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European Commission
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
1049 Brussels
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Re: Cover letter – EY's comments to the targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR)

Sustainable finance is a vital element in the global financial landscape and is increasingly recognised as a key contributor to sustainable economic growth and development. Since its launch in March 2021, the Sustainable Finance Disclosure Regulation (SFDR) has made progress to create greater transparency and accountability in the sustainable finance sector, leading more companies to adopt environmentally and socially responsible investment strategies.

EY welcomes the European Commission's (the Commission) review on the implementation of the SFDR, as it presents an opportunity to enhance the framework's functionality and make improvements where necessary. Our suggestions are grounded in our experience supporting financial market participants (FMPs) such as asset managers, AIFMs, UCITS fund managers, management companies, credit institutions, insurance companies, portfolio managers, and financial advisors with their SFDR disclosures. This letter highlights our feedback and recommendations for the Commission's deliberation.

Key messages

SFDR has enhanced transparency in relation to sustainable risks and to the degree to which financial products consider environmental and/or social characteristics thereby fostering trust and attracting responsible investors. Additionally, the standardised framework for ESG disclosures facilitates investors to take more informed investment decisions. As a result, assisting market participants to align with the values of a growing segment of investors, whilst potentially boosting innovation in sustainable financial products, including the development of new instruments such as green bonds and sustainable funds.

Over the first ten months, we have observed challenges in the application of the SFDR Regulatory Technical Standards for organisations, in terms of meeting these new regulatory requirements. General issues include a lack of awareness and understanding of specific requirements, difficulty in data collection and processing, confusion over the selection of Principal Adverse Impacts (PAIs) and Key Sustainability Indicators (KPIs), and challenges arising from the mandatory asset allocation graphical representation.

Based on our observations, our summary key recommendations are as follows:

1. Further clarification to be provided in relation to the definitions used within SFDR (e.g., “what is sustainable investment”, “what is aligned to E.S.G characteristics”) including transitional investments will be helpful.
2. Refine the distinction between Article 6, 8 and 9 funds, to help tackle its misuse as proxy labels rather than a tool for disclosures.
3. Enhance the definition of Article 8 and 9 funds, with a focus on defining specific requirements that leverage relevant measures and KPIs within the EU Corporate Sustainability Reporting Directive (CSRD) and (where applicable) the EU Taxonomy.
4. Revisit the requirement for PAIs at the entity level to determine what, if any, value it brings given it is the product that is invested in.
5. Streamline PAIs in product-level disclosures, by implementing a minimum framework that outlines mandatory disclosures. Equally where a PAI is identified at the product level this should result in a corresponding action.
6. Any potential labelling regime should have clear and defined criteria and should be interoperable with other jurisdictions’ labelling regimes. This will prevent duplication, avoid ambiguity, and reduce the risk of greenwashing.
7. Provide additional clarification re interoperability between existing regulations and sectoral requirements; for example, it would be helpful to provide guidance on how to match product criteria designed by the SFDR and client preferences as per MiFID II ESG requirements.

Our overall response is also reflected within the consultation survey template. EY would be please to discuss our comments further. Should the Commission wish to do this or have any questions, please contact Nina Emordi, EMEIA Financial Services, Regulatory and Public Policy (nina.emordi@uk.ey.com)

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Our recommendations in more detail

Clarify the definitions used within SFDR

We note that various elements of the SFDR are a challenge for FMPs to interpret. Firstly, terminologies such as “sustainable investment” and “aligned to E.S.G characteristics” can be difficult due to the data methodology used to assess the criteria. According to our recent survey on regulatory reporting[1], firms use a range of approaches in their sustainable investment definition. Economic activity classification is the most popular consideration, used by 86% of respondents. With economic activities being the one of the common approaches used in the market to define sustainable investment criteria, we propose that the Commission clarifies its definitions and considers aligning with the EU Taxonomy’s methodology to define environmentally sustainable economic activities. We also welcome the alignment of the definition of the terminology for SFDR purposes with the future ESMA ‘Guidelines on funds’ names using ESG or sustainability-related terms’ (currently still in the form of ‘Consultation Paper’[2]).

Secondly, further clarity on the integration of sustainability risks within the remuneration policy would be welcomed within the market. Guidance is welcomed to ensure that the remuneration policy not only describes *whether* the remuneration is in accordance with the integration of sustainability risks, but also *how* it is consistent with the entity’s integration of sustainability risks. Clarity on the expectation and consistency on the sustainability target and remuneration policy would be helpful to further elaborate on how sustainability risks is considered as an element in variable remuneration schemes. Such guidance would not only help market participants increase their ESG ratings, but it could also help to incentivize smaller entities to share this information and achieve higher ratings.

Refine the distinction between Article 6, 8 and 9 funds to tackle its misuse as proxy labels

The SFDR has categorized financial products as either promoting environmental/social characteristics (Article 8) or having sustainable investments as its objective (Article 9). However, although FMPs are required to provide product disclosures based on their applicable article, we have observed that the categories are being misused as a perceived marker of sustainability. In this regard, we

[1] EY ESG Regulatory Reporting Asset Management Survey 2022 https://www.ey.com/en_gl/financial-services-technical-resources/esg-regulatory-reporting-asset-management-survey-2022

[2] ESMA Consultation on Guidelines on fund’s names using ESG or sustainability-related terms, published 18 November 2022: https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related

recommend that clearer distinctions be made between Article 8 and 9 financial products.

Additionally, within the market, Article 6 are facing marketing difficulties compared to more sustainable funds. Considering the market demand to invest in more sustainable funds, we recommend that the Commission provides more detailed requirements for Article 6 and considers whether its category is still fit for purpose.

As mentioned above, the distinction between financial products which fall under Article 8 or Article 9 lacks sufficient clarity for FMPs. We have observed that the misinterpretation between the two has resulted in a broad range of sustainability levels and strategies. Furthermore, the incorrect interpretation of the disclosure requirements for the funds has contributed to an increase in perceived greenwashing risks in the financial market. To address this, we propose that clearer distinctions between the two categories should be made. For example, Article 8 products should meet a minimum criterion to be considered “light green” (i.e., intention to have a positive ESG impact). Whilst Article 9, should remain with a strict sustainable investment objective’ product to be considered “dark green”. Furthermore, we believe that the criteria for both should leverage metrics/KPIs based on existing regulation such as CSRD and for environmental objectives align with EU Taxonomy

Streamline PAIs in entity and product-level disclosures

The disclosure of PAIs have become central to sustainable finance regulation as a means of assessing the impact of investments on social and environmental factors. However, we have observed various approaches across the market, where some entities make disclosures at the entity or product level, while few provide multi-level reporting.

Regarding entity level PAI application, we believe that its purpose should be reconsidered, on the basis that it is the product that market participants invest in and having two sets of PAIs may cause confusion.

Separately, regarding product-level PAI disclosures, we recommend that if the Commission decides to enforce uniform disclosure requirements for certain financial products, a limited number of PAI indicators should be made mandatory and based on materiality and, specific fund strategies, focusing on areas such as climate change mitigation, climate change adaptation, social issues, and over time, biodiversity. Additionally, we would welcome additional guidance on the approach for the consideration of PAIs (e.g., qualitative, or quantitative monitoring, use of thresholds on specific indicators).

Interoperability with other sustainability regulations and guidance

We note that the SFDR is not a standalone regulation but a regulation that is designed to coalesce and interconnect with other EU regulations and directives. To a certain extent, disclosures on Articles 3, 4, and 5 are helpful regarding its interlinkages with other regulations. However, we believe that more granularity is required in the information that is mandated. At present, the level of detail for entity-level disclosures in SFDR is lower than the requirement under the EU CSRD and the EU Taxonomy.

As the uptake of Taxonomy adoption among funds is increasing, FMPs are incorporating Taxonomy commitment to some extent into their funds. Once again, we encourage the Commission to leverage the CSRD and relevant measures within the Taxonomy to enhance reporting demands in SFDR. By accomplishing a better alignment, it will enhance SFDR's validity and accuracy.

We also suggest that the Commission strengthen the SFDR's connectivity by avoiding duplication and underpinning specific requirements using existing regulation such as CSRD, Taxonomy Regulation, Benchmark Regulation MIFID II and IDD.

Lastly, differences in application of the directive both in terms of individual Member States and National Competent Authorities has hampered comparability. A simplified approach in this area would help comparability of disclosures and enhance the SFDR interoperability.

Product categorisation

We believe that a framework for product categorisation could be beneficial to the market but will need to be carefully introduced. Should the Commission consider a labelling regime, we recommend that it should have no more than four clearly defined and mutually exclusive categories. Having products, that belong to multiple categories could cause confusion, generate legal risks, and increase the likelihood of greenwashing.

Furthermore, if a new labelling regime is introduced, we suggest that the EU Taxonomy, which assesses economic activities based on Technical Screening Criteria for Positive Contribution, (TSC), Do No Significant Harm (DNSH), and Minimum Social Safeguards (MSS), be used (when fully developed) as a minimum requirement for environmentally sustainable investment categories in the sectors currently covered by the EU Taxonomy regulation. In the market, we have observed that FMPs have shown keen interest in setting a minimum level of investment alignment with the

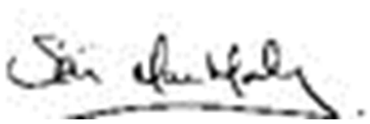
Taxonomy for Articles 8 and 9. However, we note the idea of DNSH is not well comprehended as a concept and would require additional clarification, potentially linking it with phase-out or exclusion policies.

There are also merits in developing a categorisation system based on the pre-existing Articles 8 and 9, since the market has put a lot of effort and time to align with the SFDR. However, if a categorization system is to be built on new criteria and not on existing concepts, we recommend that grandfathering rules should put in place to help support a smooth transition and implementation process.

Overall, we suggest a hybrid approach could be considered with a mandatory disclosure regime under the existing definitions of Article 8 and 9, whilst a label regime would be implemented in addition to the disclosure regime, based on aligned criteria, describing the approach regarding sustainable investments and the intent of the ESG policy (e.g., Article 9 – impact, Article 8 – transition).

Finally, we propose that the creation of a labelling regime should be carefully considered, given the labelling systems being developed in other markets such as the UK and the US. We recommend that any labelling regime should be interoperable with other key jurisdictions to limit confusion and reduce compliance burdens. This will further support the EU's wider initiative to reduce reporting burdens and make the EU more competitive for business.

Your sincerely



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