

BSW Position - SFDR Review

The BSW welcomes the opportunity to provide feedback on the review of the Regulation on Sustainability-related Disclosures in the Financial Services Sector (SFDR).

As a product association, BSW represents issuers of structured securities that are sold to private investors in Germany. At the point of sale, these products compete with investment funds, among others, also for private clients with sustainability preferences. In so far, a "level playing field" is of great importance, i.e. a comparable regulatory treatment of the various product types with regard to all aspects for which these product types do not show any relevant differences. This applies to all types of products offered to private investors – in addition to investment funds, various types of securities (including structured securities).

The BSW's feedback relates exclusively to the securities represented by the BSW.

We believe that the SFDR is an important tool to promote transparency and accountability in the financial sector and to support the transition to a low-carbon and socially inclusive economy.

It is also highly commendable that the Targeted Consultation explicitly addresses a substantial number of potential weaknesses of the current rules.

However, the Consultation Paper does not mention what is probably the most serious deficit: the different scope of application of SFDR and the sustainability rules on the distribution side and, as a consequence, the fact that both sets of rules are currently not coordinated with each other in terms of content, and have a different focus and underlying philosophy.

Structured securities, which fall within the scope of MiFID but not the SFDR, are a good example of this, and accordingly, the experience of this industry is a testament to the weaknesses of the current regulation. For example, pursuant to the rules under MiFID II, products with sustainability features in accordance with Art. 2 para. 17 SFDR can be offered to clients. However, since not all financial instruments fall within the scope of the SFDR, it is unclear how such financial instruments can be classified and distributed in a legally secure manner where not covered by the SFDR.

The consultation only mentions the interaction with MiFID in general terms, and that also relatively briefly and abstractly.

The reason for this weakness is that the current regulation – especially the SFDR – on the product side is almost exclusively focused on investment funds and materially on the disclosure of information. This does not take into account the fact that on the distribution side (at the point of sale), many more types of potential investments are effectively competing for the capital of private investors with sustainability preferences than are currently covered by the SFDR – namely, in addition to mutual funds, various types of securities (not just structured ones). In practice, private investors will regularly decide between investing in investment funds and structured securities. The current non-inclusion of structured securities in the

SFDR's scope creates a structural disadvantage for structured securities, making it difficult for sustainability-oriented investors to choose from a wider range of sustainable products, which could run counter to the objective of increasing sustainable investments.

The BSW therefore calls for a targeted extension of the SFDR's scope to securities offered to private investors according to the respective MiFID target market.

In light of this, the question whether to **extend the scope of the** SFDR to other products requires a differentiated answer.

1. The SFDR's **current disclosure rules** are tailored to products and services where **investment decisions** are made on an ongoing basis, or advice is provided, on behalf of clients.

For other financial instruments not covered by the SFDR - such as structured securities - without such investment decisions (or advice), a large part of the prescribed information would not fit. From the moment of their issuance, specially structured securities are firmly tied to an underlying asset selected before their issuance, the performance of which - in accordance with the relevant product terms - determines the payout amount due under the securities. The products do not provide for changes in the underlying asset as a result of investment decisions made during the securities' term.

In addition, the proceeds from the issuance of these products finance the issuers' general business operations. The products' sustainability features therefore also result from the fact that such proceeds contribute to financing the issuers' active business. Only for green bonds or comparable products issuers commit to a specific allocation of the issuance proceeds. Accordingly, the conceptual basis of disclosure under the SRDR, i.e. that the product itself invests in certain assets, does not apply here.

Therefore, extending the SFDR disclosure requirements to other financial instruments, i.e. securities offered to private investors according to the respective MiFID target market would run against the conceptual basis and content of these rules, and is therefore not an option. In addition, disclosure is already provided according to other rules, since issuers are subject to disclosure requirements under the CRR and CSRD.

2. The situation is different with regard to **regulation as a whole**, beyond SFDR disclosure. Here, the current regulatory approach as described above leads to adverse effects in several respects:

- The lack of harmonisation between SFDR and MiFID leads to **practical problems** (in addition to the shortcomings of the current regulation mentioned in the consultation paper), as also described in the ESMA consultation on the Product Governance Guidelines. This includes the application of the "minimum proportion" rules to products outside the scope of the SFDR for which the product rules do not provide for minimum shares, but which have only an actual share, such as structured securities.

However, it can also lead to the question of whether it is justified to apply SFDR terms and concepts to non-SFDR products, and thus ultimately to the issue of a **"level playing field"** between all relevant products.

- There is also an **inherent nexus** between the disclosure of relevant information and the circumstances relevant for ESG purposes at the point of sale, which the current SFDR, with its limited product scope, does not take into account.
- **Overestimation of disclosure compared to point-of-sale rules:** Providing sufficient information on the ESG characteristics of potential investments is of high importance for the transition to a sustainable economy. However, as discussed by the European Commission itself in the context of its Retail Investment Strategy, practical experience shows a limited use even of information provided in PRIIPs KIDs, and even more so for longer and more detailed information such as in prospectuses.

Currently, the **only part of the SFDR that receives a high degree of attention** from clients is the **de-facto classification system** that has developed based on Articles 8 and 9. The actual decision by clients for a certain investment is much more driven by what happens at the point of sale, particularly in cases where clients receive advice about the investment most suitable for them.

This also means that SFDR disclosure currently is not a **"pull factor"** for product selection.

- **Less can therefore be more in terms of ESG information** - short-form key information presented in a concise and understandable format has the potential to increase practical use of the information by clients.

3. **No new requirements for unsustainable products**

Prescribing ESG information for products without a sustainability claim would be a case of regulatory overkill. Ultimately, the basic idea here would be the "shaming" of certain products - by discouraging customers without sustainability preferences from investing in certain products by disclosing negative ESG characteristics. Given the low level of interest in the ESG information available, it seems very unlikely that this approach would have a noticeable tangible impact. At the same time, however, it would be associated with very high compliance effort and costs. A cost-benefit analysis shows that only rules that limit ESG information to products with sustainability claims are efficient and proportionate.

Overall, the current SFDR regime has **room for improvement** in the following respects:

a. General Regulatory Approach - Holistic Approach Needed

The ESG information regime needs to be looked at together with, and materially attached to, the relevant point-of-sale rules, for all relevant financial instruments and in a **truly holistic manner**. The actual decision by clients for a certain investment is much more driven by what happens at the point of sale than by the product-focused (disclosure) rules. So the general practical focus needs to shift more to the point-of-sale rules. These, in turn, need to be linked up closely with the product-focused rules.

b. Clear interfaces to MiFID II needed

A serious shortcoming of the SFDR is the lack of alignment with the relevant point-of-sale rules. As the exploration of clients' sustainability preferences under MiFID II covers all financial instruments and at the same time refers to the SFDR nomenclature (cf. Article 2(7)(a) to (c) of Delegated Regulation (EU) 2017/565), it remains unclear how these rules should be applied to financial

instruments that do not qualify as financial products within the meaning of the SFDR. This is particularly important in case of investments by private clients.

A reformed regime must therefore apply to all relevant financial instruments under MiFID, and thus at least to securities represented by the BSW, i. e. securities that can be offered to private clients under the relevant MiFID target market.

c. Replacement of Articles 8/9 with a product classification for all relevant products, combined with rules on product naming.

In practice, the only part of the SFDR that receives a high degree of attention from clients is the de-facto classification system that has developed based on Articles 8 and 9. Even if this was not intended by the legislator, both the demand from investors and the efforts of product manufacturers to meet this demand show that there is a practical need for such a legal classification.

However, for products outside the scope of the SFDR (such as bonds and structured securities), rules governing the conditions which have to be met to market such products as sustainable are currently missing. This creates an uneven playing field across the whole range of competing products.

The limited product scope of the SFDR also leads to problems in the application of the MiFID rules on sustainability preferences, e.g. in understanding the "minimum share" for non-SFDR products. ESMA pointed this out very clearly in the consultation on the Product Governance Guidelines.

Accordingly, there is a need for product regulation, particularly a comprehensive classification system, in addition to disclosure rules, covering all securities with private investors as their target market, which either have a sustainability claim or are to be distributed to clients with sustainability preferences (extended new product scope).

This new regime should also include rules on naming relevant products.

d. Standardised ESG Key Information

The current SFDR is based on the idea of horizontal rules prescribing the same ESG information for all product types covered by the SFDR. However, it only applies to a subset of all products with ESG characteristics, namely those where investment decisions are made on behalf of clients, or where clients are advised about investments. For other financial instruments not covered by the SFDR, such as structured securities, without such investment decisions (or advice), a large part of the required information would not fit.

Extending the SFDR disclosure obligations to other financial instruments is thus not an option. At the same time, a universal ESG information regime is of great importance to facilitate customers' comparison of different products and to create a level playing field.

Therefore, short and consistent information on sustainability characteristics should be required for all financial instruments, namely information on the classification of the product, in particular an ESG scale, as well as on the three categories of MiFID sustainability preferences. If the permitted maximum length of KIDs is not increased to four pages, as suggested by the BSW in connection with the legislative proposals under the Retail Investment Strategy, this information should be included in a new KID ESG annex for products with a PRIIPs KID.

e. Conceptual inconsistencies need to be eliminated

In addition to the high degree of detailed information currently required under the SFDR, which is out-of-step with the amount of information clients are prepared (and/or able) to take into account

in practice, as already mentioned, the SFDR also suffers from conceptual deficiencies, in particular inclarities with regard to terms such as "sustainable investment" and "consideration" of PAIs, and the high degree of complexity of legal constructs such as a PAI, which makes it difficult for clients to understand the practical relevance of such terms.

f. More clearly structured SFDR regime

The current SFDR is not split into clearly segregated segments dealing with individual topics, which makes it more difficult to apply in practice and increases the risk of misapplication and misinterpretation. A reformed regime should therefore be clearly structured into individual parts, such as general rules and definitions, disclosure rules and material product regulation (classification system and product naming rules).

g. Categorization: Focus on comprehensibility

Introducing an easy-to-understand product classification is of crucial importance. Most clients do not have in-depth knowledge of ESG concepts and struggle to understand and weigh "sustainability preferences".

All products should therefore always be classified on the basis of an "ESG scale" based on the three categories of MiFID sustainability preferences – such a classification is easy to understand for investors and easy to administer for product issuers.

Apart from this, in terms of a thematic categorisation, the practical difficulties that have arisen in connection with categorising products according to Articles 8 and 9 SFDR in our view demonstrate fundamental weaknesses of this categorisation approach which cannot be fixed by limited clarifications or amendments.

For any new categorisation approach, it is of high importance that any minimum criteria need to be compatible with the whole product universe subject to the classification system, which in our view should apply to all financial instruments with sustainability claims, not only investment funds. This includes products which do not involve continuous active investment management, which are invariably linked to an asset or assets selected initially

Finally, in our view, both the applicable qualitative and quantitative category should be reflected in the final categorisation of the product, so that both elements can be taken into account in forming a judgement on the product. This would also allow to put the quantitative element into perspective based on the qualitative categorisation of the product.

h. Faster adoption of new standards on a voluntary basis

Due to the expected long duration of an SFDR reform, certain new requirements - such as a new product classification - should be able to be implemented beforehand on a voluntary basis, as a recommendation or as a market standard of the associations.

i. Transitional rules needed

Although it will certainly be several years before new rules come into force, the final shift to a new regulatory approach (including new product categorisation) requires sufficient transitional rules, especially for the products already offered at the time when new rules come into force. Otherwise, application of the new rules would lead to serious practical problems that could harm the distribution of ESG products over a longer period of time.