European Regulators Input on SFDR Review

July 2024

Supervisory Authorities ("**ESAs**") have issued a joint opinion on the assessment of the Sustainable Finance Disclosure Regulation ("**SFDR**"). The publication of the own-initiative opinion follows the European Commission ("**Commission**") consultation on the review of the SFDR issued in September 2023. The European Securities and Markets Authority ("**ESMA**") followed up by issuing its own opinion on the functioning of the sustainable finance framework on 25 July 2024.

ESAs' Joint Opinion

The ESAs' opinion acknowledges that the SFDR framework could be improved and that the required disclosures may be too complex by nature and difficult to understand, in particular for retail investors, a view that is supported by consumer testing exercises. The ESAs also recognise that, despite the fact that the framework was originally designed as a disclosure and transparency regime, in practice financial market participants have been using the requirements to classify their financial products, using "Article 8" and "Article 9" as product labels. The Commission also noted this in its consultation, and has proposed the introduction of a new opt-in product labelling regime by either: (a) expanding on the requirements currently applicable to Article 8 and Article 9 SFDR funds, including the introduction of minimum sustainability requirements; or (b) introducing four entirely new product labels based on the investment strategy, which would cover impact and transition strategies. (Please see our briefing note on the Commission's consultation for further detail.)

The ESAs called for simplifying disclosures by introducing a product classification system and / or sustainability indicators. The categories should be simple, with a clear criterion to identify which category the product falls into. The ESAs recommend that there be at least two categories of 'sustainable' and 'transition'. A sustainability indicator could outline the environmental sustainability, social sustainability or both, allowing investors to be informed of the sustainability features of a product on a grading system. The ESAs recommend consumer testing and consulting on options for product categorisation and / or sustainability indicators so that disclosures would not need to be as detailed and extensive.

The ESAs discuss improvements to the definition of sustainable investments, suggesting that the Commission revisit the coexistence of two parallel concepts of "sustainable investment" as defined in the SFDR and "Taxonomy-aligned investment" as defined in the EU Taxonomy Regulation. It is also suggested that the Commission should ensure sustainability disclosures cater to different investor needs and improvements in sustainability disclosures should consider distribution channels and ensure consistency of information. The Commission should only prioritise essential information for retail investors, though professional investors can benefit from detailed information. Other recommendations relate to expanding the scope of the SFDR, considering key adverse impact indicators for all financial products and the introduction of a framework to analyse the sustainability features of government bonds. The ESAs have also suggested that it would be useful if the Commission could clarify the role of funds' depositaries and the extent of the controls to be performed on the SFDR related disclosures where not clear under sectoral rules.

ESMA Opinion

ESMA's opinion sets out possible long-term improvements to the sustainable finance framework, seeking to identify how the framework can be developed to enhance investor access to sustainable investments and to support the effective functioning of the sustainable investment value chain. ESMA has put forward a number of recommendations for the Commission to consider, summarised in the table below.

EU Taxonomy	The EU Taxonomy: ▪ should become the sole, common reference point for the assessment of sustainability and should be embedded in all sustainable finance legislation; ▪ should be completed for all activities that can substantially contribute to environmental sustainability; and ▪ should be complemented by a social taxonomy.
Transition Investments	Transition investments should be defined and should be incorporated into the framework.
Product Categorisation	A product categorisation system should be introduced catering to sustainability and transition, based on a set of clear eligibility criteria and binding transparency obligations.
Minimum Sustainability Standards	All financial products should disclose some minimum basic sustainability information, covering environmental and social characteristics.
ESG Data	ESG data products should be brought into the regulatory perimeter, the consistency of ESG metrics continue to be improved, reliability of estimates ensured.
Consumer / Industry Testing	Consumer and industry testing should be carried out before implementing policy solutions to ensure their feasibility and appropriateness for retail investors

Next Steps

The Commission is not bound to act on the ESAs' or ESMA's recommendations. It is currently reviewing the feedback received from stakeholders on its consultation and may issue proposals in relation to revising the SFDR later in 2024. What seems clear is that both the Commission and the ESAs accept that market practice has been to treat the SFDR framework as a product categorisation regime and it is likely that the revised SFDR will formalise this approach, with the introduction of product categories or labels subject to minimum criteria.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

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