Position Paper

Targeted consultation on the implementation of the Sustainable Finance Disclosure Regulation (SFDR)

Context

As a pioneering sustainable investment firm, Mirova has been a strong advocate for the European Union's initiative to establish a transparency framework within the financial sector. We firmly believe that transparency is critical to ensure that investors have access to accurate and reliable information about the sustainability contribution and risks of their investments. The emergence of the Sustainable Finance Disclosure Regulation (SFDR) framework has encouraged more investment companies to disclose their sustainable investment approach and improve their ESG capabilities.

The SFDR regulation requests that each product be categorized according to its characteristics. The definition of each of these categories is as follows:

- Article 6: the product has no sustainability objective;
- Article 8: The product promotes environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices;
- Article 9: the product has a sustainability objective.

Two years after its implementation, it is important to recognize that the SFDR regulation has been effective in achieving its primary objective by providing transparency to the market by classifying products based on their sustainability credentials. This has resulted in more investments being directed towards sustainable products: flows into Article 8 & 9 funds have significantly outpaced Article 6, with cumulative flows into ESG equity funds in the past three years standing at 3.4x compared to non-ESG counterparts[1].

Nevertheless, considering the numerous clarifications made by the regulatory authorities, the current framework appears to have reached its limits. **It may no longer be sufficient to meet the clarity needed**

[1] Source: Morningstar, Goldman Sachs Global Investment Research

by investors to navigate the market and make informed decisions. Thus, new measures may be necessary to address emerging challenges and opportunities in the realm of sustainable investments.

Main challenges

Increasing Disclosure Requirements Across the Board

While there has been an effort to increase transparency on environmental, social, and governance (ESG) factors in the investment product industry, it is important to note that such transparency has not been equally applied to all types of products. The reporting requirements for article 8 and 9 funds has been disproportionately higher than those for non-ESG funds (Article 6). This has significantly limited the ability of end investors to fully understand the profile of their investments.

We believe that mandating transparency on ESG factors solely for sustainable funds is similar to having nutritional scores exclusively on healthy foods, while withholding such information on other products. This lack of transparency can lead to confusion and dissatisfaction among investors as it prevents them to access full, adequate information regarding their investment opportunities. Therefore, in order to meet investors' need for clear and transparent information across the market, **we feel that all products classified under SFDR should be required to report on ESG criteria and performance as well as harmful activities.**

Product classification

Over time, the practical implementation of Article 6, 8, and 9 has resulted in categorization being used as "labelling" for investment products, leading to a situation where **the definition of Article 8 products is too broad** and covers various realities. For example, under Article 8 are found both funds with limited exclusions and funds that have over 90% sustainable investments.

In contrast, the definition for Article 9 products seems very narrow, covering only funds with 100% sustainable investments (excluding cash). As a result, the current classification system barely differentiates products of the Article 9 category on their degree of sustainability.

We firmly believe that requiring that Article 9 funds have "100% sustainable investments at all times" is not always appropriate for many investment products and investor needs:

- **In the case of listed assets**, the strict "100% threshold" can prevent funds from investing in other assets for liquidity and risk management purposes, which may be detrimental to the fiduciary obligation of asset managers to their clients, by undermining the ability of fund managers to effectively manage performance and risks of their products.
- **In the case of illiquid assets or for insurance investors**, the requirement for "100% sustainable investments at all times" can be impractical as investors do not have the possibility to sell assets as easily as listed assets investors, for instance when a controversy emerges.

Therefore, we argue that it is important to consider specific investment objectives and constraints according to the different specificities of each asset class when establishing sustainability requirements to **ensure that these requirements are practical, attainable, and effective**. This should enable asset managers to fulfil their fiduciary duty towards investors, but also to enable the financial sector to strive for greater sustainability.

Moreover, we believe that institutional and retail investors would greatly beneficiate from better clarity between SFDR and other regulations such as the European taxonomy[2] and the sustainability preferences under Mifid II[3].

Mirova's position

Mirova is convinced that the objective of the SFDR regulation should remain twofold: facilitating the development of sustainable investing while at the same time providing tools to the market to ensure the best transparency possible for investors and to avoid greenwashing.

To that purpose, the revised regulation should clearly differentiate between its disclosure requirements and requirements linked to products categorization.

Disclosure requirements: product categories in addition to transparency requirements

We strongly endorse the Commission's proposal to broaden the scope of sustainability disclosures for all products regardless of categorization. It is particularly important to promote fairness and transparency in the financial sector by ensuring that all investment products are subject to the same standards and requirements. This includes establishing shared minimum transparency standards related to environmental and social impacts. **Only by doing so can we trust that institutional or retail investors will make fully informed investment decisions.**

Rather than developing new reporting standards, which could lead to confusion and potentially conflicting regulation, we believe minimum disclosure requirements could be linked to existing tools and regulations, including exposure to sensitive activities or practices. These requirements could build on the Corporate Sustainability Reporting Directive (CSRD)[4] disclosure requirements for companies and/or some relevant Principal Adverse Impacts (e.g. greenhouse gas emissions, involvement in fossil fuels, tobacco industries, anti-personnel landmines and cluster munitions, etc.). These minimum disclosure requirements should be applied across all financial products, with additional requirements for funds with sustainability objectives. This approach will ensure that all financial products meet the minimum disclosure standards, while also addressing the unique sustainability objectives associated with each product category.

Although SFDR's mandate should not be to produce labels, the way the market has been using Articles 6, 8 and 9 as labels since its implementation show how much more than a need for transparency is at stake ("nature abhors a vacuum"). As such, **the Commission's proposal to introduce product categories, alongside setting minimum requirements, seems to be a fair "in between" that would allow labels (national or supranational) to build on this framework.**

Product categories: building on the existing framework rather than "starting fresh"

While we support the Commission's proposal to introduce formal product categories, we see a risk with a "starting fresh" strategy such as the four proposed categories which would also need to be clarified

[2] The European taxonomy lists environmentally sustainable activities. REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[3] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

[4] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting

to be properly implemented (e.g., what could be considered as a "credible sustainability standard" in category B? What would be the definition of transition focus in category D?). Besides, as the categories cannot be mutually exclusive (products can use a mix of exclusions, transition and sustainable investments), this could result in a complex categorization and hamper the clarity objective for end investors.

Instead of exploring new alternatives and potentially creating uncertainty in the market, **formalizing Articles 8 and 9 as product categories and establishing clear and specific criteria to support these existing concepts (including adopting the four proposed categories) appears to be a more effective approach, particularly when addressing the retail market.**

With this perspective in mind, we strongly advocate for a framework that incorporates the following key elements:

→ **Keeping the current "Sustainable investment" definition unchanged** as it already includes the fundamental concepts of positive contribution, Do No Significant Harm (DNSH), good governance. Establishing a unified qualitative definition of what constitutes a sustainable investment was a significant step forward in the ESG sector. Omitting this concept from the SFDR regulation would run the risk of creating multiple definitions, which would ineluctably undermine the coherence of the transparency framework. In the foreseeable future, the definition could be enhanced by considering:

- **An all-encompassing environmental taxonomy (including ultimately a taxonomy of "negative activities").** As the current taxonomy only covers a limited number of activities and sectors, it would be premature to use this criterion as it would automatically constrain investments to these specific areas. Therefore, including a minimum threshold of "taxonomy-aligned activities" in the definition of sustainable investment should only be considered once a comprehensive environmental taxonomy has been implemented.
- **Establishing a specific taxonomy for social issues** which have often been given less attention compared to environmental issues. It is crucial not to restrict Article 9 to "green" investments and disregard the social dimensions of sustainability such as diversity and inclusion, creation of quality jobs, fair pay, etc., which reflect the broader sustainability challenges of our society.

→ **Keeping three levels of products categories,** not based on their objective (all ESG products must have a sustainable objective) but on their level of ambition. While Article 9 funds should remain largely composed of sustainable investments, Article 8 funds could allow a significant proportion of transition investments. The regulation should further clarify that minimum shares of sustainable investments and/or transition investments should be calculated excluding cash, cash equivalents and derivatives.

→ **Differentiating "Solutions" and "Credible sustainability standards"** as part of the "sustainable investment" definition. Reflecting on the Commission's proposal, we consider that category A ("solutions") and category B ("credible standards") both reflect the current "sustainable investment" definition. We feel that asking market participants to disclose the proportion of these two categories as part of their reporting on the proportion of "sustainable investment" would bring more clarity to end investors.

→ **Introducing the concept of "transition investment" in the regulation** (as reflected in category D). As it is the case for taxonomy-aligned activities, "sustainable investments" still remain a minor part of the economy, and therefore cannot be the sole concept used in SFDR. The concept of "transition investment" could be defined when related to climate-related transition based on existing tools such as Science Based Targets (SBTi), Assessing low-Carbon Transition (ACT), Transition Pathway Initiative (TPI), etc. However, it should also cover other aspects of the transition (in particular with regards to improved social impact) and be attached to mandatory requirements on credible targets, engagement activities and reporting on progress (Key Performance Indicators).

→ **Aligning definitions of article 8 and 9 with CSRD by further embedding double materiality in SFDR.** Although double materiality is already present in SFDR notably with the concepts "sustainability risks" and "adverse sustainability impacts", ESG product classification should only be applied to funds implementing double materiality, i.e., that have a sustainability objective. In this regard, the notion "promotion of environmental or social characteristics" in Article 8 should be deleted. Instead, differentiation between Articles 8 and 9 should be done according to the level of ambition with regards to the sustainability objective of the fund.

→ **Setting minimum standards.** For Articles 8 and 9 categories, the regulation should define minimum standards applicable to all investments in the fund to ensure the respect of the DNSH principle and of good governance practices. These minimum standards could be built on information required by CSRD for companies (i.e., tobacco, fossil fuels, anti-personnel landmines and cluster munitions, chemical products), or draw from the list of exclusions established for Paris Aligned Benchmark (PAB) and Climate Transition Benchmark (CTB)[5] and/or use of some Principal Adverse Impacts (including those on biodiversity and human rights). *(see Appendix)*

[5] Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks

Appendix

	Article 6	Article 8 Transition	Article 9 Sustainable investment
Level of sustainability ambition of the strategy	**No or low level of ambition** Products that do not have sustainability as an objective (including products that intend to consider sustainability risks in their investment decisions, with the objective to improve financial returns only)	**Moderate level of ambition** Products that intend to invest in the transition towards sustainability	**Significant level of ambition** Products that intend to invest in sustainability
MAIN APPROACH Corresponding categories proposed in the consultation	C Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet (optional)	D Products with a transition focus	A Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability related problems that affect people and/or the planet B Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme
COMPLEMENTARY APPROACH Corresponding categories proposed in the consultation	None	C Products that exclude activities and/or investees involved in activities with negative effects A Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability B Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme (optional)	C Products that exclude activities and/or investees involved in activities with negative effects D Products with a transition focus (optional)
Criteria at portfolio level	No ESG characteristics in investment decisions	At least 70% minimum share of transition investments (TI) and/or sustainable investments (SI)* Minimum standards applicable to all investments	At least 70% minimum of sustainable investments (SI)* Remaining investments in transition (TI) Minimum standards applicable to all investments
Disclosure requirements	Exposure to sensitive activities/practices GHG emissions (Scope 1/2/3)	Exposure to sensitive activities/practices GHG emissions (Scope 1/2/3) Taxonomy alignment Proportion of SI (with split between solutions and sustainability standards) / TI	Exposure to sensitive activities/practices GHG emissions (Scope 1/2/3) Taxonomy alignment Proportion of SI (with split between solutions and sustainability standards) / TI
Naming Rule	Not possible to have any ESG related terms in the fund name or marketing communication	Possible to have ESG/sustainability related terms in the fund name and marketing communication	Possible to have ESG and Impact/Sustainability related terms in the fund name and marketing communication
Correlation with former SFDR classification	Article 6 + part of Article 8	Article 8	Article 9 + part of Article 8

**70% minimum share is an indicative threshold aiming to represent a significant proportion of investments pursuing the sustainability objective. Defining the most appropriate threshold would require technical works conducted by the Commission. These thresholds would need to be calculated excluding cash, cash equivalents and derivatives.*

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