SFDR's Early-Life Crisis Presents an Opportunity to Level the Playing Field

Alasdair Docherty, Sustainable Finance & Data Analyst

November 2023

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Key Findings

SFDR is failing its transparency goals, with capital flow data adding weight to a growing recognition of issues. In reaction, the recent consultation seeks opinion on options for course correction.

Two competing approaches for reshaping SFDR have emerged, but only by replacing the current article system with a labelling scheme applied uniformly to all products can we redress current imbalance.

Increased compliance burden on managers should be tempered by retooling existing processes, significant overlap with similar UK based proposals and development of the European Single Access Point.

National regulators need to prepare for increased supervisory demands, and asset managers should already be looking to tighten practices, particularly as they relate to current Article 8 products.

Executive Summary

A continually evolving regulatory landscape in Europe now includes a broad-ranging consultation on the Sustainable Finance Disclosure Regulation (SFDR), opening the door for a fundamental reworking of the current system. This latest consultation comes in reaction to growing industry concern that SFDR in its current format is not achieving its transparency goals. A poll conducted during the European Commission's open forum on the consultation showed that almost two-thirds of respondents believe SFDR disclosures have created more confusion than clarity, raising the risk of greenwashing.

Problems with SFDR stem from a disconnect between its intended use as a system for identifying appropriate fund disclosure levels and its adoption as a de-facto environmental, social and governance (ESG) labelling system used by managers to signal the sustainability ambition of products. Vague definitions and managerial agency over the SFDR categorisation process may have been appropriate for a disclosure regime, designed to accommodate various investment approaches, but have ultimately led to a damaging lack of consistency in application. This is particularly true of Article 8 funds where sustainability ambition varies widely. This in turn presents a real headache for asset owners trying to allocate capital to more sustainable products, particularly at the retail end of the market.

Stakeholder sentiment on this issue is further backed up by evidence from recent capital flow data. Article 8 products (which promote environmental or social characteristics) have seen outflows in both of the last two quarters, even as the reverse has been true of sustainably ambivalent Article 6 counterparts. More tellingly however, redemptions have disproportionally affected Article 8 funds with no commitment to sustainable investments, which represent around two-thirds of recent outflows, despite only accounting for one-third of the universe in terms of size. Additionally, demand for less sustainably ambiguous Article 9 products (which have sustainability as an explicit objective) remains intact. Perhaps then, reports of the death of sustainable investing have been somewhat exaggerated, but there is little doubt that funds claiming some level of sustainability ambition need clear qualifying criteria setting out.

Based on the consultation, there seem to be two trains of thought as to the future shape of SFDR:

1. Keep the SFDR article definitions as they are, but apply minimum standards for Articles 8 and 9, potentially with labels then built upon them.
2. Do away with existing SFDR article levels and switch to a system of labelling.

The first option ignores a significant imbalance in the current regime whereby the most demanding disclosure requirements are targeted at sustainably led products (Articles 8 and 9), making investing on this basis more burdensome, and more importantly, reducing comparability with Article 6 funds. This serves to mask the negative impacts of products with no sustainability ambition.

The second option, and IEEFA's preferred approach, would involve applying sustainability reporting requirements consistently to all funds, logically removing the need for article distinctions. IEEFA envisages that any fund voluntarily seeking a label must adopt minimum, label-specific standards that are decided centrally as a safeguard. Process-specific standards should then be additionally applied to tighten criteria where it is appropriate. In order to address concerns around the stymying of innovation, managers should be able to set their own criteria at the process level, so long as it is ratified and verifiable by a third party.

IEEFA acknowledges further industry concern regarding the potential for increased compliance burden and cost to managers, but any impact should be tempered by a few factors:

1. Significant overlap with similar proposals recently presented by the Financial Conduct Authority (UK).
2. The retooling of existing operational processes.
3. Development of the European Single Access Point.
4. Potential for future streamlining of mandatory universal reporting metrics.

In the advent of labelling, where third-party verification is required, improvements in the current supervisory environment must also follow. The burden on national competent authorities will also undoubtedly increase, and consideration should be given to the development and adoption of artificial intelligence systems to assist in this process.

Finally, although we cannot yet predict the outcome of this latest consultation, the onus should already be on asset managers to get ahead of the curve and tighten certain practices voluntarily. For example, managers that stubbornly refuse to adopt any form of minimum standards in their Article 8 products will appear weak in terms of their ESG commitments. Indeed, as we have seen in the capital flow data, such managers are already being punished for adopting this stance as flows disproportionately desert funds without minimum sustainable investment thresholds. Be it through regulatory catch-up or market forces, the message to asset managers should be clear—jump or be pushed.

The Regulatory Background

Despite phased implementation, the pace and breadth of regulatory transformation in European financial markets have presented challenges, not only to financial market participants (FMPs) and advisers (FAs), but also to the majority of the real economy with a presence in the European Union (EU). Firm cross-border political support for the EU Green Deal has facilitated this rate of change, but a shifting landscape brings with it uncertainty and cost. This landscape now includes a broad-ranging, almost existential consultation on the Sustainable Finance Disclosure Regulation (SFDR), which presents the possibility of a fundamental reworking of the current system.

The EU's regulatory approach revolves around what are often described as three pillars. The first pillar, the SFDR, chiefly targets asset managers and obligates the standardised publication of environmental, social and governance (ESG) credentials at both a product and entity level. Currently, a system of categorisation sits at the heart of SFDR, whereby a product must be qualified by the offering manager as Article 9, 8 or 6. The higher the categorisation, the higher the level of disclosure required. This process is designed to force asset managers into being transparent on how deeply issues of sustainability are integrated into investment practices and to ultimately disclose appropriately, allowing asset owners to make informed investment decisions.

Figure 1: Article Meanings and Related Disclosure Requirements

Disclosure level required (higher → lower)	Article	Meaning
higher	Article 9	Must have an explicit sustainable investment objective
	Article 8	Must promote environmental or social characteristics
lower	Article 6	Other products (no environmental or social characteristic requirements)

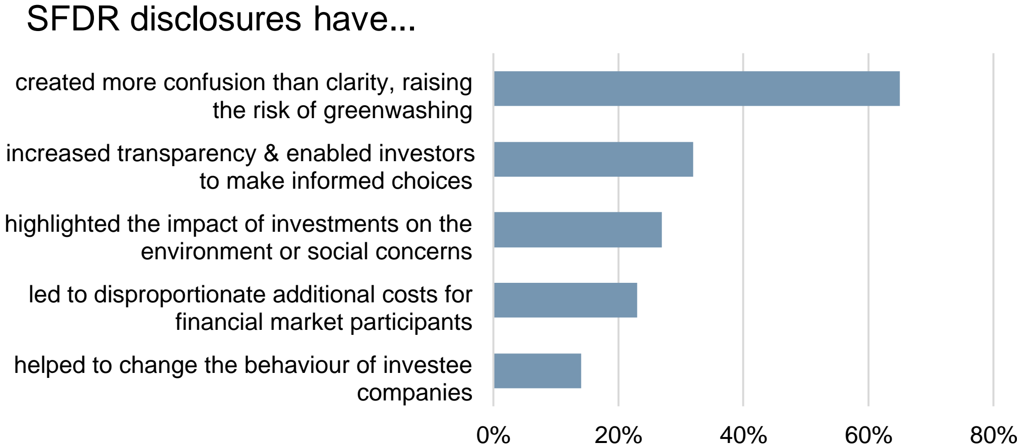
In many ways, SFDR represents the end goal of the regulatory process, leveraging the groundwork laid by other regulations, including that of the two other "pillars", namely the Corporate Sustainability Reporting Directive (CSRD) and the EU taxonomy. For a more holistic view of the current landscape, including illustrations of stakeholder relationships and how certain legislation fits together, please refer to IEEFA's EU sustainable finance regulation explainer.[1]

[1] IEEFA. EU Sustainable Finance Regulation. November 2023.

SFDR has "Created More Confusion Than Clarity"

This sounds good on paper, but as the finance industry grapples with the practical application of new transparency rules, SFDR has increasingly come under fire. Debate may remain over more garden-variety regulatory issues, such as the burden of implementation costs, the effectiveness of certain technical indicators or the potential suppression of innovation, but stakeholders across the spectrum seem to agree that SFDR in its current format simply isn't achieving its intended transparency goals. Nowhere was this laid bare more than during polls conducted at an open forum hosted by the European Commission in October. When presented with five multiple-choice responses to the statement "*SFDR disclosures have…*", a rather unforgiving two-thirds of the 600 respondents opted to include "*…created more confusion than clarity, raising the risk of greenwashing*".

Figure 2: Results from Consultation Open Forum Poll Regarding the Current State of SFDR



Source: European Commission, IEEFA, October 2023. Results of a poll taken during an open forum on the consultation. Figures denote the number of respondents that selected an option as one of two (maximum) possible choices, as opposed to the overall share of the vote.

This response may be related to fallout from the second half of last year, when central guidance confirmed that Article 9 funds must be composed solely of sustainable investments. According to Morningstar, around 350 funds were subsequently downgraded by managers to Article 8, prior to receiving further clarification on the definition of a "sustainable investment" under Article 2(17).[2] Despite previously signalling that managers would begin seeing tighter criteria going forward, later clarification encouraged managers to construct their own definition of a sustainable investment and

[2] Morningstar. SFDR Article 8 and Article 9 Funds: Q2 2023 in Review. July 2023.
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confirmed that passive strategies tracking climate benchmarks would automatically classify as Article 9, leading to swathes of reversed downgrades in an episode that is unaffectionately referred to as the great classification flip-flop. Perhaps this later guidance was to be expected in the absence of a fully functioning EU taxonomy, but outside of managerial circles, an endorsement of discretion over sustainability definitions was met with some consternation. Already Article 8 adherence was viewed as too freely open to interpretation, defined as it is as any product "promoting" environmental or social characteristics, with supervision of the categorisation process seen as inadequate. Although end-investor understanding of such issues has grown, vagueness of definition and managerial agency has ultimately led to a lack of consistency in application, particularly for Article 8 funds where sustainability ambition varies considerably. This in turn presents a real headache for asset owners trying to allocate capital to more sustainable products, particularly at the retail end of the market. The open forum audience probably had a point.

Recognition of Problems

To the uninitiated, it may seem strange that such ambiguity has been permitted, even encouraged by standard setters. Initially intended as a system for identifying appropriate disclosure levels, rather than a means for signalling the level of sustainability ambition, it is widely understood that the European Commission (the Commission, EC) left definitions intentionally vague in order to accommodate the various approaches taken by managers when integrating ESG considerations into investment processes. Perhaps predictably, however, SFDR quickly established itself as the de-facto ESG labelling system used by an entire industry, with article levels ubiquitously shorthanded as "dark green", "light green" and "grey" by most stakeholders and used in marketing material to signal a certain level of environmental or social commitment. The Dutch Authority for the Financial Markets (AFM) recently published guidelines on the use of SFDR when making sustainability claims in marketing material, describing the process quite plainly as "undesirable" given sustainability ambition "varies widely" within classifications.[3] The authority went on to explicitly warn managers against giving the impression that article designations were labels that had been assigned by third parties, citing multiple observed examples of this practice. Other national competent authorities have gone a step further, calling for solutions in the form of minimum sustainability standards as part of SFDR categorisations. France's Financial Markets Authority (AMF), for example, has laid out plans for the introduction of exclusionary criteria. Indeed, when assessing the development of its own disclosure regime, the UK-based Financial Conduct Authority (FCA) acknowledged such practical implementation issues, ultimately suggesting labelling as an alternative approach, given "the categorisation of sustainable financial products introduced by SFDR has become a de facto classification and labelling system for sustainability-related investment products".[4]

Clearly, recognition of a disconnect between the intended and actual usage of SFDR pervades the industry, with this disconnect ultimately being the root cause of problems. Despite this growing

[3] AFM. AFM publishes Guidelines on Sustainability Claims. October 2023.
[4] Financial Conduct Authority. Sustainability Disclosure Requirements (SDR) and investment labels. November 2021.

recognition, until the launch of the most recent consultation, little indication had been given that the Commission was ready to meaningfully review the fundamentals of SFDR. Given this, it is with some surprise just how far-reaching the latest SFDR consultation is, suggesting the possibility of gutting the existing tenets and indeed, musing whether the regulation is even relevant to achieving underlying goals. Question 1.1 of the consultation document[5] kicks off proceedings as it means to go on:

> "The SFDR seeks to strengthen transparency through sustainability-related disclosures in the financial services sector to support the EU's shift to a sustainable, climate neutral economy. In your view, is this broad objective of the regulation still relevant?"

The targeted consultation goes on to seek advice on a few key areas, noted below. Most conspicuously section 4 focuses on potentially scrapping the current article categorisation system altogether, in favour of a labelling system. This would be the largest departure from the existing framework and the impact of such a conversion will form the basis of much discourse between now and the December deadline.

Consultation Areas

1. Current requirements of the SFDR
2. Interaction with other sustainable finance legislation
3. Potential changes to the disclosure requirements for financial market participants
4. Potential establishment of a categorisation system for financial products

Source: European Commission.

The Commission has been at pains to stress it is simply covering all bases, meaning questions in the consultation should not be taken as a statement of intent. Regardless, such an examination is naturally unsettling for an industry still absorbing the existing nascent regulation. Given the interdependency of regulatory directives, to second-guess the existence of SFDR might on the face of things call into question the validity of an entire regulatory approach—one that has been adopted at considerable expense, and not only by financial market participants.

To second-guess the existence of SFDR might on the face of things call into question the validity of an entire regulatory approach.

[5] European Commission. Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR). September 2023.

What Data Can We Look to for Guidance?

The possibility of throwing the baby out with the bathwater has been noted in attention-grabbing fashion by a few commentators since the consultation launch. But before dismantling SFDR entirely we should at least try to quantify its achievements in improving the mechanisms that underpin European investment habits. Recognising that regulatory design is ultimately in service of the EU's broader Green Deal initiative, the most obvious top-down indicator of success would be evidence of capital flow realignment towards "greener" or more sustainable areas of economic activity. Of course, transparency measures don't force end investors or custodians of our capital to reallocate towards sustainable products or activities, but they should provide the toolset required to make those decisions and effectively enact them. In its most simple reading, we would expect an ongoing gravitation towards products categorised as Article 8 and 9 when compared to Article 6 counterparts, but an understanding of underlying dynamics is key.

In the pursuit of interpreting flows and other related data, Morningstar's quarterly reporting, which assesses capital allocations to open-end and exchange-traded funds through the lens of SFDR, provides valuable insight.[6] Despite not being a fully comprehensive universe, it acts as a bellwether for the direction of travel.

Looking at the top-level data, it is striking that Article 9 products have seen persistent inflows since the advent of SFDR, even as the broader universe saw capital redirected in the wake of Russia's invasion of Ukraine. Clearly, the demand for products with sustainability as an explicit objective remains intact.

On a cumulative basis, flows to Article 8 funds have also outstripped those to Article 6, but both categories have been volatile. Perhaps of some concern is the fact that since the first quarter of 2023, the organic growth rate (measured as flows as a percentage of universe size) for Article 8 products has fallen (and stayed) below that of Article 6 counterparts. In fact, Article 8 products have seen outflows in both of the last two quarters, even as the reverse has been true of Article 6.

[6] Morningstar. SFDR Article 8 and Article 9 Funds: Q3 2023 in Review. October 2023.
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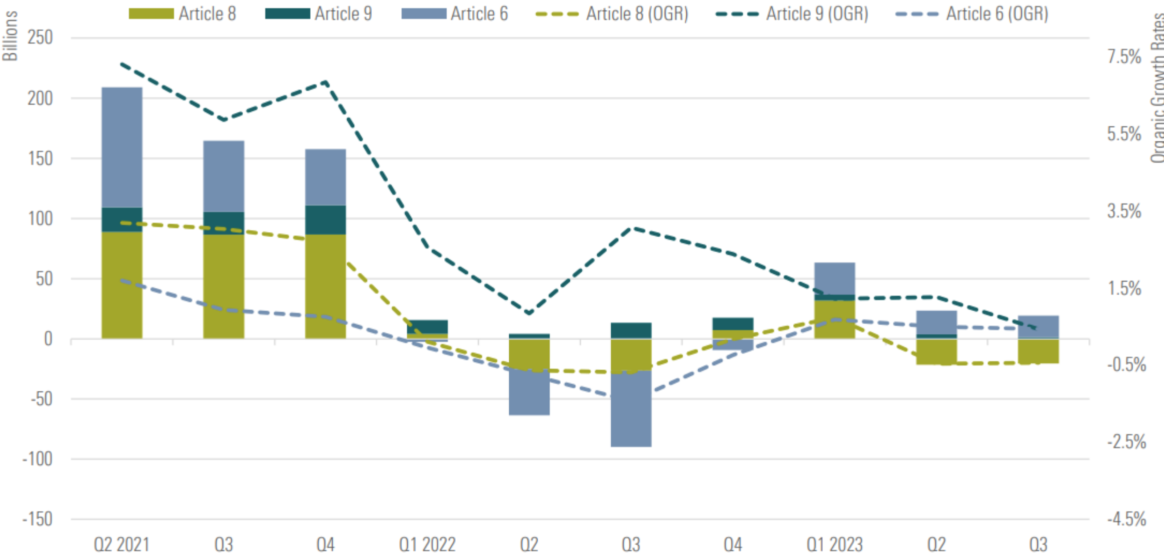
Figure 3: Quarterly Flows by Article Category (billions of euros) and Organic Growth Rates (%)



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Interpreting Flows Data

Although one swallow does not a summer make, two might imply that SFDR has stopped efficiently providing a pathway for flows to ostensibly more sustainable Article 8 products. That, or investor sentiment towards this category has begun to wane. The reality is a bit of both. Morningstar provides additional colour here, highlighting that recent redemptions have disproportionally affected Article 8 funds with no commitment to sustainable investments, which represent close to two-thirds of total Article 8 outflows over both recent quarterly periods, whilst accounting for only one-third of the Article 8 fund universe in terms of size.

> **Recent reports of the death of sustainably led investing have been somewhat exaggerated.**

Perhaps then, recent reports of the death of sustainably led investing have been somewhat exaggerated. A better reading of recent outflows is to take encouragement from the fact that assets are predominantly moving away from Article 8 vehicles with less substantial ESG integration guarantees. Such a clear divide in terms of outflows is, however, symptomatic of criticisms already noted: That the language surrounding Article 8 adherence has been too freely open to interpretation by managers who exercise too much agency over the categorisation process. Given this lopsided make-up of outflows, it is rather likely that a portion of the investor base recognises not all Article 8 products are born (or converted) equal. The European Securities and Markets Authority recently

published similar findings in the TRV Risk Monitor,[7] ultimately concluding that there was no significant correlation between outflows and funds that were downgraded from Article 9 to Article 8 during the great classification flip-flop, meaning "investors looking to invest in ESG funds are paying attention to the sustainability profile of funds rather than their specific SFDR disclosure regime". It must be appreciated, however, that some asset owners, particularly at the retail end, will be unaware of such nuance and that Article 8 products employing meaningful ESG integration will suffer by association.

Reshaping SFDR: Two Approaches

Recognition that SFDR causes confusion and inevitably leads to suspicions of greenwashing is increasingly backed up by the evidence from recent data. Funds claiming some level of sustainability ambition now need clear qualifying standards setting out. Rather than whether SFDR needs to apply such standards, the question is now more one of how to apply them. Based on the consultation, there seem to be two trains of thought here:

1. Keep the SFDR Article definitions as they are, but apply minimum standards for Articles 8 and 9, potentially with labels then built upon them.
2. Do away with existing SFDR article levels and switch to a system of labelling.

Both options would signal a marked improvement over the current system, and although the latter might sound like subscribing to a throwing-the-baby-out approach, the practical reality would be far from it. Given other considerations around SFDR, in IEEFA's view, this would be the preferred implementation method.

Comparing Apples with Cigarettes

To touch on the first approach, general standards that could be applied might include minimum sustainable investment commitments, minimum reductions to the investible universe (through exclusionary screening) and/or quantifiable stewardship standards. The key point is that by applying minimum standards, much of the subjectivity and managerial ownership of the categorisation process is removed. In doing so, we greatly improve asset owner confidence in, and understanding of, what an article level represents, which in turn reduces suspicions of greenwashing. With minimum standards in place, fund managers could then apply for labels, which may require additional but more process-relevant standards. Indeed, prior to the publication of the latest consultation, IEEFA might have backed calls for an approach that adopts a fourth, co-existing SFDR product category (Article 8+), that would share the same disclosure requirements as Article 8, but apply such minimum standards as outlined above. In terms of sustainability ambition, this new category would then sit somewhere between the loosely defined Article 8 and stricter Article 9. This would have

[7] European Securities and Markets Authority. TRV Risk Monitor. August 2023.

been a measured solution, leveraging groundwork done in establishing existing articles as standard nomenclature, whilst acknowledging more wholesale change to the regulatory landscape might run the risk of further confusion and compliance fatigue, especially if adding to disclosure requirements.

However, this approach ignores a significant imbalance in the current regime and the fact that article numbering is in no way intuitive for a retail audience to understand. To expand, currently the most demanding disclosure requirements are targeted at sustainably led products (Articles 8 and 9), making investing on this basis more burdensome and more importantly reducing comparability with environmentally and socially ambivalent Article 6 funds. This serves to mask the negative impacts of products with no sustainability ambition, and redressing this imbalance outweighs the potential for increased compliance burden. During the open forum for the consultation, one speaker representing an impact-only investment house argued that the inequity of the current SFDR framework is akin to apples being sold with an accompanying leaflet, detailing all positive and negative effects of apples, whilst allowing cigarettes to be sold without health warnings. Perhaps the analogy wouldn't stand up in a court of law; not every Article 6 fund is selling tobacco. In fact, many Article 6 funds hold up pretty well in sustainability terms, but it does illustrate the point.

> **The inequity of the current SFDR framework is akin to apples being sold with an accompanying leaflet, detailing all positive and negative effects of apples, whilst allowing cigarettes to be sold without health warnings.**

Keep the Baby, Change the Bath Water

Under IEEFA's preferred approach, which envisages replacing the current article structure in favour of a labelling system, it is unlikely that SFDR would be rendered entirely obsolete, not least because if labelling is to be applied, and presumably voluntarily, then we still need reporting standards for funds that fall outside this remit. Given SFDR already completes this objective, starting from scratch would be an unintuitive and backward step. However, if sustainability reporting requirements are to be applied consistently to *all funds* regardless of whether they make sustainability claims or not, we logically remove the need for article distinctions. In short, the categorisation process may become obsolete, but many of the data points currently required under SFDR would remain pivotal. Mandatory universal reporting metrics under this approach could feasibly be streamlined; the only initial difference to the status quo would be that managers no longer need to self-designate article levels, based almost entirely on their own criteria.

Minimum Label Standards

Going forward under this second approach, any fund voluntarily seeking a label should first have to adopt baseline minimum standards as a safeguard. Applying such standards on a per-label basis seems appropriate but will be a challenge for standard setters, requiring careful consideration and further consultation. Exacerbated by the absence of an all-encompassing EU taxonomy, minimum sustainable investment commitments may not be suitable for all labels, but there should be no reason for funds seeking any label not to apply minimum exclusionary policies or quantifiable engagement programmes. If we use funds seeking the "sustainable improvers"[8] label as an example, perhaps it would not be appropriate at all to mandate minimum sustainable investment commitments, but such a product category should have a much higher bar in terms of quantifiable engagement and improvement metrics.

Process-Relevant Standards

Secondly, and in addition to baseline label-minimum standards, process-relevant standards should be adopted where appropriate. This may be less necessary in some instances, for example under the proposed "exclusionary policy" label but will be entirely necessary in cases where a fund has a thematic or more focused approach and may apply for a "sustainable focus" label. For example, should a product target betterment of the United Nations Sustainable Development Goal (UN SDG) 6 (affordable and clean energy), it should provide clear guidance on minimum standards applied within that space; e.g. companies must reach a minimum 50% of revenue in one of the EU taxonomy-defined "enabling" activities. The practice of defining more process-specific standards needs to be as objective as possible, and we would encourage standard setters to propose potential metrics, perhaps on a UN SDG basis, given many investment processes are built around these or could have minimum standards adapted from them. Regardless, we would expect that typical standards for different process types might emerge over time and propose that managers are given some leeway in this area to construct their own criteria.

Addressing Industry Concerns

Some managerial agency needs to remain. In order to address concerns around the stymying of innovation, managers should be able to set their own criteria at the process level, so long as it is ratified by a third party—in all likelihood by a corresponding national competent authority (NCA). Continuing with the example above, certain "sustainability focuses" lend themselves better to centrally standardised criteria than others, but any non-standardised criteria forming part of a labelling process needs to be easily monitored and verifiable.

[8] An FCA term, coined as part of its own labelling propositions, but aligned with the EU's "products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in".

IEEFA also acknowledges concerns raised regarding increasing the compliance burden but notes that adopting the labelling system as outlined would not require additional data collection by increasingly beleaguered industry participants than is currently the case. Rather, we would expect that a relatively less painful retooling of reporting systems is required. It would however mean that products currently classified as Article 6 would be subject to the same reporting burden as products that have some form of sustainability claim.

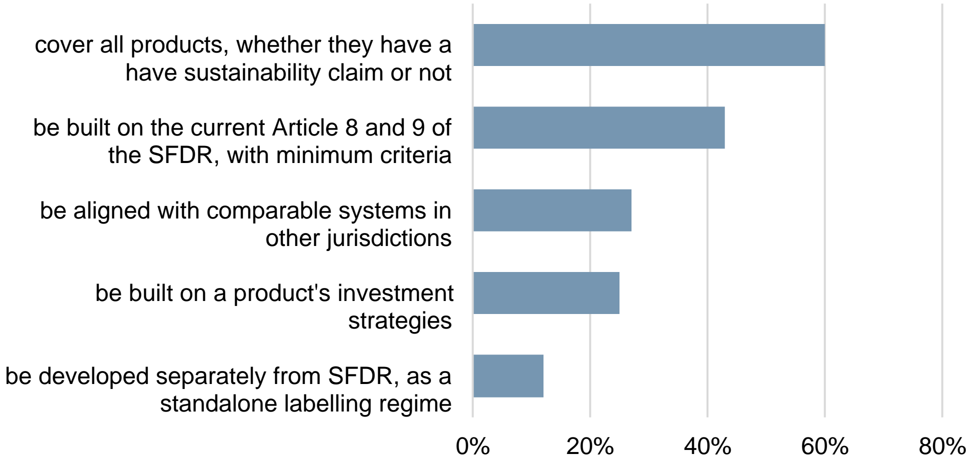
Much of the cost burden of implementation comes from the complexities of data sourcing, and although we expect universal reporting requirements may be streamlined in the future, IEEFA would strongly support calls for rapid development and deployment of the European Single Access Point (ESAP). The first harvest of CSRD should go some way to addressing concerns here, but without an easily accessible centralised database for complete sustainability-related information, smaller FMPs may disproportionately struggle to obtain the information they need to accurately report under SFDR. The advent of the ESAP would also go some way to addressing another major outstanding concern with SFDR: That comparability of metrics at an entity level is currently not possible, particularly with regards to certain principal adverse impact (PAI) indicators, owing to inconsistent data sources and methodologies applied. IEEFA would further recommend that over time, the ESAP should make its best efforts to synthesise data on companies that fall outside of the scope of CSRD. In order to encourage out-of-scope entities to engage with the ESAP platform, where sustainability metrics cannot be reasonably calculated with publicly available data, sectoral maximums should be applied. Regardless, rather than is currently the case, whereby every single asset manager is required to devote resources to filling in data gaps resulting in dozens of varying methodologies, we should capture once as part of ESAP.

It should also be noted that by adopting a system of labelling that largely maps onto those proposed by the FCA, we move closer to a harmonised approach across jurisdictions, serving to reduce compliance burden and, perhaps more importantly, asset owner confusion. The European Commission should be commended for its foresight in this regard, and we would encourage standard setters to continue to evolve regulation with an eye on cross-jurisdictional developments.

Reaching a Consensus

Given potential implications on compliance cost, it was somewhat surprising to learn that IEEFA would be far from alone in suggesting an approach to sustainability reporting and labelling that covers all products. Returning to polls taken during the open forum as an indicator of stakeholder sentiment, 60% of participants chose to include this approach as one of their two most important future considerations, compared to around 43% that would prefer we continue to differentiate between levels of reporting across categories:

Figure 4: Results from Consultation Open Forum Poll Regarding the Future of SFDR



Source: European Commission, IEEFA, October 2023. Results of a poll taken during an open forum on the consultation. Figures denote the number of respondents that selected an option as one of two (maximum) possible choices, as opposed to the overall share of the vote.

A subsequent Morningstar survey narrowed this gap somewhat but again showed a preference for the cover-all-products approach. Perhaps this implies that most asset managers operating in the EU already offer products with some claim of sustainability and would welcome a more level playing field, especially seeing as such a transition would involve less costly operational amendments. Regardless, there does appear to be recognition that moving away from the current approach would improve transparency. Doing so would also end a system of article naming that is confusing for retail audiences—it was never designed to function as a label and is perhaps already tainted in the eyes of asset owners.

Moving away from the current approach would end a system of article naming that is confusing for retail audiences—it was never designed to function as a label and is perhaps already tainted in the eyes of asset owners.

Increased Onus on Supervision

We would be remiss not to mention that this system only works with greater emphasis on NCA involvement and engagement than we have seen to date, as well as greater harmonisation of supervisory approaches across national borders. Monitoring of SFDR adherence has so far been a soft touch, partly to give participants breathing room during a burdensome transition period, but also owing to difficulties in assessing the broad range of interpretations and implementation methods adopted by managers. Recently, the three European supervisory agencies (ESAs) published a report highlighting inconsistencies and in some cases errors in NCA application of SFDR regulation.[9] Although these findings focused on a subset of SFDR (principal adverse indicator disclosure), it was noted that "there is still an improvement and build-up of expertise needed by the NCAs to enable thorough checking of compliance". In the advent of labelling, where third-party verification is required, improvements in the current supervisory environment will also naturally be required. The application of minimum quantifiable standards for labels should at least give NCAs transparent baselines for assessment to help facilitate this. Even so, the burden of monitoring will be considerable given the wide variation in investment processes that need to be accommodated, potentially each with varying minimum criteria at the process level.

There is still an improvement and build-up of expertise needed by the NCAs to enable thorough checking of compliance.

As proposed by industry group the Investment Association (UK), perhaps consideration should be given to the development and adoption of artificial intelligence systems to assist in this process, on the grounds that it "holds substantial promise for enhancing supervision within financial services".[10] At the very least, exploration of measures that could ease the monitoring burden should be explored and regular progress checks made by the ESAs in order to harmonise international approaches. Furthermore, we would hope to see the establishment of financial consequences for non-compliance. Although some initial leniency will again be required, this step would prevent FMPs from ignoring commitments without fear of reprisal and act as a much stronger deterrent than simply mandating label removal.

[9] Joint Committee of the three European Supervisory Authorities. 2023 Joint ESAs Report on the extent of voluntary disclosure of principal adverse impacts under SFDR. September 2023.
[10] The Investment Association. Making Investment Better for All. September 2023.

Anything Else to Worry About?

Naturally, much of the consultation response will focus on the future of SFDR. What this latest consultation means for others, such as the joint ESAs consultation on the regulatory technical standards for SFDR, remains to be seen, and it would be easy to simply pay lip service to earlier sections of the current consultation that focus on the existing requirements and interactions of SFDR. The European Commission explicitly requests that answers here focus on the regime as it stands, rather than hypotheticals that would relate to any suggested proposals for labelling systems. Such an exercise remains important seeing as it is unlikely that SFDR will be dismantled entirely, and any fundamental changes will take years to filter through. IEEFA will also be providing feedback in this regard, for example on matters of SFDR misalignment with CSRD, whereby investee companies only need to report certain metrics if they deem them material, irrespective of the fact that asset managers are often required to produce information including such metrics on an aggregate basis. Other areas of concern include the poor comparability of entity-level PAI data across managers and the sheer complexity of information initially presented to asset owners as part of SFDR reporting packages.

Jump or Be Pushed

Although we cannot yet predict the outcome of this latest consultation, recognition of a need for minimum standards has snowballed and is increasingly acknowledged by a range of stakeholders, including the standard setters themselves. Taken in this context, the content of the latest consultation means we surely expect to see developments in this space soon. Given this direction of travel, the onus should already be on asset managers to get ahead of the curve and tighten certain practices voluntarily. For example, managers that stubbornly refuse to adopt any form of minimum standards in their Article 8 products or hide complacently behind the excuse of incomplete investee company-level data (soon to be addressed, at least in part, by CSRD), will appear weak in terms of their ESG commitments. Indeed, as we have seen in the capital flow data, such managers are already being punished for adopting this stance as flows begin to disproportionately desert Article 8 products without minimum sustainable investment commitment thresholds. Be it through regulatory catch-up or market forces, the message to asset managers should be clear—jump or be pushed.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

About the Author

Alasdair Docherty

Alasdair Docherty is the Sustainable Finance & Data Analyst for IEEFA's European team. His research predominantly covers asset management and equity markets in Europe.

Alasdair has over 15 years of experience working with equities management, earned during his time at Schroders, where he built a deep understanding of the regulatory environment and how sustainability considerations are integrated into both investment and operational processes.

He further has a background in data analysis, having spent time earlier in his career at industry analytics provider FactSet Research Systems, and is qualified as a data analyst through BCS (UK). He graduated in 2004 with a bachelor's degree in Business Finance from the University of Durham.

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