EFAMA
European Fund and Asset Management Association

KEY MESSAGES

Brussels, 20 December 2023

EC's targeted consultation on the implementation of SFDR

Executive Summary

The Sustainable Finance Disclosure Regulation (SFDR) has introduced several benefits, especially in terms of transparency. However, it has yet to fully realise its potential in strengthening investor protection and steering capital toward sustainable activities.

For us, the much-needed amendments in the revision of SFDR provide a good opportunity to meet the Regulation's intended objectives. Our recommendations focus on refining SFDR to be **more investor-centric.** We can achieve this by providing retail investors with clear and meaningful information. This involves a balanced approach between comparability and flexibility, as well as rationalising and simplifying disclosure requirements. We specifically recommend:

- **Product-level disclosures**: We advocate for simplified disclosures for retail investors, using a uniform template across **all financial products with sustainability claims**.
- As part of the simplification, we would maintain the existing website disclosures (Article 10 SFDR) but believe that the detailed disclosures should only be available upon request. The additional information disclosed on the website should be limited to further information on the methodologies of financial market participants (FMP).
- If the European Commission (EC) considers broader transparency through quantitative indicators for **all financial products**, they must be simplified and uniform, with a minimal set of KPIs/disclosures comparable across different markets and asset classes.
- **Entity-level disclosures:** To avoid regulatory duplication between the Corporate Sustainability Reporting Directive (CSRD) and SFDR, we propose streamlining entity-level sustainability disclosures. This can be achieved through the horizontal application of CSRD reporting requirements, aligned with the double materiality principle. This **removes** redundant obligations under Article 4 of SFDR, which currently add costs without enhancing decision-relevant information. If eliminating entity-level PAI disclosures is not feasible, **streamlining** the disclosure requirements to focus on material KPIs based on entity holdings is a viable alternative.

Product categorisation: We support **voluntary product categorisation driven by intentionality**. All product categories should require intentionality of outcomes aligned with a product's sustainability commitment and be based on objective criteria. These criteria should include (i) a clear articulation of

product intention in the investment objective/strategy, (ii) an explanation of the ESG strategy, and (iii) a specification of credible KPIs to measure the attainment of the product's intention. Products should be designed in a clear, objective, **principle-based manner** suitable for various asset classes and investment types while remaining simple and intuitively **comprehensible for retail investors.** As far as relevant to the product's intention, we also see value **in recalibrating certain existing SFDR concepts to complement this categorisation regime.**

We support the following product categories:

1. Products with the intention of positively contributing to environmental/social objectives.

2. Products with the intention of transitioning.

3. Products with the intention of credible sustainability standards or adhering to a specific sustainability-related theme.

For the SFDR framework and product categories to be effective, certain regulations need **alignment,** such as **SFDR with MiFID/IDD sustainability preferences**, and the alignment between **CSRD and SFDR** for consistent sustainability reporting.

1. Current requirements of SFDR

Preliminary comment

Scope of SFDR: SFDR primarily aims to enhance transparency in the financial market regarding sustainability risks and considerations. MiFID ESG preferences, however, focus on integrating clients' ESG preferences into the advisory process. **Segregated portfolios/mandates** are **already subject to MiFID sustainability preferences**, ensuring that ESG considerations are integrated at the client level as part of the suitability assessment. Therefore, subjecting them to SFDR would be redundant.

We are concerned about the **duplication of disclosures** across the investment chain, particularly when an FMP engages with another FMP also subject to SFDR (e.g. sub-advisory agreements). It could potentially lead to a proliferation of operational costs due to redundant disclosure tasks (i.e. both FMPs will have to produce disclosures).

Moreover, the divergence in strategy categorisations between subadvisors and FMPs also lead to ambiguity or misinterpretation of disclosures. This would seriously challenge the required consistency and clarity for effective investor communications.

Asset managers often operate with tight margins. The added burden of producing redundant disclosures can strain resources and divert attention from core investment activities. By focusing **SFDR** on **investment products** and relying on MiFID sustainability preferences for segregated accounts, asset managers can maintain operational efficiencies without compromising on ESG considerations.

While SFDR's intent is commendable, its application to segregated portfolios/mandates is unnecessary given the existing coverage by MiFID sustainability preferences. A more streamlined approach would serve both the interests of investors and the operational needs of asset managers.

Meeting retail investor needs

Transparency in financial services is a cornerstone for building trust with investors, particularly retail investors. However, the balance needs to be finely tuned to prevent an overflow of complex, incomparable disclosures that could potentially overwhelm rather than inform. Indeed, certain questions mandated by

SFDR form a barrier to understanding the ESG strategy employed in their investments. Hence, a holistic review of the disclosure requirements is warranted.

The aim of such a review should be to make the disclosure regime **more user-friendly**, especially for retail investors. The disclosures' current emphasis on ensuring comparability, has sometimes overshadowed meaningful disclosures. The inherently subjective nature of ESG factors further complicates comparability, highlighting the need to shift our focus towards **genuinely meaningful and valuable information to investors.**

We propose to refine the disclosure practice to be more investor-centric, ensuring that retail investors receive clear and decision-useful information and ensuring that there is a proper recalibration of comparability and flexibility in the way firms communicate with their clients. We believe this can be done by among others, rationalizing **the disclosure requirements and simplifying the documentation:**

- Streamline the disclosure rules to focus on information that is significant for investors, making it easily comprehensible and accessible. This means creating a **single template for Article 8 and Article 9 products** (a template for the pre-contractual documentation and another template for the annual periodic reporting). This template should be aligned with how investors define their sustainability preferences.

- As part of this simplification, more detailed disclosures available on the **website as per Article 10 SFDR are no longer necessary**. Alternatively, more detailed disclosures should be available **upon request.** The additional information disclosed on the website should be limited to further information on the FMP's methodologies. Like this, investors are not bombarded with information they may not necessarily need to make informed investment decisions.

Focusing on the disclosures towards retail Investors

As mentioned earlier, retail investors often find the complexity of financial sustainability disclosures overwhelming. They struggle to understand, analyse, and act on this information. Therefore, we favour a more educational approach tailored to retail investors. It would facilitate informed investment decisions and ensure a better understanding of financial products, while also avoiding a disproportionate burden on FMPs. Indeed, **disclosures need to be simplified and tailored specifically for retail investors, using a uniform template across all financial products with sustainability claims.**

However, if our recommendation for segregated accounts is not taken into consideration, greater flexibility is needed when communicating with institutional clients. These clients, equipped with more expertise and resources, require detailed data and additional metrics to align investments with their sustainability benchmarks. They frequently seek specific sustainability information from asset managers, customised to their strategies, preferences, and sector-specific regulations.

Cautiousness about introducing unnecessary changes, among others, burdening investors

SFDR aims to improve transparency, but its implementation comes with **high economic costs** that ultimately fall on the end investors. So, it is crucial to **avoid unnecessary changes** that may increase this burden.

Implementing SFDR, creating and updating pre-contractual documents has already cost a lot of money. There is little evidence, however, that clients are engaging with these documents. We, therefore, question their usefulness. Some unclear aspects of SFDR have also forced our members to limit the launch of products or to seek expensive external legal advice, further increasing the implementation costs. In addition, overlapping and inconsistent regulations, varying interpretations across EU jurisdictions, and data

quality issues from providers, add more to the expense pile. Investors also struggle to engage with the ESG/sustainability questions due to their complexity, turning this into a mere checkbox exercise, with **no real change in investor behavior**.

While SFDR's intentions are good, the costs and complexities associated necessitate **a careful review.** This review should ensure that it serves its purpose without overburdening investors. However, before amending the current SFDR framework, a **comprehensive cost-benefit analysis** is needed. This analysis should consider both the potential advantages and disadvantages of any proposed changes.

Any proposed changes should be tested against the following fundamental questions:

- **Does it lead to enhanced consumer protection?**

- **Has the right balance between comparability and flexibility been achieved?**

- **Does it respect the wide spectrum of ESG strategies available in the market post-2027?**

Following the ESAs' submission of potential SFDR RTS amendments to the Commission, it must be ensured that **any interim amendments to Level 2 measures must withstand any future review of the Level 1 framework**. We need to address the fundamental issues within SFDR rather than "tinker around the edges". As such, Level 2 amendments not only create an **unnecessary burden with limited added value**, they also confuse end investors who are already grappling with information overload and constantly changing disclosures. We urge the Commission to first assess the Level 1 feedback before considering the amendments brought forward by the ESAs.

Transition finance

The absence of the transition concept in SFDR undermines the broader objective of steering capital toward a more sustainable economy. The European Commission's recommendations on facilitating finance for the transition to a sustainable economy as part of its Sustainable Finance package published in June 2023 are a step in the right direction.

However, transition finance must be embedded within SFDR and further aligned with the MiFID/IDD sustainability preferences. This will ensure that companies are supported while they pivot towards sustainable practices. By **having a well-defined place within the SFDR framework**, transition finance can be more effectively channeled, enabling a robust financial backing for companies embarking on this green transition.

Furthermore**, the concept of 'transition'** should **not only be limited to climate-related transition** but should also **encompass wider improvements in other environmental and/or social aspects.** Indeed, transition strategies should also be applicable to social objectives, such as, companies transitioning to a more socially sustainable business model or enhancing social standards within their business chains.

Therefore, **a refined SFDR framework that clearly articulates and integrates the concept of transition finance is indispensable.** It will not only foster a conducive environment for sustainable investments but also ensure that the transition to a green economy is equitable and socially responsible, resonating with the broader sustainability ethos of the European Union.

2. Interaction with other sustainable finance legislation

The web of sustainable finance regulations is inherently intertwined. However, certain inconsistencies hinder their effective implementation and, essentially, hinder them from achieving their core goals. This

evaluation provides an opportune moment to rectify some of these inconsistencies and/or consider the possibility of revisiting other regulatory facets to ensure alignment within this framework.

Alignment with CSRD

The alignment between the Corporate Sustainability Reporting Directive (CSRD) and SFDR is crucial for consistent sustainability reporting. However, the discrepancy in disclosure requirements between investee companies under the European Sustainability Reporting Standards (ESRS) and asset managers under SFDR is concerning.

At investee company level, the ESRS delegated acts allow reporting entities their own "materiality assessment" while leaving explanations as to why the reporting entity has considered a disclosure 'not material' optional. This leads to data gaps between CSRD and SFDR. Unlike investee companies, which are only mandated to disclose indicators they deem material, FMPs are required to disclose all mandatory indicators under SFDR, regardless of whether these indicators are material to the FMP's investments. Consequently, FMP struggle to collect, measure, or quantify certain indicators. This leads to incomplete or inaccurate reporting which, in turn, can be misleading for investors. We believe that FMPs should instead be allowed to focus on the indicators that are most relevant and significant to their business and financial products, while still providing sufficient coverage of the principal adverse indicators.

We must emphasise a consistent approach to sustainability reporting under both SFDR and CSRD, including a common approach to materiality assessments. To avoid leaving room for interpretation or uncertainty, **clear guidance from regulators is essential to ensure fair treatment and integration of 'non-material' data by all stakeholders.**

Furthermore, while the CSRD will enhance access to harmonized non-financial information, it will not fully address coverage issues as FMPs have global portfolios. We would welcome the EC to provide guidance on how to bridge these gaps.

Alignment with MIFID and IDD sustainability preferences

Realigning SFDR with MiFID and IDD sustainability preferences is imperative. Retail investors often struggle to comprehend the vast and technical disclosures. Significant challenges arise when aligning the product categorisation under SFDR ("Article 8" versus "Article 9") with the questions posed by financial advisors to assess their clients' sustainability preferences under MiFID II and IDD (taxonomy alignment, % of sustainable investments, and PAI consideration). Moreover, the ESG concepts employed by MiFID II and IDD contrast starkly with the market reality. This is evident in the notably low percentage of taxonomy alignment within the economy, a moderate level of sustainable investments or use of a limited number of PAI (data gaps, PAI considered as not material).

When engaging with retail investors, it is essential to understand first their perspective on sustainability and ESG-related matters. To get such a clearer picture, we could start **by exploring their ESG-related needs**, in line with those that have been previously identified by the CFA Institute:

- "I want to know that the ESG factors that are material to the risk and return of my investments are explicitly considered."
- "I don't want to violate my personal beliefs or the mission, principles, or beliefs of my organization."
- "I want to make investments that I believe have relatively fewer negative effects, and more positive effects, on the people and things I care about and the world in which I live."
- "I want to capitalize on investment opportunities related to long-term environmental or social trends."

- "I want to invest in specific solutions that intend to make a measurable contribution to a defined environmental or social need, problem, or goal."

Depending on the identified needs, various ESG strategies across different product categories can be mapped against them. For example, to address the ESG needs "I don't want to violate my personal beliefs or the mission, principles, or beliefs of my organization", all products applying exclusions could be presented to the client regardless of the category of these products.

This could then be followed up by the below three questions that would enable a better engagement with clients by targeting their **sustainable investment objectives**, expressed in plain language and aligned with the specifications of financial products.

- Question 1: *"Do you want to direct all or part of your investment to products that integrate Environment (broadly or climate only) and/or Social objectives?"*

- Question 2 (If yes)

    - What dimension: Environment (broadly or climate only) and/or Social?

    - How (link to categories)?

        - Financing companies or projects that are developing technologies, infrastructures, products or services that are contributing to build a more sustainable economy or are expected to contribute to positive impact **("Contribution")?**

        - Portfolios that are committed to transition to more sustainable business models. For instance, reducing their carbon intensity **("Transition")**

        - Products that are focusing on **other "Environmental and/or Social standards/ themes"**?

- Question 3: (If yes) To what extent? (i.e. all of your investment or in order to maintain a certain level of diversification you want to combine different types of solutions;..)

Throughout this process, **the communication of ESG features should be tailored to the investor's level of understanding and capacity to assimilate information.** It is not necessary to delve into every ESG detail with investors, as this can overwhelm them and potentially hinder their decision-making process. Therefore, **more flexibility is needed in how information is conveyed to clients, especially at the point of sale.** The focus should be on providing clear, concise, and relevant ESG information that assists investors in making informed choices without overburdening them with excessive details.

Alignment of ESG information under the BMR for ETFs and other index-tracking products

It would be a stretch to assert the general premise that information provided by benchmark administrators is sufficient and is aligned with the information required by SFDR. We have highlighted previously that the success of SFDR (and related regulatory initiatives connected with the EU Financial Services Action Plan) rely heavily on the availability and flow of data to enable disclosures that facilitate the comparability of sustainable investments by end-investors. While SFDR directly applies to managers of EU-domiciled funds, including ETFs and other index products, it does not apply to benchmark administrators themselves. Accordingly, save for the Climate Benchmark Regulation (which only relates to Paris-aligned and Climate-transition benchmarks), benchmark administrators lack any regulatory incentive to provide the data to support asset managers to meet their disclosure and product governance requirements without the potential for significantly increased costs and where managers have no direct agency over the consistency, validity or quality of such data.

This has, and continues to, create challenges for managers, which may be exacerbated by recent proposals to remove non-significant benchmarks from the scope of the EU Benchmarks Regulation. In many areas, managers still need to fill data gaps, which are often sourced either internally or from a third party, sometimes at considerable additional cost. In addition, some non-EU administrators have not treated the provision of sustainable datasets to managers seeking to comply with SFDR as a priority. The data/information mismatch extends to disclosures, where no consistent disclosure standards applicable to benchmark administrators exist - All of which results in additional operational, regulatory and reputational risk for managers.

A Disclosure Framework at EU Level

The development of SFDR at the European level is crucial as it ensures a harmonised and standardised approach towards sustainability disclosures across all Member States. It ensures a level playing field for all funds operating within the EU and safeguards consistent and comparable information for all EU investors, regardless of which Member State they live in.

A standardised EU-level framework also facilitates cross-border operations of funds by eliminating discrepancies and potential conflicts in local disclosure requirements. It simplifies the regulatory compliance process for funds operating in multiple EU countries.

More importantly, with a unified framework, investors are better protected as they receive standardized, transparent information which is crucial for informed decision-making. It builds investor trust as they can compare funds across different EU countries based on a common set of disclosure standards.

Likewise, national marketing rules often require the inclusion of additional information in prospectuses or KIDs. This practice has inadvertently created barriers to cross-border investment products. These products often need to provide supplementary information to their prospectuses for different Member States, leading to inconsistencies and potential confusion for investors. Also from a marketing perspective, a harmonised comprehensive set of marketing rules is needed.

3. Potential changes to the disclosure requirements for FMPs

Entity-Level Disclosures

The Principal Adverse Impact (PAI) entity-level statement, consisting of PAI metrics and the PAI due diligence policy is an important component of disclosure. Its placement within a product regulatory framework, however, warrants careful consideration to avoid redundancy.

Entities currently adhering to the Article 4 SFDR disclosure requirements also fall under CSRD. CSRD, however, already requires firms to provide this information. To prevent regulatory duplication, it is essential to maintain a clear demarcation between SFDR. SFDR must focus on product-level information while CSRD deals with corporate-level disclosures. Therefore, **we suggest removing the PAI entity-level disclosure requirement from SFDR to avoid this overlap.** Asset managers not subject to CSRD should have the option to voluntarily produce the PAI statement at the entity level, particularly in response to clients' demands.

Importantly, retail investors typically channel their investments into specific financial products rather than the companies managing these products. Consequently, the demand for entity-level disclosures is relatively low, as their **primary concern lies with the details of the individual investment products themselves**. Furthermore, the requirement for entity-level PAI disclosures imposes **considerable additional costs** particularly in relation to the mandatory and opt-in PAI indicators, **without providing any added value** in terms of decision-relevant information. The PAI reports aggregate data upon all managed portfolios, in

many cases hundreds of them, without providing retail investors with any insights relevant to specific products. Additionally, due to many open questions in terms of calculation and persisting lack of data/different data sources, the reported figures cannot at all be compared between FMPs.

Should the removal of entity-level PAI disclosures not be feasible, **a viable alternative would be to streamline the disclosure requirements.** You can achieve this by **reducing the number of indicators published at the entity level to only those PAIs that the entity has assessed as material based on their holdings.** Moreover, removing non-essential PAIs and focusing the disclosures on a select few macro indicators could provide a holistic yet concise overview of the entity's impact and performance.

Product-level disclosure

Uniform Product Level Disclosures

Article 6 already requires all financial products to disclose whether or not they integrate sustainability risks as part of investment decisions. This already provides baseline information to consumers on whether ESG factors are material to the risk and return of the investments. To a limited extent, the revised Shareholders' Rights Directive (SRD II) already requires disclosures on stewardship at the product level upon request.

Nonetheless, should the EC see added value in introducing broader transparency on sustainability-related issues through quantitative indicators, we reiterate the importance of **simplified disclosures.** This entails a single template for pre-contractual disclosures and another for periodic reporting, applicable across all financial products and specifically tailored for retail investors.

In line with this, we suggest **keeping the focus on a small number of key sustainability indicators that are comparable across different markets and potentially different asset classes.** Examples based on the current mandatory PAI indicators include climate-related indicators (e.g. PAIs 1 to 4), board gender diversity, controversial weapons for companies, and share of energy-inefficient buildings for real estate.

Products that do not pursue a sustainable objective (please refer to our proposal based on three categories in section 4) must include a disclaimer in their documentation stating that they do not have any sustainability-related intentions.

Generally, sustainability-related information must be disclosed in pre-contractual documents (as part of product offering) or included in regular reporting. For products with no specific sustainability claim that do not adhere to any of the proposed categories, it is advisable to disclose information on sustainability factors only in regular reporting. This approach would help prevent misunderstandings about the product's commitments and reduce the risk of greenwashing allegations. Therefore, it is essential to clearly differentiate this basic sustainability reporting from reporting on the implementation of a product's ESG investment strategy to attain any sustainability-related intentions.

Product Level Disclosures expressed on a scale

As highlighted above, we underline the critical importance of simple communication catered to retail investors. However, we doubt that a scaling system, as proposed, is the best solution. This method oversimplifies the complex nature of ESG products and introduces a subjective ranking system. For instance, comparing an environmental fund to a social fund has the potential to create a lot of complexity and confusion.

Furthermore, a scaling system will be operationally challenging, incur significant implementation costs, and require careful reasoning to explain why certain products are rated higher than others. The complexities in scaling ESG products cannot be underestimated, as a "broad-brush" scaling system might hide the nuanced differences between products, potentially misguiding retail investors.

The main goal is to provide retail investors with clear, accessible, and meaningful information that helps them make informed decisions. It is important that the chosen approach serves this core objective, ensuring that the true essence of ESG products is accurately communicated, and not misunderstood or oversimplified through a scaling system.

4. Potential establishment of a categorisation system for financial products

Product categories with objective investing driven by intentionality

EFAMA supports the establishment of a voluntary product categorization driven by intentionality, i.e. what the product is seeking to achieve.

The fact that SFDR Articles 8 and 9 have been used as de-facto labels, despite their intended role as disclosures, serves as a compelling indicator of the market's clear demand for a categorisation system. We believe that clear and deliberate categories, characterised by clear names, offer simplicity and are intuitively understood by investors. This categorisation in turn, would allow investors to confidently rely on these categories as quality labels. Those desiring deeper insights can delve into the investment strategy to comprehend the approach used to attain the objective.

Key Principles:

We believe that all product categories should **(i) require intentionality of outcomes in line with a product's specific sustainability commitment and (ii) be based on objective criteria.**

These category-agnostic (cross-cutting) criteria should include the following:

- **Product intention** needs to be clearly articulated in the investment objective and/or investment strategy/policy;

- ESG **strategy** employed to achieve intention needs to be explained, including how stewardship forms part of attaining the product's intention;

- Rigorous and evidence-based KPIs should be specified to **measure the attainment** of the product's intention and ambition.

We recommend avoiding overly stringent minimum criteria for sustainable product categories**.** Instead, sustainable products should be obligated to incorporate clear, **objective, principle-based criteria**, such as a clearly defined sustainability objective and the use of KPIs to assess outcomes.

These principles outlined above can be effectively integrated into both approaches (1 and 2), as proposed by the EC.

Although a number of our members support building the categories around SFDR's established concepts, there is unanimous agreement among EFAMA members on the necessity to articulate the principles of intentionality and level of ambition of the products.

We support the **three product categories, based on their intentionality,** as outlined below.[1]

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[1]While majority of our members view exclusions as an important ESG strategy to be used in the remaining categories, a subset of our members utilise exclusions as a primary strategy to reduce/minimise ESG risks & adverse impacts

1. **Financial products with the intention of positively <u>contributing</u> to environmental/social objectives.** Within this category, the criteria for the **level of ambition** is: making a pre-defined, measurable positive contribution to either environmental and/or social objectives as defined in the specific product terms. The broader term "contribution" should be used to encompass both impact-generating and impact-aligned investments. This category refers to products that **offer targeted and measurable solutions** to sustainability matters that affect people and/or the planet, e.g. investments in firms generating and distributing renewable energy, or in companies building social housing or regenerating urban areas. It can, among others, include Environmental products with an EU Taxonomy-alignment or products investing in green bonds, green infrastructure, green equity, impact investing funds relating to Environment. It also typically refers to social products investing in social bonds or impact investing funds relating to Social, etc. In the case of impact products, alignment with an impact investing framework (e.g. GIIN, Operating Principles for Impact Management (OPIM), etc.) can be considered a relevant criteria.
2. **Financial products with the intention of <u>transitioning.</u>** Within this category, the criteria for the **level of ambition** is: facilitating sustainable transition and measuring the relevant progress. Measurability should be based on sustainability indicators stipulated as binding in the product terms. The demonstration of improvements (in relation to KPI chosen) should not be on a year-on-year basis but rather improvement over time. This approach typically refers to Environmental products like Net Zero aligned funds, transition-linked-bonds, sustainability-linked-bonds, PAB, CTB, or even best-in-class strategies, etc
3. Financial products with the intention of credible <u>sustainability standards</u> or adhering to a specific <u>sustainability-related theme.</u> Within this category, the criteria for the **level of ambition** is: Environmental and/or social and/or governance factors that are more process-based and could rely on credible sustainability standards (e.g. EU Taxonomy or other taxonomies, EU Green Bond standards, SDGs, ICMA Social Bond Principles) sourced either from a third-party or proprietarily without aiming at achieving measurable outcomes in sustainability terms. This category can be fulfilled by investing in green bond, but also in climate thematic with companies that are complying with specific sustainability-related criteria.

associated with these exclusions and meet investor preferences that do not go as far as sustainability outcomes. Having a specific category for exclusions would make it easier to align investors' preferences with these products. Indeed, some investors do not have positive sustainability intentions and are comfortable investing in products aiming to avoid or reduce significant harm on people and/or the planet.

Additional remarks/clarifications:

- **EC proposed category C: Exclusions**

  We consider exclusions to be an important strategy to be used within the categories**. Exclusions is an ESG strategy that can be used to achieve the sustainability intentions of a product category adhering to one of the categories provided that the rationale for these exclusions can be demonstrated and that the effect of these exclusions can be measured through appropriate KPIs, such as the reduction in the investment universe or comparison of certain KPIs, e.g. PAIs with those of an appropriate reference index.**

  Exclusions is an ESG strategy that can be used both as a primary and a secondary means to achieve the sustainability commitments of a product, which can be demonstrated through the effect of these exclusions, as explained above. In this regard, the use of exclusions, if sufficiently rigorous, can also result in implementing credible sustainability standards (e.g. if investments with high GHG emissions or in breach of international conventions on social or governance issues are excluded).

  In line with our proposal to recalibrate sustainability preferences, ESG needs should be wider than just those products adhering to the categories. An investor whose ESG needs are not to violate his/her personal beliefs or the mission, principles, or beliefs of his/her organisation could be offered with products employing exclusions as a strategy whether or not they are adhering to any of the categories.

  In all cases, for the communication and marketing materials, firms should be able to to disclose these exclusions and any other E/S characteristics in marketing materials provided that the disclosures are done in a proportionate way and in line with ambition of the product. This ensures that the investment products, which solely focus on exclusions, can still be clearly communicated and offered to consumers. Investors should remain informed about the nature of the products they are considering, while the industry retains the flexibility to cater to a diverse range of ESG investment strategies and ESG needs.

- For each category the ambition can be measured at the "product" level or "asset" level.

- Where widely-used/recognised frameworks, standards or agreements exist (Paris agreement, Kunming-Montreal biodiversity agreement, impact investing framework, PSF Final report on Minimum Social Safeguards2 etc…), the fund should reference them.

- At this stage, there should be no minimum quantitative criteria related to the EU Taxonomy. It is not complete and does not cover all EU activities. Therefore, it is not appropriate to impose a minimum quantitative criterion for taxonomy alignment as this point in time. If used, our preference is that it will be a disclosure, indicating whether the product commits to investing in taxonomy-aligned activities.

Mutual exclusiveness

We support product categories based on intentionality, designed in a mutually exclusive manner. However, it is critical to recognise that investment products often employ a range of strategies to realise the product's intention.

To illustrate with an example, within category 1, "financial products with a focus on positive contribution to environmental/social objective", we expect a product's strategy to be focused on achieving a measurable positive outcome. **The main investment objective should be implemented in the holistic investment**

[2] *Final Report on Minimum Safeguards, EU Platform on Sustainable Finance, October 2022*

strategy, including elements like stewardship and/or exclusions that in combination support the intention of the product. While these approaches can overlap and be used in tandem, the product's core intention is singular: achieve measurable positive impact.

In this context, we would like to highlight a critical aspect: for certain asset classes, fixed income being one example, the universe of assets that will be eligible for some product categories (e.g. 1 or 3) will be narrow. It may therefore not be possible to create diversified labelled portfolios for these asset classes if a numerical threshold is imposed (e.g. 70%) requiring that the underlying assets of the investment product be within only one product category to benefit from a product category. Such a restriction could lead firms to compromise on the liquidity profile of assets to try to diversify the universe of assets. This is also true in relation to multi-asset funds, wherein the different asset types cannot be attributed to a single category (e.g. equities are already meeting the sustainability standard but corporate bonds and real estate assets are in the improver's category). These products should still be able to qualify for a specific product category by choosing the category that is dominant within the asset types.

An asset-neutral approach

It is crucial that the future SFDR approach also ensures that all asset classes are supported, as well as multi-asset strategies. If numerical thresholds will be imposed as per the previous section, multi-asset funds should have the possibility to fall within the different product categories in function of the % of exposure, on the condition that they remain transparent and disclose on their effective mix of product categories. Additionally, it facilitates the natural evolution of assets as they evolve, for example, transitioning from category 2 (transition focus) to 1. or 3. upon meeting their intended improvements.

It is also important that the funds' product strategy, the funds' objective could be assessed at the portfolio level or the activity level. For instance, the Paris-Aligned Benchmarks appear to focus on overall portfolio objectives rather than individual asset-level assessments.

A hybrid approach: recalibrating existing concepts and KPIs to complement the categorization regime

The future SFDR approach should be designed to (i) effectively cater to and distinguish among the diverse ESG strategies in the market, (ii) adequately address some of the issues market participants are already facing in relation to the implementation of SFDR, and/or (iii) provide the Commission with the freedom or flexibility that is required in order to create a clear, pan-EU categorisation regime that is 'fit for purpose. While mindful of the limitations to which existing concepts can be adapted, we also see merit in **leveraging the market's existing familiarity with SFDR concepts.**

Maintaining continuity with established SFDR concepts is important to preserve the credibility of the EU sustainable finance regulatory framework. We see value in using elements of the current regime, especially the Principle Adverse Impact (PAI) indicators, **as far as relevant to the product's intention.** Therefore**, recalibrating certain existing SFDR concepts to complement the categorization regime can enhance the overall effectiveness and acceptance of the future SFDR approach.**

Realigning SFDR with MIFID and IDD sustainability preferences

As indicated above, it is crucial to **review and align the criteria for sustainability preferences under MiFID and IDD with SFDR**, making this alignment a key aspect of the overall review process.

We propose aligning these regulations by linking **investor's ESG needs to ESG strategies (rather than directly to the product categories) and supplementing these needs with information on investors' sustainable investment objectives.** For example, a consumer whose ESG needs is to ensure his/her

investment does not harm the environment and/or society could be offered with various products applying exclusions or best-in-class strategies. These products may span across different product categories (or could also be outside product categories), as long as they incorporate these strategies.

We reiterate that for the new product categories to be effective, they must be understandable and comprehensible to retail investors. It is essential to conduct practical tests with actual distribution channels and consumers before finalizing any categorization. This real-world testing ensures that the categories are not only theoretically sound but also workable in practice.

We refer to section 2 for the messages around the interaction between the sustainable finance legislation, particularly with MiFID and IDD sustainability preferences.

Aligning with global financial markets where possible

The EC should broaden its regulatory scope to align with global financial markets, particularly in sustainable finance. By collaborating with counterparts in the UK, US, Singapore, Hong Kong, and other regions, the EC can work towards a common set of sustainability labels or concepts that are internationally recognised. This approach is crucial because financial products are distributed globally, and differing regional standards can lead to confusion and a heightened risk of greenwashing.

We acknowledge that achieving formal alignment across various regions may be a too-ambitious endeavour. However, we believe that the EC should at least extend its vision beyond the EU by striving to foster mutual recognition of frameworks. This approach would support the collective goals of a globally sustainable economy.

Levelling the playing field between active and passive funds

The categorisation approach should also be agnostic to the investment style (i.e., passive vs. active), ensuring that every product is captured by the categories proposed above.

Furthermore, the clarification provided by the EC relating to funds tracking PABs/CTBs being eligible to be automatically classified as having sustainable investment objective (Article 9), whilst welcomed, created an uneven playing field between active and passive funds. Our preference is that while we wait for the outcome of this review, the same relief is also provided to active funds employing the same criteria and methodologies (e.g. 7% reduction in GHG intensity on average per annum, exclusions, etc.) used by PAB/CTB administrators. Ensuring there is level playing field between active and passive funds is important if we proceed as proposed regarding transitioning to a more formal categorisation regime. As such, it is critical that PABs/CTBs should not qualify for the sustainable fund categories if they do not adhere to the same qualitative criteria reflected in our response.

Marketing and Fund Naming

It is important to ensure that the communication of the sustainability-related terms is always proportionate to the role that ESG plays in an investment strategy. The “fair, clear, and not misleading” rule should already be sufficient to address this.

The prohibition on the use of sustainability-related terms in marketing materials will be extremely difficult to implement in practice. While we agree that some of the terms provided should only be associated with products adhering to the categorisation regime (as linked to sustainable outcomes – SDG, green, net zero), words like ESG and responsible have wider meaning and should not be limited to those products that are adhering to the categorisation regime. For instance, ‘responsible’ is a term that has been associated with the integration of sustainability risks within investment decisions. With the introduction of SFDR, the consideration of sustainability risks has increasingly been considered as integral to a firm’s acting in

accordance with its fiduciary duty and has often been central to investment strategies that pursue a financial return objective.

By prohibiting their use, this could also limit consumer access to decision-useful information. We fear that the prohibition will lead to firms being less transparent regarding their consideration of both ESG risks and opportunities, outside of the mandated disclosures. This could potentially lead to green bleaching and will not help consumers understand how products that do not use the categorisation regime consider ESG risks and opportunities.

Moreover, if specific rules apply to a product, the underlying benchmark tracked by passive products must also comply with these same rules. For example, if an ESG index fund follows the “XYZ ESG Index”, it would be reasonable to name the fund “XYZ ESG Index fund” or something similar. If, under these requirements, the fund could not use this name, investors would likely be (understandably) confused, especially if the fund was required to change its name to one that now differs meaningfully from its underlying index.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book.

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