

SFDR review

The Chair welcomed attendees and introduced the panel on the Sustainable Finance Disclosures Regulation (SFDR) review. The Commission is also looking at the SFDR framework, which has been operational since March 2021 and broadly well-received by stakeholders. Criticism is being addressed. A review started in January 2023, including two public consultations, a number of workshops with the industry, and meetings with stakeholders, supervisors and representatives of civil society. All stakeholders have already been asked to contribute, but the debate is still open.

A provisional conclusion has been reached. The main elements and the main objectives of the framework are still valid. There is more transparency, particularly when it comes to sustainability reporting and sustainability-related information in general, but some aspects can be improved. This includes the Article 8 and Article 9 issues, which have been used as de facto labels without being conceived as labels. They therefore do not provide the necessary criteria that need to accompany a label. The exercise is separate from the Omnibus Directive proposals that are already in play and that are going to be imminently negotiated by the Council and the Parliament. Thought will be needed about how to link the two workstreams.

1. Assessment of the implementation of SFDR

A consumer representative stated that the SFDR has played an important role in paving the way to the sustainable finance framework, but it has also raised awareness about the issues in the investment universe. As the sustainable framework has expanded, it has become clear that the disclosure regime that was established has its limits. At the time, a significant amount of flexibility was left to define the key concepts that SFDR has, such as the concept of sustainable investment and consideration of principal adverse impacts. That led to the situation where asset managers published disclosures on the same issues, but in an incomparable way, which caused many misleading statements.

A problematic issue is the fact that SFDR is aimed at establishing a disclosure regime, but it has effectively mutated to a labelling regime. The absence of transition products in SFDR has also become problematic, because it has led to inconsistent practices. Some asset managers or product manufacturers will state that they can invest in any sector or industry with the justification that such investments support transition, despite the fact that there is no credible baseline to verify transition efforts. The current product disclosures largely focus on disclosing sustainability characteristics and do not

speak about reporting the actual adverse impacts of the products. This puts a significant burden on sustainable products and leaves an unlevel playing field for the remainder.

There are also many legislative inconsistencies which need to be resolved beyond just revising SFDR to address the aforementioned issues: Simultaneous alignment of the other substantial elements of the sustainable finance framework, such as fund naming rules, Packaged Retail and Insurance-based Investment Products (PRIIPs), and the consideration of sustainability preferences in the Markets in Financial Instruments Directive (MiFID) and the Insurance Distribution Directive (IDD) is needed to ensure a consistent framework.

The framework needs to be simplified so that retail investors better understand it. Transparency is needed, in order to allow investors to understand the sustainability level of the products and allow retail investors to express their sustainability preferences in an understandable way. The framework potentially needs to be tailored to impact-driven investments, which have largely been left unconsidered. The current discussions on the Omnibus Directive will have a significant impact on the functioning of SFDR, because the availability of data, namely on taxonomy and alignment of economic activities might be hampered.

An official acknowledged the context of Germany currently operating under a caretaker government. The coalition agreement has just been announced, but the SFDR review is not specifically mentioned in the 150-page document. The SFDR was an important first step, but several shortcomings have been identified. The first question is what is provided with the current text, how it is applied in practice, and whether the information that is contained is what investors need, particularly retail investors. There are significant doubts that it does. The second question is around how it interacts with the distribution rules in terms of MiFID and IDD, and whether it is coherent and consistent.

The regulation is currently misused as a label for Articles 8 and 9 which deviates from its original intent. It is likely that Article 8 is too complex, and it is quite diverse in terms of what the investors can read out of it. It is therefore very difficult for retail investors to digest it and to make investment decisions based on the information.

A regulator remarked that focusing solely on potential improvements overlooks the positive changes brought about by the SFDR regulation. The SFDR has dramatically changed market dynamics by effectively creating incentives for asset managers to incorporate sustainability risks into their investment strategies, thereby increasing market transparency. The implementation of the SFDR has shown that, depending on the data source referenced, up to 60% of assets under management are now linked to Article 8 and

Article 9 classifications, which is encouraging. However, though improvements are necessary, maintaining the fundamental principles of the regulation remains paramount, which is to allow investors to take informed decisions and contribute to transforming the productive models towards more sustainable models.

2. Recommended improvements

An official stated that there could be a creation of a simplified labelling system that categorises sustainable investments clearly and understandably, in order to benefit retail investors. This would involve establishing definitive categories that could aid clarity in assessing products. There is an imperative to fostering investments in transition financing; a framework could be created to facilitate and encourage transition focused investments, while avoiding excessively strict criteria that could hinder flexibility.

The risk of greenwashing needs to be addressed, but it is vital not to hamper the financing of transition and of the green economy. The question of a global investment horizon of the products is about disclosure, so it is potentially not ideal to solely rely on European rules and standards like the taxonomy. SFDR needs to apply to products that can be sold or distributed globally. Customer engagement is also needed in the regulatory process. Customer testing can help regulators design frameworks that are genuinely effective and comprehensible for retail investors.

A regulator highlighted that there are three lines of improvement. The first is the categories. An evolution from the ambiguous labelling of Articles 8 and 9 is needed into more definitive categories with clear definitions. These could include a specific sustainable category, a transition category, and a broader environmental, social, and governance (ESG) base category. Simplified, easy to-understand categories will undoubtedly aid both asset managers and investors.

The second area of emphasis is consistency across various regulatory frameworks dealing with sustainability in the EU, which is a critical factor for effective implementation. The third area is the need for simplification, specifically regarding retail investors' easier access to sustainable fund options, which currently often entail cumbersome questionnaires that can act as barriers for potential investors.

An industry representative agreed that the SFDR has contributed to the transition to a more sustainable economy, though there is room for improvement. Enhancing the existing Article 8 and Article 9 classifications could be beneficial rather than moving towards entirely new categories, which could introduce additional complexity into the regulatory landscape. The first condition is to put the customers and clients at the core of the new framework. The new categories will only be successful if they help to send a clear message to customers about where their money goes. The new categories should also be a simple and clear description of what each product invests in.

The second point is about what the product does not invest in, so there must be a clear view on how selection is made for each category. There is a strong need to review the sustainable preferences that are currently defined under MiFID and IDD. Existing criteria in terms of taxonomy, sustainable investment and consideration of principal adverse impacts needs to be removed and replaced with the aforementioned categories and a simple description of the categories.

Overly prescriptive criteria could lead to a situation where certain products no longer qualify for categorisation, consequently diminishing the effectiveness and credibility of the overall framework. There is a delicate balance between sufficient ambition and achievable realism, so there is a necessity of ensuring that the new sustainable categories will not indiscriminately encompass all products not captured in the transition categories, as that will dilute the intended objectives of the SFDR.

An industry representative highlighted four key considerations for ensuring the success of the SFDR 2.0 review from the perspective of a benchmark and data provider. The framework should be adaptable to all investment strategies, with particular emphasis on passive investment approaches. Existing regulatory frameworks often overlook unique characteristics of benchmarks, which result in complexities and confusion regarding compliance and implementation. It is essential to conduct thorough testing of the criteria proposed within the regulation to gauge their actual impact on real investment portfolios. While there appears to be consensus on the general criteria, a focus on understanding the thresholds for these criteria will be critical to the successful implementation of the SFDR.

There is also a need for an agile and flexible framework. Ongoing communication with industry stakeholders will be crucial for addressing emerging questions and challenges. A centralised coordinating body could be established within the EU, such as the European Securities and Markets Authority (ESMA) or the European Commission, to streamline the communication process and allow for a cohesive regulatory environment. There is also the necessity to ensure consistency with the requirements set forth by the Corporate Sustainability Reporting Directive (CSRD) to create a cohesive framework that endeavours to maximise the quality and comparability of available data. Aligning the SFDR with the CSRD will help ensure that the information provided across different regulations is complementary rather than conflicting.

A consumer representative expressed support for changing the SFDR regime to become a product labelling regime. However, the disclosure regime for all products should remain, as it is essential to provide retail investors with that information. It is also vital to not only put the burden on manufacturers that sell sustainable products. Three distinct categories are needed. A sustainability focused category is mandatory, which will capture the products that are already sustainable and respect the minimum requirements in terms of taxonomy alignment. There is a question

around what will happen if the CSRD omnibus comes in and there are fewer disclosures on taxonomy alignment, which will push more focus on defining what sustainable investment is.

There is also the possibility of having a flexible adjusting threshold for the sustainability level of products as the economy transforms and the market changes.

The second product category is transition focused, the absence of which has been a problem with SFDR. It would be useful to focus the transition category on giving the product manufacturers the obligation of means, rather than obligation of results. The category will be linked to actual actions that asset managers can take to facilitate sustainable transformations. A debate can take place around whether it should be called 'transition' or 'improving', the latter following the example of the UK SRD.

The third category, impact-focused investments, would cater to investors prioritising social or environmental impact. This category will require clarity and transparency regarding how impacts would be assessed.

One additional category could be a harmful product category, which will effectively allow consumers to avoid investments linked to detrimental activities, while also accommodating exclusions within other product categories.

3. The UK's scheme around voluntary labelling of funds

A regulator acknowledged that the UK has established a voluntary labelling system for funds, which aims to simplify the consumer's understanding of sustainable products. Through extensive consumer tests, it became evident that the public prefers simple and clear labels over complex gradations of categorisation. There are parallels to supermarket practices, where products like eggs are simply labelled as caged, free range or organic, rather than categorising them with complex numerical systems.

Equally, through extensive testing, consumers have expressed a desire for labels that straightforwardly convey the sustainability outcomes of a fund. Funds should inform consumers about their investment outcomes in terms that are easily digestible, rather than relying on complicated financial jargon. Fund documentation should succinctly distil essential information, demonstrating that consumers comprehend the information conveyed, regardless of the length or complexity of the material provided.

In regard to stewardship, there is an importance of asset managers proactively demonstrating their commitment to sustainability. Stewards of capital should be accountable for the investments they make and how these investments support sustainable practices. Robust anti-greenwashing rules are necessary to protect consumers from misleading claims regarding fund sustainability. Consumers often

seek diversified investment options that still have a positive impact, rather than a stringent pursuit of only 'perfect' funds. The UK has expressed a commitment to fostering a landscape conducive to sustainability, while at the same time maintaining flexibility and choice for consumers.

4. The Omnibus package and consistency with SFDR

An official recognised the significance of the Omnibus package and stressed its critical role in achieving robust reforms. There is an appreciation for the Commission's efforts in the tabled proposals. The Omnibus package is imperative in ensuring that sustainable finance does not devolve into mere compliance exercises. The objective should be to develop a framework that is well utilised by corporates, which must be able to effectively apply the regulations in practice.

There is optimism regarding the ongoing discussions in the Council concerning sustainable finance. The agreement for the 'stop the clock' mechanism will delay the implementation of new reporting and due diligence requirements, providing more time for deliberations about the substantive proposals put forth by the Commission. While negotiations will be delicate, they are necessary to arrive at effective and responsive measures.

A regulator concurred around the significance of the Omnibus proposal as a necessary initiative aimed at simplification. Simplification has to be prioritised in order to ensure a practical closure regime that genuinely promotes sustainability, rather than adding burdensome layers of compliance. The hope is that the political discussions will be more ambitious when considering the scope of the legislation, as reducing it too much will create gaps in the availability of critical sustainability information from significant portions of the economy.

The range of companies required to comply with the legislation needs to be expanded, but without overwhelming smaller entities with excessive burdens. Sustainability disclosure must be relevant across various segments of the market, ensuring that smaller firms can participate meaningfully in corporate sustainability initiatives while keeping the principles of transparency intact.

An industry representative stated that their company is in favour of simplification, which it has supported for a significant period of time. However, simplification does not necessarily mean a large descope. What is most important is a simplification of the European Sustainability Reporting Standards (ESRS) and the number of data points that corporates will have to publish. All the data points are being examined to identify the ones that are relevant and useful from an investor perspective, and to remove all the information that does not have added value.

The next step is to examine other companies. It could make sense to make a distinction between companies

that have more than 250 employees, and ones that have fewer than 250 employees, for which disclosure should be voluntary and optional. For companies with between 250 and 1,000 employees there can potentially be simplification of the ESRS, with 40 or 50 data points. For bigger companies, there could be between 140 and 150 data points. Companies not publishing information on extra financial matters is not positive, because all stakeholders need this information. If companies want to be visible, then they have to produce this information. It is vital to achieve the right balance between two potentially opposite objectives.

The last point is the concern that reporting on taxonomy will potentially become optional, so derogation might be needed. Making taxonomy reporting optional could undermine the consistency of information available to investors, leaving questions surrounding the reliability of data across the industry.

The Chair highlighted that the comments made show how everything is interlinked in the area of the sustainable finance framework, and how important it is to ensure consistency.

A regulator stated that discussions around sustainability should pivot back to fundamental principles, which is a perspective grounded in consumer needs rather than regulatory complexities, especially given the plethora of existing taxonomies globally. Consumer understanding of what a fund does in terms of sustainability is vital, as well as the importance of clear communication. Consumers often seek out straightforward, well-defined explanations, rather than overly detailed technical specifications.

The sentiments that were shared earlier about the necessity for clear labelling in the market are pertinent. Asset managers must proactively clarify what sustainability metrics they employ and how they gauge their investments' impacts. There needs to be

transparency in the communication of these factors to lay audiences, because simplistic communication can significantly enhance consumer confidence and trust in sustainability related products.

Stewardship is also a key issue. Asset managers have a responsibility to act decisively if they encounter inadequate reporting from their portfolio companies. Investors should feel empowered to scrutinise the sustainability narratives and the performance of companies that they have invested in.

An industry representative stated that establishing alignment and interoperability between the UK and EU frameworks is indispensable to avoiding fragmentation within the market. Many firms operate within both regulatory jurisdictions, meaning that differing approaches will invariably lead to compliance complexities and inflated costs. An aligned regulatory stance greatly benefits corporates, regulators, and investors alike by ensuring a competitive environment. The EU should consider adopting successful aspects of the UK's regulatory framework for sustainability as a model. Aligning the two systems will facilitate seamless operations for firms and minimise the compliance burden, while delivering clarity to investors at the same time.

The Chair concluded the session by expressing gratitude for the insightful contributions made by all panellists, recognising the complexity and interlinkage of the discussions surrounding sustainability finance regulation. He reiterated the European Union's commitment to the objectives outlined in the Green Deal, ensuring that the framework for sustainable finance remains a priority within regulatory agendas. The work on enhancing the SFDR and related frameworks will be ongoing and will necessitate further discussions in future panels.