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15 December 2023

Commissioner Mairead McGuinness
European Commission
Financial services, financial stability and Capital Markets Union
Rue de la Loi, 200, 1049 Brussels, Belgium

Re: Federated Hermes' Comment Letter Accompanying our Response to the European Commission's Targeted Consultation on Implementing the Sustainable Finance Disclosures Regulation

Dear Commissioner McGuinness,

Federated Hermes very much appreciates the opportunity to provide our views on the Consultation. Federated Hermes is a global leader in active, responsible investment. We are guided by the conviction that responsible investing is the best way to create long-term, sustainable wealth for our clients and their beneficiaries. We provide specialised capabilities across equity, fixed income, and private markets, in addition to multi-asset strategies and proven liquidity management solutions. Through our world-leading stewardship services, we engage with companies on strategic and sustainability issues to promote investors' long-term performance and fiduciary interests. Our goals are to help individuals invest and retire better, to help clients achieve better risk adjusted returns, and where possible, to contribute to positive outcomes in the wider world.

We believe there are two mutually reinforcing strands of responsible investment management: responsible investment and responsible ownership. Together, these aim to generate sustainable wealth creation for the end beneficiary investors, encompassing investment returns and their social and environmental impact. This drives our governance structures – designed to put our clients and beneficiaries at the heart of everything we do – and our investment and engagement activities, through which we seek to deliver strong risk-adjusted returns and where possible, to contribute to positive outcomes in the wider world, consistent with client objectives and applicable requirements.

We firmly endorse the pursuit of effective and purposeful regulation for investment funds and their managers. We appreciate the opportunity to share our insights on SFDR, both the positives and negatives, the challenges encountered during its implementation, and suggestions for enhancing its clarity, certainty and efficiency. We appreciate the Commission's candour in acknowledging that while SFDR was a positive first step, the framework can be improved.

First and foremost, we urge the Commission to consider the simple application and enforcement of a fund's disclosure as the ultimate measure by which supervisors should consider. Application of a strict disclosure regime in the SFDR space would reinforce the notion of transparent, clear, and concise, and accurate reporting on what a fund is doing and intending to so as it relates to environmental, social and governance factors. Turning back to a reliance on relevant and useful disclosure and encouraging the enforcement by Member State regulators of those firms found to be intentionally misleading their investor base, would put E, S and G characteristics back on par with all other investment risks and considerations that are vital for shareholders to consider. The work on SFDR, and its surrounding enactments to create more uniformity on the taxonomy will not be wasted but will serve as vital tools as European managers build out their disclosures. This disclosure regime can then be supplemented with a new enhanced EU labelling framework, which when combined with the disclosure, will provide EU investors and regulators with a clear and concise framework by which investment decisions can be made and investment managers can be judged. In order to protect investors, we would stress that an enhanced labelling framework should be clear in what funds and their investments might qualify and should not favour a particular approach to sustainable investment over another.

Should the Commission opt to retain SFDR in its current, or near current format, we will provide further insights on how best to move forward. This comment letter is provided in conjunction with and offers a summarised version of our comprehensive response to the online questionnaire (targeted consultation).

1. Most Concerning Flaws of the Current SFDR

There are ambiguities in SFDR concepts as well as inconsistencies and inaccuracies in definitions which should be addressed. For instance, the definition of "sustainable investment" is vague, leading to legal uncertainty, increasingly perceived/potential greenwashing by some FMPs and reputational risks for various FMPs.

- **Challenges with standardised sustainability disclosures**: the distinction between Article 6 and 8 of the SFDR is imprecise. Minimal differentiation is evident between products under Article 8 and Article 9 of the SFDR. As a result, undue effort is spent classifying financial products rather than focusing on genuine, relevant and useful sustainability disclosures.
- **Issues with entity-level disclosures**: The current entity-level disclosures, whether presented independently or in an aggregated format, present limited practicality. Additionally, the intended audience for this level of information is not clearly defined. It is apparent that most retail investors are unlikely to scrutinise the comprehensive exposure of a specific fund manager to Principal Adverse Impacts (PAIs). Instead, their primary concern should revolve around understanding the specific fund in which they are investing and whether that fund is operating in line with its specific mandate.

Finally, SFDR is incorrectly being used as a labelling regime, contrary to its original intent. Clear legal definitions for product categories are lacking. International interoperability remains a concern. And, as Federated Hermes has been advocating since the initial design of SFDR, there's a notable absence of categories for transition products as well as incentives to engage with investee companies.

2. Other Struggles in Achieving the Original Objectives of Investor Understanding and Consistency

The mandated set of PAI indicators often fails to align with investment strategies' material topics and themes. SFDR adopts a generalised "one size fits all" approach.

Currently, the costs associated with the SFDR far outweigh the benefits. Whilst we have not quantified the costs, the number of resources across different departments, the technological work to meet reporting requirements and external resources used to understand the regulation in areas where there is lack of clarity has been a huge burden on us. Scant evidence suggests that capital has been effectively redirected as intended; instead, the financial market has grown increasingly intricate and perplexing. One positive outcome of the SFDR is its role in improving how FMPs have articulated their strategies in the fund documentation as well as having an indirect impact on improving disclosures made by corporate companies.

Unfortunately, the sequencing of ESG legislation in the EU (SFDR adopted before CSRD) led to an inappropriate expectation that fund managers need to engage with investee companies to fill data gaps. The majority of financial institutions have traditionally relied on third-party data providers to meet their reporting requirements. Once companies submit the data, the responsibility then falls on the investment team to interpret it based on their understanding of the company, determining whether it aligns with the fund's investment criteria.

In instances where data is scarce, data providers adopt various approaches:

- Estimation based on available information: Data providers often resort to estimating data based on the information accessible from the company. The methodologies employed can range from relatively crude estimates to more sophisticated approaches. Understanding these methodologies is crucial for investment managers, who must assess the company accordingly. This practice is widely accepted in the market standard.
- Proxy metrics: Addressing a lack of specific data can be particularly challenging. Some data providers resort to offering proxy metrics, which poses a more complex situation. Instances have been observed where data providers present metrics as proxies for those outlined by SFDR (Sustainable Finance Disclosure Regulation). For instance, water usage might be used as a proxy for water emissions. Although these metrics represent different data points, the scarcity of data has led many providers to adopt this approach.

While CSRD will eventually close most data gaps in the EU, large gaps will persist for non-EU companies. It is impractical and inappropriate to expect fund managers to fill data gaps. More pertinently the ability to engage and gain information creates: i) risks of some investors having access to more information; and ii) an unfair commercial advantage to large investment firms with the resources and scale of asset under management to be able to engage for such purposes.

Federated Hermes' portfolio managers and engagers in their stewardship activity whose objectives in public markets are described in its subsidiary EOS' engagement plan[1], assess what are the material risks and opportunities for a company. Once identified, we engage with the company to deliver on our engagement objectives. Where a company is in early stages of addressing a risk, the initial engagement will be focused on understanding exposure and improving relevant and useful disclosure. For example – before engaging with a company to set a credible climate transition plan, it is important to understand its current emissions and exposures. We have published our engagement plan that sets out the objectives we engage across different themes for different sectors.

Additionally, the lack of harmonisation with other EU sustainability regulations requires reform. The SFDR's integration with the EU Taxonomy Regulation, especially the new "safe harbour" provision for Taxonomy-aligned investments, is problematic. We also notice a discrepancy between the SFDR's strict PAI guidelines and the more flexible disclosures under the ESRS. In addition, the SFDR's disclosure categories misalign with the sustainability preferences of MiFID II.

[1] EOS Engagement Plan 2023-2025 (hermes-investment.com)

3. Enhancing the Effectiveness of SFDR for Its Intended Purposes

Against this background, it is imperative that we promptly reconsider the original purposes and objectives of SFDR. Combating greenwashing remains an appropriate objective. In addition, we would argue that the ultimate aim of sustainable investment is to redirect capital in investees towards achieving positive environmentally and societal outcomes which deliver long term financial returns for investors. Simply investing in what is already 'green' does not directly lead to real world outcomes society needs.

To achieve this, we ideally should return to a strict disclosure regime, where fund managers provide transparent information about their funds and their performance against the objectives. Then, NCAs would conduct thorough reviews and focus on whether funds are being managed in accordance with their clear and concise disclosure, and that assertions relating to environmental, social and governance issues are not misleading. In the rush to focus attention on E, S and G considerations, we have placed these particular risks above all others in fund disclosures, and it is more appropriate to rightly identify these as key areas of risk that investors should be informed of, but that such information and the manner in which it is disclosed remains with the investment manager. Thus, permitting regulators to rule against a misleading claim, a standard that has worked for decades.

Upon returning SFDR to its original disclosure purpose, the EU can look to introduce an EU labelling regime which can put in place heightened environmental, social and governance criteria – something that should firms choose to accept, would be invaluable for those investors seeking to direct their capital in these products. Such labelling should however be carefully considered to provide transparency to investors and protect investors in not favouring one sustainable investment approach over another.

Consensus on the Need for a Strict Disclosure Regime:

There is a widespread agreement on the need for a disclosure regime in sustainable investment. Ideally, we believe it should be the responsibility of managers to disclose their practices—or, if preferable, to let managers make that disclosure. However, if the European Commission wishes to retain SFDR, we are amenable, with the caveat that there is a requirement to enhance clarity and address inconsistencies. Specific examples are detailed in the comprehensive response.

Entity level disclosures: Federated Hermes sees very limited utility in entity level disclosures and believes it is far more appropriate, as proposed in the consultation, to exclude entity-level disclosures from the SFDR's purview. Instead, these disclosures could be more effectively addressed under the CSRD. Reporting PAIs at the firm level comes with its own complications when combining different asset classes together; lack of methodologies available makes this reported data not useful for investors. Instead, it would be more appropriate to have requirements to set out a climate transition plan at the entity level.

Product level disclosures: Federated Hermes suggests that the EC consider simplifying the current framework by eliminating the concepts of Article 6, 8, and 9, and instead, adopt a unified disclosure format applicable to **all** investment products. This streamlined approach could align more seamlessly with the principles of MiFID II's Sustainability Preferences, which encompass a holistic evaluation of Principal Adverse Impacts (PAIs) in relation to sustainability factors, sustainable investment allocation, and alignment with the EU Taxonomy.

Key environmental, social and governance indicators which the Commission believes to be universally relevant and useful should be disclosed, could become part of the formal requirements –

even though we believe that a general standard of disclosing all material risks, as exists today, should capture these areas and we are not clear that indicators that are universally relevant and useful necessarily exist.

Should the EU decide to implement uniform disclosure requirements across all financial products, it is vital to establish a foundation level that ensures comparability and consistency, effectively making "apples-to-apples" comparisons feasible. To this end, the most pertinent disclosures could encompass:

- Exclusions: providing information about what specific assets, sectors, or practices are excluded from the investment strategy. This would help investors understand the ethical or sustainable aspects of the constituents of a fund.
- Taxonomy-Related Disclosures: detailing how the fund aligns with the EU Taxonomy and its criteria for environmentally sustainable economic activities. This disclosure would clarify the fund's green credentials and its contribution to sustainability objectives. A good regulatory frameworks should duly acknowledge the following key considerations:
    - Principles-Based Approach: Embrace a principles-based approach that mandates FMPs to articulate their strategies clearly, establishing unambiguous objectives for investors to assess performance. For instance, in the context of running an impact strategy, it is likely to be appropriate for FMPs to be obligated to report on the tangible impact their strategy generates. When the need arises to report performance on secondary objectives, FMPs must thoughtfully integrate these considerations into their investment processes, thereby advancing the integration of sustainability data into investment decision-making.
    - Recognition of Transition: Acknowledge the pivotal role of transition in the current landscape, arguably representing one of the most impactful ways to contribute to environmental and societal well-being. Establish clear requirements to measure this transition impact effectively, reinforcing the importance of accountability in fostering meaningful change.
    - Interoperability Between Regions: Recognise the financial burden associated with regulatory compliance. Global interoperability in reporting standards can significantly alleviate the challenges faced by both FMPs and investors. By promoting consistency at global level, such interoperability ensures a more efficient and cost-effective adherence to regulations, fostering a more harmonised and streamlined regulatory landscape on a global scale.

Disclosures of principal adverse impacts (PAIs): the mandated set of PAI indicators often fails to align with investment strategies' material topics and themes. SFDR adopts a generalised “one size fits all” approach. There is spectrum of investment strategies within the sustainability space from ‘ESG integrated’ funds (considers risks and opportunities) through to impact strategies. It would be more appropriate to mandate FMPs to select indicators that they think are relevant for the strategy in question against which they have to report performance.

Reporting PAIs at the firm level comes with its own complications when combining different asset classes together; lack of methodologies available makes this reported data not useful for investors. Instead, it would be more appropriate to have requirements such as set out in your climate transition plan at the entity level.

Moreover, the PAIs themselves when relevant may be useful at an issuer level. However, summing a PAI’s measure across a portfolio which includes companies operating in different sectors is not helpful to investment decision-making or the ability of an investor to evaluate how sustainable the fund is. This would be true for both retail and professional investors.

Relevance concerns for professional investors: mandating public information disclosure for products targeting professional investors has triggered various confidentiality and marketing regulation challenges. Federated Hermes believes Article 10 may lack practical relevance for private market and professional investors. This is primarily because such investors typically obtain the necessary information through their extensive due diligence processes. Therefore, it is imperative to acknowledge and address the fundamental distinctions between dealing with professional investors and retail investors in the context of SFDR.

In essence, the granularity of information mandated for website disclosures, can be perceived as redundant and burdensome for professional investors. These sophisticated investors often engage in thorough due diligence, negotiations and direct interactions with asset managers to acquire comprehensive insights into investment products. Recognising these disparities is critical, as it allows for the development of tailored disclosure requirements that acknowledge the unique characteristics, needs, and practices of professional investors. Such an approach ensures that regulatory efforts are efficient, relevant and focused on enhancing the effectiveness of SFDR for all market participants.

Product-level disclosures should not be expressed on a scale: the EC queries the feasibility of assessing the sustainability of financial products through a scale, seemingly alluding to risk profile scales such as Synthetic Risk and Reward Indicators (SRRI) and SRI for retail funds. We strongly advise against embracing such an approach, emphasising the inherent flaws in the SRRI framework, that is fraught with contentious issues. Moreover, despite its apparent simplicity, the SRRI has not yet proven to be informative for investors. Of greater significance is the complexity associated with determining the comparative sustainability or impact of various strategies, rendering the use of a scale challenging and potentially misleading. Categorising financial products into specific 'baskets' based on a scale introduces additional complications. Consequently, we advocate for a more apt solution in the form of a clear labelling regime.

By streamlining and refining the disclosure requirements in this manner, the European Union can foster greater transparency, facilitate informed investment decisions, and contribute to the overall effectiveness of sustainable finance initiatives.

Promoting the Establishment of a Consistent EU Labelling Regime:

Our preference would be to avoid sustainability labelled funds completely. Our rationale is that there is significant subjectivity in defining what is a ‘sustainable’ product and even more so a ‘sustainable’ operational process or ‘sustainable’ business culture. As such due to the commercial pressures, investment management firms may feel compelled to adopt practices in line with a specific label and not embrace ‘sustainable’ investment practices not catered for by the labels. Furthermore, adherence to the strictures of the label may be detrimental to the investment performance achievable for investors due to an unnecessarily constrained universe.

Nevertheless, we do recognise there is a market demand for labels and as such would strongly urge that in order to protect investors, the labelling framework be clear and as far as possible not favour a particular approach sustainable investment over another. We also recognise that there are many regional level labels in the EU with varying requirements; having an EU labelling regime will help create efficiencies when marketing to different countries across the EU.

The European Commission's recognition that Article 8 and 9 of the SFDR have inadvertently become de facto product labels underscores an essential point. While these articles were not initially designed for this purpose, their adoption as labelling tools highlights a clear market demand for effective means of conveying the sustainability performance of financial products. Nevertheless, relying on a categorisation system based on Article 8 and 9 of the SFDR, which is inherently flawed, ultimately proves inefficient. Moreover, the proliferation of various national 'ESG' and sustainability labels serves as a substantial barrier to market entry, driving up costs significantly due to the need to adhere to a complex patchwork of categorisation regimes. In light of these challenges, we advocate for the establishment of a coherent and harmonised EU labelling regime that takes a different approach. Instead of relying on the flawed articles of the current SFDR, we propose a focus on the type of investment strategy employed by financial products. This approach mirrors one option (approach 1) presented by the Commission, albeit with necessary adjustments to ensure the regime's clarity, consistency, practicality and efficiency.

The EU labelling regime we are proposing would introduce 4 labels that would correspond to the following definitions:

1. **Responsible ("ESG integrated") Products**: many EU investment funds consider select environmental, social and governance characteristics when investing their assets. For instance, Federated Hermes manages MMFs where 90% or more of the assets of the Fund are invested in companies, or other issuers or guarantors that satisfy certain environmental or social characteristics and follow good governance practices. These investments are selected by following investment strategies that include negative screening, which excludes investments issued or guaranteed by companies that operate in certain excluded sectors; and positive screening, which seeks to ensure the portfolio as a whole satisfies certain environmental, social and governance characteristics. Without a "Responsible" category, such EU products would not fall in any category and thus, be conflated with non-sustainable products.
2. **Engagement/Transition/Improvement Products**: we strongly recommend that a relevant EU labelling regime include a "transition" or "improvement" category to reflect funds which are seeking to improve the sustainability performance of its investees rather than simply have categories of funds which reflect how sustainable investees already are. It is incredibly important that the definition of "sustainable investments" under a revamped SFDR include investee companies that either i) have transition strategies; or ii) are identified by financial market participants as being entities that could improve their environmental and social characteristics through engagement and such investee companies are, as evidenced in a reasonable period of time, willing to engage and/or are engaging. This label would cover funds that invest their assets in companies that are deficient in their E (for instance, decarbonisation of the economy), S, or G aspects and that, through existing or future engagement and requesting the elaboration of a transition plan, will accompany those assets to transition to or improve their sustainable operations, processes, and activities. The Commission's Recommendations on Transition Finance[2] is a good starting point.
3. **Impact Products**: to cover funds whose constituents that specifically focus on generating a positive, measurable impact on environmental or social issues, in addition to seeking financial

[2] Commission Recommendation (EU) 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy.

returns. These funds are designed to direct capital towards companies, projects, or organisations that aim to make a tangible and beneficial difference in areas such as environmental sustainability, social equality, or other specific impact goals.

4. **Sustainable Mixed Approach**: such a category may include investing in assets that either currently meet or have the potential to adhere to a rigorous, evidence-based standard for sustainability. This approach involves a dynamic blend of both active and passive investment strategies, strategically harnessing the strengths of each. The overarching goal is not only to achieve financial returns but also to actively contribute to positive environmental and social impact.

When formulating these sustainable categories, it is crucial to prioritise international consistency, particularly in alignment with the forthcoming UK SDR: e.g., the category titles should aim for consistency across jurisdictions. To foster global harmonisation, both the quantity and the definition of these categories should exhibit similarities across all jurisdictions.

The Commission asks whether the categories should be exclusive. Given the breadth of investment approaches in the market, we strongly believe that requiring financial products to be allocated to only one of these categories, will be very difficult or even impossible to maintain. The Commission should steer clear of establishing rigid, mutually exclusive categories, as it is entirely reasonable for a financial product to encompass a hybrid approach. Flexibility is paramount, as FMPs may wish to blend various strategies within a single fund, combining elements of transition, exclusion, sustainability with defined contributions to the environment or society, and best-in-class assets. Imposing a restriction on categorising a fund under only one approach could hinder innovation. Confining funds to a single category may present challenges in product design and ultimately stifle innovation within the industry, resulting in reduced options for consumers.

Further, the EC queries the minimum criteria to be met in order for a financial product to fall under the different product categories. Federated Hermes thinks that allowing funds to fall into categories based on a substantial part of eligible assets meeting the corresponding requirements – say [65%] of the fund assets - is the best approach. However, in the "Transition/Improvement" area, we caution against a purely quantitative approach. Any inclusion of transition assets by fund managers to meet a quantitative threshold should be supported by evidence, ex-ante, of the identification of a transition/improvement opportunity. The nature and measurement of engagement success is, indeed, intrinsically qualitative[3].

Thus, a fund which falls into the "transition" or "improvement" label should be able to: i) evidence to the NCA that the portfolio is constructed accordingly; ii) evidence that improvement or transition has been realised or may still be realised; and iii) evidence that proportionate engagement efforts

[3] For example, the engagement objective milestone progress approach which Federated Hermes pioneered and launched in 2009, whilst ostensibly quantitative and systematic, if considered solely in that way and without the qualitative evaluation of the objectives set and the progress made that we do, would lead to box-ticking, not meaningful change. Another example illustrating the need for a qualitative approach is that some fund managers may purport to offer a transition fund on the basis that the fund would deliver a year-on-year improvement in the portfolio WACI. At face value this could suggest the fund comprises a portfolio of companies improving their carbon intensity and transitioning to be Net-Zero aligned. With a purely quantitative measure however, the fund manager could tweak portfolio weightings to show a WACI reduction at fund level, while there is possibly no change in the absolute emissions associated with each of the portfolio companies.

have been made to achieve the improvement or transition. A combination of these points should enable such funds/financial products to be distinct from a 'vanilla' ESG-integrated (currently SFDR Article 8) product. The focus should be on quality of engagement combined with a commitment by the NCAs to thoroughly review a fund's disclosure against its real-world performance, evaluate its supporting documentation, and when necessary, hold firms accountable for greenwashing.

Federated Hermes cautions against the potential risks associated with establishing rules around the use of certain words in fund names. Nevertheless, recognising the prevailing direction, we reiterate our response to the ESMA Consultation Paper on Guidelines on funds' names using E, S and G or Sustainability-Related Terms (the "Consultation"). Addressing the issue of fund names and their alignment with actual 'ESG' practices requires that co-legislators first include in SFDR (or in another stand-alone Regulation) a requirement for such considerations that ESMA can then work on and provide guidance. Under a revamped SFDR and after the establishment of a consistent EU labelling regime, market participants could label and communicate accordingly to the category or categories in which the products fall. We believe that fund managers ought to be able to i) design their funds to meet the objectives and interests of investors; ii) describe in detail to investors and the regulator how they intend to deliver the investment objectives and which indicators should be used to measure the fund's performance against its stated investment policy; and iii) name their funds in accordance with their stated investment policy. It is then incumbent on the regulator to assess whether these three elements are coherent and to judge whether the fund manager is delivering in accordance with what has been articulated. In our view, such an approach would best protect investors from greenwashing. In this way the regulator will focus on holding fund managers accountable, avoid misleading behaviour and not encourage box-ticking compliance by being over prescriptive.

In conclusion, we strongly urge the Commission to consider and implement the approach outlined above. By doing so, we can collectively work towards enhancing and rectifying the early flaws within SFDR and established of a more efficient and streamlined EU labelling system. This system will provide investors and consumers with a clear and consistent means of assessing the sustainability performance of financial products. This initiative will not only address the current market demand but also alleviate the challenges faced by financial institutions as they navigate the intricate landscape of ESG and sustainability regulations.

Through this comprehensive and revitalised regime, we can foster transparency, instil trust and enhance accessibility in the realm of sustainable finance, benefiting all stakeholders in the EU market.

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