the alignment levels will be reported, it will be possible for investors to identify the different levels of ambition of products through their report data.

Ensuring FMPs can reasonably make Taxonomy disclosure– adjusting the Q&A on Data Use

Removing or aligning the SI definition with that of a sustainable economic activity presupposes that FMPs can make relatively easily disclosures about the alignment of their products with the Taxonomy Regulation. However, FMPs have faced several challenges.

There is an overall challenge on the availability of Taxonomy alignment data from investee companies. Currently the majority of investee companies are not reporting their alignment. As of 2023, the European companies subject to the Article 8 Taxonomy Delegated Act will. Companies outside the EU will however not be required to conduct this reporting. As a result, data availability on alignment with the Taxonomy coming directly from investee companies will only improve for part of the total investable universe of asset managers.

This limited data availability means that many FMPs have had to rely to different degrees on one or more data providers to fill the data gaps and accurately calculate alignment with the EU Taxonomy across their portfolio. However, the supervisory statement by the ESAs from March 2021 indicates that estimates are not allowed, and only 'equivalent information' is allowed to compute the alignment level if data from companies is not directly available. On the other hand, Recital (21) of the Taxonomy Regulation indicates the strict conditions under which estimates are authorised. Finally, the latest Q&As from the European Commission and the ESAs introduces the concept of 'reliable data'. This has created confusion amongst many FMPs regarding the data sources they can legitimately and reasonably use for their disclosure obligations.

Finally, the latest Q&A seem to discourage narrative explanation seeking to explain the current limits in data availability. However, we are currently in a landscape

where companies are struggling to prepare and report their taxonomy alignment, FMPs have only very partial data available across their entire portfolio and data providers are estimating how aligned companies are. In this environment, if FMPs are precluded from explaining the limitations of the data they are required to disclose, it leaves them exposed to significant legal and compliance risks.

The combination of these factors will make FMPs increasingly reluctant to disclose their alignment with the EU Taxonomy and will only disclose very low numbers. As a result, these criteria for the purposes of MiFID II will become less relevant. In such an environment, it would not be advisable to apply option 2 and remove or align the definition of sustainable investment with that of a sustainable economic activity.

3.4 An overview of the classification of products/strategies under our proposed approach

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