**Overview of the categorization regime**

**There is a need for a categorization regime.** The fact that articles 8 and 9 of SFDR have been used as labels, despite their intended role as disclosure standards, indicates this. A disclosure framework alone will not impose high, and uniform, sustainability standards. SFDR should be evolved by adding sustainable categories covering the main sustainable investing strategies in the market.

**The categorization regime should use a hybrid approach.** Certain (limited) concepts from the current art. 8 and 9 classifications should be maintained and evolved at least in the short term (to minimize costs and retain some continuity for investors). Overtime, references to art. 8 and 9 may no longer be necessary. At the same time, the sustainable product sub-categories should be added. These should be defined by their sustainability objectives which must meet minimum criteria. 

**Overview**

The following categories recognize the wide spectrum of ESG approaches available. They have some similarities to the UK FCA’s SDR categories (and we note that European convergence, here, would be beneficial). 

Note: Thematic strategies may fall under any category. \* Only comprises Impact, no longer has a SI requirement.

|  |  |  |  |
| --- | --- | --- | --- |
| Art. 8 | | | Art. 9\* |
| *Not Sustainable* | *Sustainable* | | |
| Other Art. 8 | 1. **Sustainable Improvers** | **2. Sustainable Focus** | **3. Sustainable Impact** |
| Other environmental or social characteristics      Some sustainable term use restrictions. Notice that ‘not sustainable’.        **Coverage**: 70% of investments. | Credible transition standard    OR    Improvement of relevant E/S characteristics measured by metrics.    OR      **Coverage**: 70% of investments. | a)  Comprise: i. a minimum % Sustainable Investments; and ii. 70% of investments have E/S characteristics.    OR    b) Binding ESG approach covering 70% of investments which is selective resulting in reduction of  universe by a specified percentage.    **Coverage**: Per a) and b). | Adheres to a recognized impact market standard. Specifically, has a theory of change, investor, and investment impact.          **Coverage**: 70% of investments. |
|  | **4. Mixed - For Strategies Combing the Above** | | |

**Article 8**: The following categories exist -

* Sustainable Improvers: An ‘Improvers’ sub-category would be defined setting out the minimum ‘environmental or social characteristics’ that need to be met. Specifically, that Improvers strategies must evidence a credible transition standard or relevant E/S characteristics that are improved over an appropriate timeframe by reference to metrics (including engagement). 70% of the portfolio should meet these requirements. This is a sustainable category that seeks sustainability performance over time (or ‘momentum’).
* Sustainable Focus: To qualify for this category, the strategy would either:
  1. Comprise a minimum % of ‘sustainable investments’ (as defined in Art. 2(17) SFDR or by reference to the EU Taxonomy), which is rigorous but lower than the 50% proposed under the ESMA Names Rule which would be too restrictive1. This is in addition to having environmental or social characteristics covering 70% of the portfolio; or
  2. Be a binding ESG approach covering 70% of the portfolio which is selective and results in the reduction of the universe by a specified percentage. Stringent exclusions (for example CTB exclusions) may be a component of this.

This is a sustainable category with a focus on ‘already sustainable investments’.

Sustainable Investments: The definition of ‘sustainable investments’ should be evolved to provide for minimum standards, objectivity, and comparability. The European authorities should be empowered to issue guidance setting out i) what constitutes a positive contribution to an environmental or social objective under the first limb of Art. 2(17); and ii) what the appropriate thresholds are for ‘doing no significant harm’ under the second limb of Art. 2(17). This should be calibrated to provide for high but attainable standards, i.e., not a stringent as the EU Taxonomy, recognizing that the sustainable transition is work-in-progress and to facilitate the construction of diversified, sustainable portfolios. The SI test should remain an entity level (and not an activities level) test. For emerging market investments, lower PAI thresholds should be required to ensure sustainable investments reach the locations where they are needed most and can have the biggest impact.

* Other Art. 8 Strategies: Where at least 70% of the portfolio has some environmental or social characteristics but do not meet the Improvers, Focus or Impact requirements. This is **not** a sustainable category. These strategies would not be able to use certain terms reserved for the categories (e.g., ‘Sustainable’, ‘Sustainability’ or ‘Impact’ and related terms) in their names or elsewhere. However, they would be allowed to use other ESG terms (in their name and in other materials) to describe the product’s environmental or social characteristics and provided that the fund’s name is in line with those characteristics. Further, they must disclose that, and why, they do not have a category label.

**Article 9**

Impact: Article 9 would be amended so that only Impact strategies meet the requirements. Specifically, an Impact strategy would need to meet accepted market frameworks for impact investing, such as the IMP Impact Management Framework’s *Operating Principles for Impact Management* or the Global Impact Investing Network’s (GIIN) *Principles*. There are some key common requirements:

1. *Intentionality*: A theory of change (articulating the impact thesis), including how to measure and evidence its logic and objectives with metrics.
2. *Additionality*
   1. Investment contribution to the theory of change. How are investments contributing to solutions to environmental or social problems, often in under-served markets or to address observed market failures.
   2. Investor impact / contribution to investment impact. This can include financial additionality of capital i.e., growing new or undersupplied capital markets and / or driving change through engagement.
3. Impact management by establishing, monitoring, and reporting impact metrics and performance in line with the fund objectives set in the theory of change.
4. The requirement to have Sustainable Investments at all or a certain minimum % Sustainable Investments should be removed, as this category would only comprise Impact. 70% of the portfolio should meet these requirements. This is a sustainable category.

**Mixed Category**

To accommodate a multi-manager or multi-asset strategy a fund or portfolio ought to be able to combine approaches, say 50% Improvers and 50% Sustainable Focus provided that the requirements of each category are met (proportionately).

**Universal Criteria**

The following should be applied across all three sustainable categories -

* Sustainable Objective: Should be clearly articulated and should be rigorous and underpinned by metrics or key performance indicators.
* Investment Strategy: To achieve the sustainable objective should be described.
* Good Governance Requirement: Should be retained.
* Minimum Coverage: Calculation methodologies should be internationally aligned, for example with the UK FCA and SEC, in particular for determining how derivatives exposures are counted.
* Asset Neutrality: The categories should be able to be applied to all asset types, including real estate.