European Commission
DG FISMA
Rue de Spa 2
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23 February 2021

Dear Lukas,

Many thanks again for your time on the phone the other day. Your insights were extremely helpful. During our call, we briefly touched upon the draft Regulatory Technical Standards (RTS) that were published by the ESAs on 4 February and the uncertainty that they add to the already existing grey areas in the application of the Sustainable Finance Disclosure Regulation (SFDR).

Even though the RTS are not expected to come into force until 1 January 2022, they are already relevant now both in assessing the compliance burden which will apply later, and for the insight they give into the thinking of the ESAs on some of the known unknowns concerning the primary legislation.

In this letter, I would like to expand on our concerns with the draft RTS and in particular shed light on issues of potential overreach by the ESAs and/or divergence from the Level 1 legislation. In a nutshell:

- Whilst we believe that, on the whole, the operative provisions of the draft RTS make sense, Article 16(1)(b) arguably divides the Article 8 category in two, creating a new Article 8+ or "mid-green" product category, which further confuses the boundary between Articles 6, 8 and 9 respectively. Please see our letter from 4 February 2021 for more information on the lack of clarity between funds falling under those Articles and our recommended position.

- Several of the recitals (e.g. 18, 22 and 25) go directly to the questions which the ESAs flagged in their letter of 7 January 2021 to the European Commission expressly seeking guidance. However, they are arguably internally inconsistent and only further confuse the picture.

- Others of the recitals (e.g. 19 and 23) do the same but arguably represent overreach by the ESAs, since they are arguably at odds with the primary Level 1 legislation.

Each of these considerations is set out in more detail below.

<u>Potential overreach by the ESAs</u>

In three respects, it seems that the ESAs may have reached positions, which are not necessarily supported by the text of the primary legislation already in force.

Article 7 = Article 8?

First, the ESAs could be taken to suggest in recital 19 to the RTS that a product which falls within Article 7 SFDR because the financial market participant considers the principal adverse impacts (externalities) of its investment decisions on environmental or social factors (either on a mandatory or voluntary opt-in basis) necessarily also falls within Article 8 SFDR on the basis that giving such consideration is "*[o]ne of the ways in which financial products can promote environmental or social characteristics*".

We do not believe that an Article 7 product ought necessarily to be an Article 8 product in that Article 7 only requires a consideration of the PAI factors. The primary legislation sets up these two categories independently of each other. **We hope that the European Commission guidance provides some assistance here, and that perhaps the RTS will be adapted to conform to it.**

Article 9 = Article 7?

Second, in the same recital, it is ambiguous whether the ESAs are suggesting that an Article 9 product (one which has sustainable investment as its objective) must necessarily also fall within Article 7 and its manager within Article 4 (both concerning PAI reporting).

We think this cannot be the intention. We believe the ESAs must mean instead that the manager of an Article 9 product (when making an investment decision) will be obliged to have regard to PAI indicators in order to determine whether particular investments are "sustainable investments" on the basis that they "do no significant harm" (or are disqualified on this basis), which is to be determined in part by reference to relevant PAI indicators, and this will show up in their periodic reporting under Article 11 SFDR. This is very different from having to gather data and report periodically against the PAI indicators pursuant to Articles 4 or 7.

Article 9 threshold

We had thought that it should be fairly clear whether a product falls within Article 9 or not. It will if it has "sustainable investment [as defined] as [one of] its objective[s]". In other words, an Article 9 product is one which (at least for a material proportion of its capital deployed) targets making a measurable contribution to an environmental or social objective (likely in addition to financial return, a so-called "double bottom line") and does no significant harm to the relevant PAI factors. If it has such an objective, it will necessarily have bespoke or standardised "sustainability indicators" against which its performance will be capable of being assessed.

The ESAs asked the European Commission in their letter for guidance as to whether an Article 9 product must invest *exclusively* in sustainable investments and, if not, whether a minimum proportion of sustainable investments is required. We don't see any possible basis in the law to support these suggestions – although we acknowledge that there will need to be meaningful investment in sustainable investments if the fund is to pursue the relevant sustainability objective. However, recital 23 suggests that Article 9 products are "*expected to make only* *sustainable investments*". In our view, **this is arguably purporting to amend the scope of the primary legislation by means of a recital to a delegated act**.

Further muddying the waters

As noted above, the draft RTS beg some of the questions which the ESAs raised in their letter to the European Commission and on which further guidance is expected. It is therefore unclear to us whether the ESAs have decided to adopt their own position, or whether the relevant sections of the draft RTS will be changed, depending on the European Commission's response.

Article 8 threshold

In particular, is the mere existence of **a norms-based or industry-standard screen** sufficient to make a product engage Article 8? That remains unclear (and, as I'm sure you will remember, is also a key issue on which we shared our views in our letter from 4 February). Recital 18 could be read to suggest that specific sectoral exclusions are a means of promoting environmental or social characteristics, whereas recital 25 could be read in many ways, including that a product is only within Article 8 if such exclusion strategies are "*showcased as material*". This sits oddly with recital 22, which provides that where environmental or social characteristics are "*promoted*" in the product name, marketing material or pre-contractual information, then that product should comply with the disclosure requirements of the RTS (i.e. no reference to materiality). In other words, must concerns about greenwashing be cured by subjecting a product to Article 8 or can it be addressed by using the Article 6/8 boundary to force financial market participants to be clearer in their claims?

In our view, these recitals only add to the confusion, and could be read in support of either side of this debate. Given a core purpose of the regime is to help investors distinguish "green" products from other products, **we think it would be unhelpful for private fund products to be classified as light green solely on the basis of using industry standard screens which are not intended to make the product "green"**. Please see our letter from 4 February for a more detailed outline of our thoughts on this.

A new category of mid-green product?

The draft RTS contemplate the concept of an Article 8 product that commits to make a sustainable investment. Does this in effect create **a new category of an Article 8+ product**? Such products will likely need to be particularly mindful of recital 21 to the RTS, which provides that firms need to be fully transparent as regards the allocation of underlying investments, i.e. those which are sustainable investments, versus other investments (including those held for diversification, liquidity and hedging, etc.).

New requirement

Finally, we wanted to use this opportunity to share our concerns with a new – and worrying - requirement set out in the draft RTS to make available the following disclosures not only in English (for products marketed in more than one Member State) **but also** in "*a language of all the Member States where that financial market participant's financial products are marketed*" (apparently whether or not the product is marketed pursuant to a single market passport):

- Summaries of website disclosures concerning PAIs pursuant to Article 5(2) of the RTS; and
- Summaries of website disclosures required of Article 8 and Article 9 products (Article 10 SFDR and Articles 33(2) and 46(2) of the RTS).

If this requirement is reflected in the made law, it may add significantly to costs of compliance, and pose practical challenges.

For your convenience, I have pasted all the relevant recitals of the draft RTS referred to above in an Annex to this letter.

As always, we are at your disposal for any further information you may need and would welcome the opportunity to discuss this with you and your colleagues in more detail in the near future. Given the remaining – and increasing – uncertainty in the market, our members look forward with great interest to the Commission's swift guidance on the topic of SFDR, in relation to both the Known Unknowns covered in our letter from 4 February and the draft RTS.

Yours sincerely,

Martin Bresson
Director of Public Affairs

Annex I – Relevant recitals from the draft RTS under SFDR

- Recital 18:

"There are a variety of financial products with various degrees of ambition with regard to taking into account sustainability factors. Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions. The disclosures required from financial market participants making available such financial products should reflect this diversity and cover the widest possible range of approaches. Among financial products, a difference is to be made between financial products that exclusively pursue sustainable investments and all other financial products that promote environmental or social characteristics."

- Recital 19:

"One of the ways in which financial products can promote environmental or social characteristics is to take into account principal adverse impacts of investment decisions. Financial products that have a sustainable investment objective must also consider adverse impact indicators as part of their disclosures of no significant harm to sustainability objectives. For these reasons, financial products should indicate whether they consider principal adverse impacts of investment decisions on sustainability factors as part of their disclosures in this Regulation."

- Recital 21:

"Financial products that promote environmental or social characteristics can invest in a wide range of underlying assets, some of which may not themselves qualify as sustainable investments or contribute to the specific environmental or social characteristics promoted by the financial product. Examples of these investments are hedging instruments, unscreened investments for diversification purposes, investments for which data is lacking or cash held as ancillary liquidity. Financial market participants marketing such financial products should be fully transparent as regards the allocation of the underlying investments to those categories of investments."

- Recital 22:

"To ensure comparability, where a financial product promotes environmental or social characteristics in a pre-contractual or periodic document, in its product name or in any marketing communication about its investment strategy, financial product standards, labels it adheres to or applicable conditions for automatic enrolment, the financial product should include the pre-contractual and periodic disclosures set out in this Regulation. Also, where the financial product intends to pursue in part sustainable investment, that information should also be included in that information."

- Recital 23:

"*As regards investments that do not qualify as sustainable or as contributing to the environmental or social characteristics promoted by the financial product, financial market participants may decide to apply some baseline environmental or social safeguards such as those referred to in Regulation (EU) 2020/852. Where that is the case, financial market participants should explain those safeguards so that end investors receive accurate information on the entirety of the investments made by the financial product. Furthermore, while products that have sustainable investment as an objective are expected to make only sustainable investments, it is appropriate to require disclosures on the amount and purpose of any remaining investments to demonstrate how those investments do not prevent the financial product from attaining its sustainable investment objective.*"

- Recital 25:

"*In particular, considering that many financial products currently rely on exclusion strategies based on environmental or social criteria, end investors should be provided with the necessary information to assess the materiality of such criteria on investment decisions, and the impact of that strategy on the composition of the resulting portfolio. Current market practice demonstrates that some exclusion strategies are showcased as material, while in fact they actually lead to the exclusion of only a limited number of investments or are based on exclusions required by law. It is necessary to address concerns about 'greenwashing', that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards. In order to prevent mis-selling and greenwashing, disclosure of any commitment with regard to a minimum reduction of the set of potential investments as a result of the application of the exclusion strategy is necessary to give end investors better visibility over the materiality of the offered strategy.*"