ESG Book Response to Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR)

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Last week (14th December), ESG Book submitted its response to the latest EU Commission Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR), addressing concerns about the regulation's current ambiguity and lack of clarity in defining 'sustainable investment.' We advocate for refined definitions, clear criteria, and standardized machine-readable formats to improve transparency and reduce compliance burdens. ESG Book also supports collaboration with standard-setting bodies to align with global reporting initiatives.

In terms of principal adverse impacts (PAIs), ESG Book highlights challenges in standardizing reporting practices and emphasizes the importance of standardized metrics for PAIs. ESG Book recommends the removal of materiality assessments on crucial indicators for comprehensive sustainability reporting, particularly in climate-related information. Quantitative data analysis by ESG Book reveals disparities in reporting levels among companies, indicating the need for enhanced disclosure.

ESG Book further suggests harmonizing definitions and frameworks across different regulations to streamline sustainability-related disclosures. The company proposes assessing the materiality and relevance of PAIs across legislations and advocates for sector-specific adaptations to ensure proportionate impacts on different industries.

Regarding product-level disclosures, ESG Book recommends incorporating Taxonomy-related disclosures to ensure alignment with sustainability objectives. We propose criteria for reporting obligations, including identifiable sustainability characteristics, alignment with the EU Taxonomy, and quantifiable targets for impact. ESG Book supports the public availability of product disclosures for transparency, but acknowledges the need to balance confidentiality.

In addressing concerns about a one-size-fits-all approach to sustainability disclosures, ESG Book suggests flexibility in granularity based on the complexity of financial products. We support digitalizing sustainability disclosures through the European ESG Template and emphasizes the importance of standardized templates for pre-contractual documents and periodic disclosures.

ESG Book additionally underscores the imperative for refining the categorization system in sustainable finance, emphasizing the need for detailed criteria, strategy-specific disclosures, and precise label-specific guidelines. Recognizing the existing shortcomings of SFDR, ESG Book advocates for additional clarity, marketing regulations, and robust communication strategies to counteract the prevalent issue of greenwashing. The firm aligns with the recently issued Financial Conduct Authority's (FCA) Sustainability Disclosure Requirements (SDR) and recommends a balanced approach for incorporating a 'Sustainable Mixed Goals' category with well-defined metrics.

Addressing the proposed transition to a new categorization system, ESG Book stresses the importance of clear communication, comprehensive training, and a realistic reporting timeline for market participants. We call for the implementation of grandfathering provisions for existing products, feedback mechanisms, and standardized reporting formats to ensure a smooth transition and minimize disruption.

In setting minimum criteria for different product categories, ESG Book proposes a holistic approach encompassing Taxonomy Alignment, Engagement Strategies, Exclusions, and Measurable Positive Outcomes. Recognizing the unique challenges of transition-focused products, the recommendations include scenario analysis and measurable improvement targets. The firm advocates for enhanced disclosure requirements, such as category-specific metrics, impact assessments, taxonomy alignment, scenario analysis, lifecycle analysis, certifications, and benchmark comparisons.

For the promotion of environmental and social characteristics, ESG Book emphasizes the need for clear and quantifiable criteria, introducing strategy-specific disclosure requirements and progress reports. Beyond the basic requirements for Article 8 and Article 9 products, we suggest additional disclosure criteria, including taxonomy alignment, scenario analysis, and benchmark comparisons.

In the realm of third-party verification, ESG Book deems this crucial, advocating for mandatory verification by audit firms to ensure credibility and reduce the risk of greenwashing. Recommending the inclusion of the product category in the PRIIPs KID, ESG Book envisions enhanced transparency for retail investors while maintaining simplicity and clarity. Finally, to counter misleading communications, we suggest strict naming and marketing rules, complemented by a comprehensive regulatory framework to foster transparency and accuracy in sustainable finance practices. These recommendations collectively aim to fortify sustainable finance regulations, fostering transparency and bolstering investor confidence.

In summary, ESG Book's response underscores the importance of clarity, standardization, and collaboration in implementing SFDR to enhance transparency and comparability in sustainable finance reporting.

Overview of consultation responses

Section 1. Current requirements of the SFDR

The open-ended interpretation and broadly defined criteria for 'sustainable investment' under the SFDR may create ambiguity for market participants. This lack of clarity makes it challenging for them to assess and determine whether their investments meet the specified sustainability standards, leading to potential compliance uncertainties. Market participants have raised concerns about the disclosure regime which defines Article 8 funds quite broadly, not prescribing any thresholds while providing little flexibility in the interpretation of Article 9 requirements. Refining definitions and providing clear criteria for product categories within the framework to align with market practices ensures that this reflects real-world sustainability efforts.

This would address the issue of mislabelling and incentivise market participants to transparently disclose and communicate sustainability information. ESG Book's platform enables companies to disclose sustainability-related information in accordance with various frameworks, standards and regulations including GRI, EU Taxonomy, ESRS/CSRD. A standardized machine-readable format (such as XBRL) would enable the development of an intuitive, high-level framework mapping to help reduce the corporate reporting burden and compliance fatigue.

Recently, the UK FCA released its final policy statement on the Sustainability Disclosure Requirements (SDR). In addition to SDR, the FCA announced a package of measures including specific naming and marketing rules preventing terms 'sustainable', 'sustainability', and 'impact' in the fund name to be set for funds falling outside of the regime. The UK's financial regulator, however, clarified that "most sustainability-related terms" will be allowed in marketing materials for non-labelled funds if they follow specific disclosure requirements. A similar logic and accompanying guidance document would also support the effective implementation of SFDR as the framework continues to evolve.

Disclosures of principal adverse impacts (PAIs)

With the evolving nature of SFDR and ongoing consultations, stakeholders may face difficulties in standardizing reporting practices. Lack of standardized reporting frameworks and methodologies may hinder comparability and transparency across the financial industry. Incorporating PAI indicators poses significant methodological challenges in the context of investment decisions. Addressing these challenges is crucial due to the extensive and intricate nature of the mandatory indicators used to evaluate the adverse impacts of investment choices. Moreover, achieving coherence with other sustainability-related disclosures necessitates the use of standardized metrics for PAIs. Most recently, ESAs have published the Final Report on the Regulatory Technical Standards under SFDR, showcasing alignment with ESRS cross cutting standards and other standards for the disclosure of ESG information. ESG Book supports the European Commission's actively collaboration and joint initiatives with other standard-setting bodies, including GRI and IFRS, to align ESRS with global sustainability reporting initiatives and EU legal frameworks.

Based on company-level data, ESG Book recommends the removal of materiality assessments on indicators crucial for accurate and comprehensive sustainability reporting across the

investment chain, from investee companies to financial market participants and from FMPs to end investors. Climate information, such as greenhouse gas (GHG) emissions, transition plans and targets, is inherently material for companies, irrespective of their sector and supports mandating all related disclosure requirements and data points. This is not only to ensure coherence with the ESRS but also to guarantee that investors and asset owners have access to the most complete set of climate-related information possible.

Furthermore, we emphasize the need to avoid phasing-on times between SFDR and CSRD to bridge the data gap caused by materiality assessments. If phasing-in periods are maintained, consideration should be given to coverage thresholds for PAIs and clear guidance on handling extended phasing-in periods.

ESG Book also suggests the elimination of materiality assessments on crucial ESRS disclosure/data points for FMPs to meet their SFDR disclosure obligations. If materiality assessments are retained, the Commission should collaborate with European Supervisory Authorities (ESAs) and engage stakeholders to recalibrate PAI entity-level requirements for FMPs and provide clear guidance on handling missing data points and the use of estimates. Additionally, ensuring interoperability among standards (GRI, ISSB, ESRS) is highlighted as a crucial aspect.

Based on the data analysis from the ESG Book, several conclusions can be drawn regarding the current implementation of the Sustainable Finance Disclosure Regulation (SFDR) and the overall reporting landscape:

- Limited Comprehensive Reporting: A small percentage of companies, approximately 0.08% (7 out of 9,000), report more than 90% of Principal Adverse Impact (PAI) metrics. Additionally, around 50% of companies report less than 10% of PAI metrics, indicating a significant gap in comprehensive reporting.
- Varied Reporting Levels: The distribution of reporting levels is diverse, with approximately 1/4 of companies reporting more than 50% of PAI metrics. This suggests that while some companies are actively disclosing, a substantial number are reporting a lower percentage of metrics.
- Overall Disclosure: The average disclosure percentage across all metrics is 20.10%, indicating a general trend of companies providing disclosure on a portion of the required metrics.
- Mandatory Metrics: The average disclosure percentage for mandatory metrics is slightly higher at 22.69%, reflecting a relatively better performance.

The mandate to disclose mandatory indicators and additional optional metrics poses a challenge related to the quality and accessibility of data. Companies are required to gather information from multiple sources to assess adverse impacts in the value chain. The key component for the effective implementation of SFDR is ESG data. Currently, there is a proposal for a regulation to enhance transparency in the ratings industry, prevent conflicts of interest and mandate authorization of ratings providers. However, there must be minimum requirements for data providers ensuring that data collection (at the source level) and analysis is not obscured by black box methodologies.

It should be clarified that ESG Book does not recommend a prescriptive methodology for all data providers. Instead, we recommend governance structures, including written policies and procedures for assuring that the methodology and supporting analysis is sound for all data ratings products. This will help further a unified and consistent methodology in interpreting and responding to adverse impacts, contributing to the overall effectiveness of SFDR implementation.

Section 2. Interaction with other sustainable finance Legislation

The proposed disclosure requirements would require sustainability information from Article 6 funds (those not integrating sustainability into their investment approaches) which may be a means for investors to accurately identify the most unsustainable assets across European markets.

SFDR introduces the key concept of 'sustainable investment' while the Taxonomy defines 'environmentally sustainable' economic activities. The Taxonomy Regulation interacts with SFDR mainly by necessitating DNSH checks for 'environmentally sustainable' economic activities. Despite similarities between these concepts and definitions, there may be differences in interpretation that could create practical challenges for both market participants and regulators in terms of legislative coherence.

Recently, the European Securities and Markets Authority (ESMA) provided clarity on questions around the assessment of the sustainable investment definition carried out by taking into account PAI indicators. ESMA's three explanatory notes clarifying: a) the definition of sustainable investments; b) the application of the do no significant harm (DNSH) principle and; c) the use of estimates offers useful guidance to asset managers that are seeking a modular methodology for high alignment or compliance with various regulations in the sustainable finance framework and national fund labelling regimes.

Another key guidance document from the Commission 'Enhancing the usability of the EU Taxonomy and the overall EU sustainable finance framework' also provides clarification that 'passive funds tracking EU Climate Benchmarks shall fall within the scope of Article 9 and have a sustainable investment objective'. Additionally, data mapping between SFDR and BMR Annex II show a high degree of overlap between mandatory PAIs and ESG reporting requirements for climate benchmarks.

Section 3. Potential changes to disclosure requirements for financial market participants

Question 3.1.2 Among the specific entity level principal adverse impact indicators required by the Delegated Regulation of the SFDR adopted pursuant to Article 4 (tables 1, 2 and 3 of Annex I), which indicators do you find the most (and least) useful?

According to ESG Book analysis:

- 7 (out of circa 9,000) companies report more than 90% of PAI metrics
- 251 companies report more than 80% of PAI metrics
- 4235 (nearly 50%) companies report less than 10% of PAI metrics
- Circa 2000 (less than 1/4) companies report more than 50% of PAI metrics
- Average disclosure % across all metrics: 20.10%
- Average disclosure % across Mandatory metrics: 22.69%
- Average disclosure % across Opt-in metrics: 18.34%

SFDR PAI Metric Description	SFDR PAI number	ESG Book Universe Metric Disclosure Rate
Share of non-renewable energy consumption and non-renewable energy production of the company from non-renewable energy sources compared to renewable energy sources, expressed as a percentage	SFDR_M_5	0.08%
Percentage of non-renewable energy distribution/ production.	SFDR_M_5_2	0.37%
Difference between the average salary paid to male employees and the average salary paid to female employees, expressed as a percentage	SFDR_M_12	1.51%
Total days lost to absenteeism from either full time, part time, zero hours, interns or FTE allocated but externally contracted roles.	SFDR_O_19	1.69%
Total weight of water pollutants emitted by the company	SFDR_M_8	1.80%
2. Water recycled expressed as a percentage of sum of water withdrawn and water recycled	SFDR_O_6_2	1.80%
Flag for companies with sites located in areas of high water stress without a water management policy	SFDR_O_8	1.82%
Sum of NOx, SOx, VOC and PM emissions emitted by the company in metric Tonnes	SFDR_O_2	5.06%
Total amount of hazardous waste produced by the company	SFDR_M_9	5.56%
Total compensation of the highest paid executive (CEO or other executive if CEO is not the highest paid) divided by average compensation of employees (after deducting highest paid executive compensation), expressed as a ratio	SFDR_O_24	6.83%
Percentage of non-renewable energy consumption	SFDR_M_5_1	7.09%
Total amount of non-recycled waste generated by the company	SFDR_O_13	7.87%
Rate of accidents in the company expressed as number of injuries per million hours worked	SFDR_O_18	9.64%
1. Total water consumption of the company converted to cubic metres	SFDR_O_6_1	9.68%

To streamline these requirements, there could be efforts to harmonize definitions, key concepts, and disclosure frameworks across different regulations. The goal would be to create a coherent and consistent set of sustainability-related entity-level disclosures applicable to various legislative frameworks. This harmonization could enhance transparency, comparability, and efficiency for both reporting entities and stakeholders. We recommend enhancing interoperability between standards, frameworks and EU legal frameworks as a means of reducing the corporate reporting burden and optimizing the system of digitally tagging sustainability data.

We would also recommend assessing the materiality and relevance of PAI indicators across various legislations as this can determine where consolidation or streamlining is most impactful. Recognizing the need for sector-specific adaptations also ensures that streamlining efforts have a proportionate impact on different industries.

3.2 Product level disclosures

The rationale behind incorporating Taxonomy-related disclosures into uniform disclosure requirements stems from the comprehensive nature of label alignment strategy. This strategy employs three meticulously devised universe screening approaches. To streamline the initial target universe in accordance with SFDR there should be an initial step of risk-based exclusions. Rigorous screenings for controversies, negative business involvements, high carbon exposure, and overall poor ESG performance. This ensures that the resulting subset of holdings aligns with the commitment to responsible investing.

Taking an additional thematic perspective, asset managers can scrutinize the refined index universe to ensure it predominantly consists (e.g., more than 50%) of holdings recognized as best-in-class in overall ESG performance. Asset managers must also consider and emphasize their involvement in green business activities, carbon transition initiatives, and/or identified SDG/ impact-related involvements.

As a final screening step, asset managers must aim to uphold fundamental normative standards and good governance practices, integral to SFDR and EU Taxonomy-aligned products. This involves assessing corporate governance performance, adherence to international human rights and labour rights norms, commitment to anti-corruption and sound tax practices, as well as diligence in ESG practices. The inclusion of Taxonomy-related disclosures ensures transparency in communicating alignment with EU Taxonomy standards.

Question 3.2.2 a) If the EU was to impose uniform disclosure requirements for some financial products, what would be the criterion/criteria that would trigger the reporting obligations?

Potential criteria could include the presence of identifiable sustainability characteristics within the financial product, such as environmental impact, social responsibility, or adherence to governance standards.

Additionally, if the financial product aligns with the EU Taxonomy Regulation, indicating a clear contribution to environmental objectives and the transition to a more sustainable economy.

To provide clarity on ESG integration, the criteria could include an explanation of how ESG factors are integrated into the investment process, strategy, risk management. Financial products with a specified impact must have and achieve quantifiable targets that could be measured over a standard time horizon.

Application of exclusion criteria for 'responsible investments' would also indicate business involvements with harmful impacts on the environment and society. However, there should be prescribed thresholds for certain activities, for example tobacco production and sale of controversial weapons.

Benchmarking performance of the financial product may also be a useful indicator for investors looking to identify best-in-class and best-in-universe. Performance against industry benchmarks or standards related to sustainability, allowing investors to assess its relative sustainability performance. Additionally, the identification of financial products that use specific sustainability labels would indicate compliance with predefined standards and criteria.

Question 3.2.2 b) If the EU was to impose uniform disclosure requirements for financial products, should a limited number of some principal adverse impact indicators be required?

The mandate to disclose the existing list of mandatory indicators and additional optional metrics poses a challenge related to the quality and accessibility of data. Asset managers are required to gather information from multiple sources to assess adverse impacts in the value chain.

Based on company-level data, ESG Book recommends the removal of materiality assessments on indicators crucial for accurate and comprehensive sustainability reporting across the investment chain, from investee companies to financial market participants and from FMPs to end investors. Climate information, such as greenhouse gas (GHG) emissions, transition plans and targets, is inherently material for companies, irrespective of their sector and supports mandating all related disclosure requirements and data points. This is not only to ensure coherence with the ESRS but also to guarantee that investors and asset owners have access to the most complete set of climate-related information possible. Furthermore, we emphasize the need to avoid phasing-on times between SFDR and CSRD to bridge the data gap caused by materiality assessments. If phasing-in periods are maintained, consideration should be given to coverage thresholds for PAIs and clear guidance on handling extended phasing-in periods.

ESG Book also suggests the elimination of materiality assessments on crucial ESRS disclosure/ data points for FMPs to meet their SFDR disclosure obligations. If materiality assessments are retained, the Commission should collaborate with European Supervisory Authorities (ESAs) and engage stakeholders to recalibrate PAI entity-level requirements for FMPs and provide clear guidance on handling missing data points and the use of estimates. Additionally, ensuring interoperability among standards (GRI, ISSB, ESRS) is highlighted as a crucial aspect.

The key component for the effective implementation of SFDR is ESG data. Currently, there is a proposal for a regulation to enhance transparency in the ratings industry, prevent conflicts of interest and mandate authorization of ratings providers. However, there must be minimum requirements for data providers ensuring that source level data and analysis is not obscured

by black box methodologies. It should be clarified that ESG Book does not recommend a prescriptive methodology for all data providers. Instead, we recommend governance structures, including written policies and procedures for assuring that the methodology and supporting analysis is sound for all data products that align with SFDR PAI reporting requirements. This will help further a unified and consistent methodology in interpreting and responding to adverse impacts, contributing to the overall effectiveness of SFDR implementation.

SFDR does not provide a clear definition of "environmental or social characteristics" but it is intended to cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions. The concept of "good governance" is not clearly defined under SFDR. The regulation states that it includes "sound management structures, employee relations, remuneration of staff and tax compliance."

The SFDR and its supervision by competent authorities regulate the quality of the disclosure of sustainability integration but do not regulate the quality of the sustainability integration that is disclosed. The latter is the task of normative frameworks like labels or standards. The SFDR intentionally leaves room for a lot of diversity of sustainable products and its products distinction should, on its own, not be interpreted as a guarantee of the quality of the ESG processes. Importantly, SFDR does not set minimal requirements on the strictness of the sustainability implementation, rather intentionally allowing for a diverse range of sustainable products, especially the group of art. 8 products can contain products ranging from having a very light to having a deep and elaborate ESG integration.

The public availability of product disclosures under SFDR is useful due to the potential for broader societal benefits. This perspective aligns with the transparency and accountability objectives of SFDR. Making such disclosures publicly available can contribute to informed decision-making by investors, foster market integrity, and encourage financial institutions to adopt sustainable practices.

Regarding confidentiality aspects, as a data provider ESG Book partially agrees with the need to take them into account when specifying the information to be made available. While transparency is crucial, it is essential to strike a balance and safeguard sensitive information to maintain market competitiveness and protect proprietary data.

On the question of whether sustainability information about financial products should be made available according to sectoral legislation rather than imposing rules under SFDR, it is reasonable to mostly agree.

While sector-specific rules may exist, the SFDR serves as a comprehensive framework for sustainable finance, and harmonizing disclosure practices across sectors can ensure consistency and comparability in sustainability reporting. However, careful consideration should be given to avoid duplicating or conflicting with existing sectoral legislation.

While it is essential to ensure comparability between financial products through product-level disclosures, requiring the exact same sustainability disclosure topics and the same level of granularity across all types of precontractual documentation may not be entirely practical or effective. The diverse nature of financial products, as highlighted by variations in document lengths such as a lengthy UCITS prospectus compared to a concise Pan-European Pension Product Key Information Document (PEPP KID), suggests that a one-size-fits-all approach may be overly rigid. Therefore, it is more reasonable to partially disagree with the statement.

While maintaining consistency in sustainability disclosure topics is crucial for comparability, allowing for some flexibility in the level of granularity based on the complexity and nature of each financial product could better serve the overarching goal of providing meaningful and relevant information to investors.

In general, it is deemed appropriate to have product-related information dispersed across precontractual disclosures, periodic documentation, and websites to a large extent. The rationale behind this perspective is anchored in the potential regulatory initiative to digitalize sustainability disclosures by financial market participants. Leveraging the European ESG Template (EET), developed by the financial industry, could facilitate the exchange of data among stakeholders and financial market participants regarding sustainability disclosures.

Specifically, the breakdown of information between precontractual, periodic documentation, and websites is considered suitable and user-friendly. The final draft SFDR & Taxonomy RTS prescribes templates for SFDR pre-contractual documents (PCD) and periodic disclosure documents (PD). These templates, mandatory for funds falling under Article 8 and Article 9 categories, ensure a standardized approach. While asset managers typically include PCD information as an annex to the prospectus, practical considerations arise for the disclosure of unit-linked products. In such cases, asset managers are required to provide a single document per fund and language through the EET. To manage the substantial text content efficiently, a narratives management solution is crucial for allocating elements to different fund families and sustainable investment styles.

The distinction between PCD and PD is significant, with the former focusing on planned investments and the latter reporting on actual sustainable investment outcomes. The EET, with its granular level data, facilitates a look-through, aiding in the aggregation of ESG data at the investment level. Despite these differences, adherence to the defined templates in the regulation ensures a cohesive and standardized presentation of information.

Section 4. Potential establishment of a categorisation system for financial products

A more robust categorization system will help investors who are looking to accurately identify sustainable finance products to effectively channel capital towards sustainable activities. As the structure of the framework undergoes changes to prevent greenwashing, asset managers may rely on clearly articulated sustainability claims in precontractual disclosures to avoid misclassification. One of SFDR's unintended consequences was to become a fund labelling regime. Additional clarification, including a marketing and communication rule from ESAs would boost investor confidence and may even lead to the proliferation of sustainable investment products in EU markets. However, asset managers and financial institutions will need to adapt to the new criteria, which could result in transitional challenges (including increased compliance costs) and additional regulatory uncertainty. The introduction of new categories may also lead to fragmentation, especially considering national fund labelling regimes such as France's AMF and SRI reference SFDR.

ESG Book supports a system of product categorization with minimum criteria/thresholds, strategy-specific disclosures, and label-specific criteria, given that SFDR has become the

de facto fund labelling regime. The rationale for this endorsement lies in the inherent limitations of SFDR in providing precise definitions and setting minimum requirements for certain crucial aspects of sustainability integration.

SFDR lacks a clear definition of "environmental or social characteristics" and is intentionally designed to encompass a broad spectrum of investment approaches, from best-in-class to specific sectoral exclusions.

The concept of "good governance" is also vaguely defined, covering aspects such as sound management structures, employee relations, remuneration of staff, and tax compliance.

While SFDR regulates the quality of disclosure regarding sustainability integration, it notably does not regulate the quality of the sustainability integration itself. This underscores the importance of normative frameworks like labels or standards, which play a vital role in assessing and ensuring the robustness of sustainability integration practices. SFDR deliberately allows for diversity in sustainable products, emphasizing that the distinction between products should not be construed as a guarantee of the quality of ESG processes.

Crucially, SFDR refrains from imposing minimal requirements on the strictness of sustainability implementation. This intentional flexibility accommodates a wide range of sustainable products, especially within the Article 8 category, where products can vary significantly in the depth and elaborateness of their ESG integration. In light of these considerations, ESG Book advocates for a more detailed and nuanced system of categorization and disclosure criteria to enhance transparency and facilitate informed decision-making within the evolving landscape of sustainable finance.

If a categorisation system was established according to approach 1 of question 4.1.2

Based on the breakdown of product categories above, there is close alignment with the investment labels proposed by the Financial Conduct Authority (FCA) in December 2022. However, the FCA has since released its final Policy Statement outlining Sustainability Disclosure Requirements (SDR) for investment labels and introduced a newly launched 'Sustainable Mixed Goals' category.

Supplemented with clear guidance, a mixed category can be achieved through the establishment of metrics and thresholds that delineate how products can be categorized as sustainable or transitional based on their level of lignment with environmental and social objectives that are pursued.

Question 4.1.9 If a categorisation system was established that builds on new criteria and not on the existing concepts embedded in Articles 8 and 9, is there is a need for measures to support the transition to this new regime?

Yes, if a categorization system is established that builds on new criteria and deviates from the existing concepts embedded in Articles 8 and 9, there is a clear need for measures to support the transition to this new regime. Implementing a new categorization system represents a significant

shift in the regulatory framework, and it requires careful consideration of the potential challenges and adjustments that market participants may face during the transition.

It is essential to provide clear and comprehensive communication about the changes, including detailed guidelines, training sessions, and educational materials, can help market participants understand the new criteria and requirements. For the effective implementation of a reformed regime, it is also important to create a realistic reporting timeline. A transition period would ensure that market participants can adapt to the new categorization system, reduce compliance burden and costs in the long-term and give entities the time needed to align their policies with the updated regulatory framework.

Implementing grandfathering provisions for existing financial products can provide a grace period for products that were categorized under the previous system, allowing them to transition smoothly without undue disruption. Regulators should also provide a feedback loop and continually engage stakeholders through consultation processes and feedback mechanisms to identify potential challenges and gather insights from the industry during the transition period. Additionally, creating a standardized machine-readable format (such as XBRL digital tagging of sustainability-related information) or template for reporting would provide much needed technical assistance and support.

Digital reporting tools, templates, and resources, can aid market participants in aligning their products with the new categorization system.

During the transition period, regulators may allow a degree of flexibility in the initial stages of the transition can accommodate unforeseen challenges and ensure a more adaptive and responsive implementation process.

Question 4.1.10 What should be the minimum criteria to be met in order for a financial product to fall under the different product categories?

- Taxonomy Alignment: Given the focus on targeted, measurable solutions to sustainability problems, alignment with the taxonomy is critical.
- Engagement Strategies: Engagement strategies can enhance the impact of targeted solutions but may not be the sole criterion.
- Exclusions: Exclusions may be relevant but should not hinder the pursuit of targeted, measurable solutions.
- Pre-defined, Measurable, Positive Environmental, Social, or Governance-related Outcome: This is fundamental for products aiming to offer measurable sustainability solutions.

Taxonomy Alignment: While relevant, adherence to specific sustainability themes may vary.

Engagement Strategies: An ESG-Focused fund that integrates one or more ESG factors in its investment strategy should have an active engagement policy with shareholders.

Exclusions: A minimum threshold of exclusions (tobacco, controversial weapons) must be defined as minimum criteria for all funds within the scope of the categorization system.

Pre-defined, Measurable, Positive Environmental, Social, or Governance-related Outcome: This is crucial for assessing the effectiveness of meeting sustainability standard but may not be equally applicable.

Products with a transition focus should aim for alignment with taxonomy criteria. An active engagement policy and strategy can also play a crucial role in achieving transition objectives. Although exclusions may not be the primary focus for a transition fund, some exclusions that conflict with the transition area may be relevant. Measurable improvements and targets could also support transition funds transform and upgrade into other product categories (for example once the fund meets the criteria to be classified 'green').

Question 4.1.11 a) If the criteria should focus on the processes implemented by the product manufacturer, what process criteria would you deem most relevant to demonstrate the stringency of the strategy implemented?

Yes, there should be additional disclosure requirements when a product falls within a specific sustainability product category. These additional requirements would serve to provide more granular and category-specific information, ensuring that investors receive detailed insights into how each product aligns with sustainability objectives. The disclosure requirements can vary based on the specific characteristics and goals of the sustainability product category. Here are some considerations:

Category-Specific Metrics: define and disclose metrics that are particularly relevant to the objectives of the specific sustainability product category. For instance, if the category focuses on carbon neutrality, disclose metrics related to carbon emissions reduction.

- **Impact Assessment:**
  Provide detailed information on the product's impact on environmental and social factors specific to the category. This may include details on biodiversity conservation, community engagement, or other relevant impacts.
- **Alignment with Taxonomy:**
  If the product category is aligned with the EU Taxonomy, disclose how the product meets the criteria outlined in the Taxonomy. This can provide investors with clarity on the environmental sustainability of the underlying investments.
- **Scenario Analysis:**
  Include scenario analysis results, especially if the sustainability product category involves exposure to climate-related risks. This helps investors understand how the product may perform under different environmental scenarios.
- **Lifecycle Analysis:**
  For products related to certain industries or sectors, consider disclosing lifecycle analysis information. This can be particularly relevant for products that claim to support sustainable practices in areas such as energy, transportation, or agriculture.
- **Certifications and Standards:**
  Disclose any relevant certifications or adherence to specific industry standards associated with the sustainability product category. This can add an extra layer of credibility to the product's sustainability claims.
- **Comparison with Benchmarks:**
  Provide comparisons with industry benchmarks or standards associated with the specific sustainability product category. This can help investors assess the product's performance in relation to established norms.

Question 4.1.13 How would you further specify what promotion of ‘environmental/ social characteristics’ means, what should be the minimum criteria required for such characteristics and what should be the trigger for a product to be considered as promoting those characteristics?

Specifying the promotion of “environmental/social characteristics” involves defining clear and measurable criteria to ensure transparency and consistency. The minimum criteria required for such characteristics should be articulated to provide a framework for assessing the environmental and social impact of financial products. Here are some considerations:

The regulation should define the specific environmental and social objectives that a product aims to promote.

This could include GHG emissions targets (standardized carbon intensity metrics), reducing hazardous waste, board diversity-related minimum requirements etc. The regulation should also establish quantifiable metrics and targets related to environmental and social characteristics. For example, if a product claims to promote renewable energy, specify the minimum percentage of assets allocated to renewable energy projects.

The regulation may introduce strategy-specific disclosure requirements for impact funds similar to the US SEC Fund Labeling Rule. The US regulation requires Impact Funds to include a progress report with quantitative analysis and disclosure of factors that materially affect the fund’s ability to achieve its specified impact on an annual basis.

Question 4.1.15 Apart from the need to promote environmental/social characteristics and to invest in companies that follow good governance practices for Article 8 products and the need to have sustainable investments as an objective for Article 9 products, should any other criterion be considered for a product to fall under one of the categories?

Yes, there should be additional disclosure requirements when a product falls within a specific sustainability product category. These additional requirements would serve to provide more granular and category-specific information, ensuring that investors receive detailed insights into how each product aligns with sustainability objectives. The disclosure requirements can vary based on the specific characteristics and goals of the sustainability product category. Criterion may include category specific metrics requiring asset managers to define and disclose metrics that are particularly relevant to the objectives of the specific sustainability product category. If the product category is aligned with the EU Taxonomy, disclose how the product meets the criteria outlined in the Taxonomy. This can provide investors with clarity on the environmental sustainability of the underlying investments.

Additionally, if product category involves exposure to climate-related risks, criteria should include scenario analysis results. In terms of best practice, funds should provide comparisons with industry benchmarks or standards associated with the specific sustainability product category (best-in-class, best-in-universe). This can help investors assess the product’s performance in relation to established norms.

4.2 General questions about the potential establishment of sustainability products categories

Third-party verification of categories (mainly by audit firms) being mandatory is crucial for ensuring the credibility and reliability of a product categorization system. This involves assurance engagements to verify the alignment of products with a sustainability product category and ongoing compliance monitoring. This external validation adds an extra layer of transparency, reducing the risk of greenwashing and providing investors with confidence in the accuracy of sustainability claims.

While self-declaration by product manufacturers supervised by national competent authorities can be part of the process, relying solely on self-disclosure may introduce potential conflicts of interest and lacks the independence and objectivity that third-party verification can offer.

Therefore, a balanced approach, combining self-declaration with mandatory third-party verification, is more likely to ensure the robustness and integrity of the product categorization system. This approach promotes accountability and aligns with the goal of establishing a trustworthy and effective framework for sustainable finance.

4.3 Consequences of the establishment of a sustainability products categorisation system

The inclusion of the product category within the PRIIPs KID (Key Information Document) could enhance transparency and provide additional context for retail investors. If a product categorization system is established under the SFDR, integrating the assigned category into the PRIIPs KID aligns with the overarching objective of providing clear and concise information to retail investors.

By incorporating the SFDR category into the PRIIPs KID, investors can benefit from a more comprehensive understanding of the sustainability characteristics and objectives of the financial product. This additional information may help investors make more informed decisions that align with their preferences and values, especially if they have specific sustainability criteria in mind when considering investment options.

However, it's important to strike a balance to ensure that the PRIIPs KID remains short, simple, and easily understandable for retail investors. The inclusion of the SFDR category should be done in a way that complements the existing information without overwhelming investors with excessive details. Clarity and simplicity remain key considerations to effectively communicate essential information to retail investors.

4.4 Marketing communications and product names

In order to prevent misleading communications from products not falling under a product sustainability category, introducing specific naming and marketing rules as part of the SFDR implementation would be useful. These rules should establish that the use of certain terms in fund names e.g., 'sustainable', 'green', 'climate' is strictly prohibited unless the use of certain terms in fund names to ensure clarity and accuracy in marketing and communication. However, relying solely on naming and marketing rules may not be sufficient; there is a need for a comprehensive regulatory framework to ensure transparency and avoid potential greenwashing.

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