Position paper of the German government's Sustainable Finance Advisory Committee on the revision of the EU's Sustainable Finance Disclosure Regulation (SFDR) and the assessment of sustainability preferences in accordance with MiFID II/IDD

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Working group: Regulatory consistency – SFDR

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Executive summary

The main objective of the Sustainable Finance Disclosure Regulation (SFDR)[1] is to protect investors from misleading statements on the sustainability of financial products. The Directive on Markets in Financial Instruments (MiFID II)[2] and the Insurance Distribution Directive (IDD)[3] require investment or insurance advisors to ask questions to identify their clients' sustainability preferences.

In practice, it has become clear that the objectives of the SFDR, MiFID II and IDD have not been achieved to date.

Against this background, this paper sets out three objectives for the revision of the SFDR:

1. It should contain a clearer definition of sustainable investments that takes greater account of investments in the transition to a climate-neutral economy and that includes these in social investment products and services.
2. The assessment of sustainability preferences should be more straightforward. We recommend that just one general question is asked at the start of the assessment process. This question should be: **"To what extent should sustainability be taken into account in your investment?"**
3. Market demand for a categorisation of sustainable investment products should be met.

We recommend four categories of investment products.

1. "Sustainable" category

- *Environmental:* in accordance with Principal Adverse Impact indicators (PAIs) in the SFDR and/or the EU taxonomy[4].
- *Social:* in accordance with Article 25 of the Universal Declaration of Human Rights and the Social Bond Principles.
- In both cases, exclusions in accordance with the Paris-Aligned Benchmarks (PABs) apply.

2. "Transition" category

- *Environmental:* in accordance with transition plans aligned with minimum standards as per the Transition Pathways Initiative (TPI) or the Transition Plan Taskforce (TPT) recommendations incorporated in the International Financial Reporting Standards (IFRS).
- *Social:* in accordance with the UNGPs[5] and OECD guidelines[6].
- In both cases, the exclusions of the EU Climate Transition Benchmarks (CTBs) and the exclusion of new projects to promote fossil fuels apply.

3. "Basic" category

- Characteristics defined by providers that need to be justified, explained and substantiated.
- Exclusions in accordance with CTBs.

[1] Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector
[2] Directive (EU) 2014/65 on markets in financial instruments
[3] Directive (EU) 2016/97 on insurance distribution
[4] Regulation (EU) 2020/852 Taxonomy Regulation
[5] UN Guiding Principles on Business and Human Rights
[6] OECD Guidelines for Multinational Enterprises

4. **No sustainability characteristics**

All investment products must report on a set of sustainability indicators. We propose a selection of essential environmental and social PAIs for which data is widely available:

1. Controversial weapons (PAI 14)
2. Respect for human rights (PAI 11)
3. Proportion of companies active in the fossil fuels sector (PAI 4)
4. CO_2 emissions, scope 1–2 (PAI 1)

Objectives of the SFDR:

Definition of terms: investors – private investors – professional investors

This paper looks at three regulatory frameworks: the SFDR as well as the MiFID II and IDD, which are relevant for advisory processes with investors (MiFID II) and insurance clients (IDD). All three frameworks are designed to protect investors and provide them with transparency. However, the three frameworks are aimed at different target groups. This difference is reflected in the wording of this paper, in which the term "investors" is used to refer to private and professional investors, while the term "private investors" excludes professional investors.

The SFDR, which entered into force in 2022, requires financial market participants to make certain disclosures at entity level and product level. Articles 8 and 9 regulate disclosures for different insurance- and security-based investment products with sustainability characteristics. Among other things, sustainability indicators known as Principal Adverse Impacts (PAIs) are defined in more detail in Level 2 of the SFDR.

The main objectives of the SFDR are:

1. to protect investors from false or misleading statements about the sustainability of an investment product, and
2. in combination with MiFID II/IDD: to set out rules on how financial advisors and financial market participants should disclose sustainability related information to investment clients.

These two objectives should also contribute to steering capital into sustainable investments.

Problems of the SFDR in the opinion of the Sustainable Finance Advisory Committee (SFB)

The SFDR and in particular the interplay between the SFDR and other parts of the EU's sustainable finance framework leads to problems when it comes to implementing the rules in practice. The main problems are:

1. a lack of clarity and missing aspects in the definition of sustainable investments;
2. the requirement to address sustainability issues when assessing client preferences hinders rather than supports the sale of sustainable investment products;[7] and

[7] https://sustainablefinancealliance.org/wp-content/uploads/2024/02/Do-advisors-respond-to-investors-preferences_-_Grasfi-2024.pdf

3. the use of Articles 8 and 9 as a type of label.[8]

The objective of both the SFDR and the EU taxonomy (EU Taxonomy Regulation) is to create more transparency in financial markets and to promote sustainable investments. However, they differ in their approaches to defining sustainability. This can be confusing for investors.

The definition of sustainable investments in Article 2 (17) of the SFDR offers only a broad definition of social and environmental sustainability. It requires further interpretation and provides only limited guidance from the perspective of many market participants.[9] The EU taxonomy sets out in detail how certain sectors and economic activities should "substantially contribute" to one of the EU taxonomy's six environmental objectives and "do no significant harm" to any of the other five objectives. Article 2 (17) of the SFDR, on the other hand, does not mention any sectors or criteria. This means that many investments can be sustainable in accordance with the SFDR, while only a very limited number of activities (i.e. those that are particularly relevant for climate and environmental protection) are deemed to be sustainable, under very specific conditions, in accordance with the EU taxonomy.

Furthermore, both regulations cover investments in the transition to a climate-neutral economy (transformation investments) only to a limited extent. They explicitly do not cover investments in social products and services.

Investment advisors have also found it very difficult to link the assessment of sustainability preferences in accordance with MiFID II/IDD to the EU taxonomy and elements of the SFDR[10]. Making this link requires fairly in-depth knowledge of the respective regulatory frameworks, which neither advisors nor investors can be assumed to have.

Another problem is the significant time and effort needed to explain the difference between financial products disclosed pursuant to Articles 8 and 9. Using them as a label is confusing for investors and contradicts the original aim of covering the entire market for sustainable products in the SFDR and creating transparency without sustainability "hierarchies".

Objectives of the revision of the SFDR from the SFB's perspective

In view of the problems outlined above, the revision of the SFDR (and in connection with this, the assessment of sustainability preferences) should have three main objectives:

1. It should contain a clearer definition of sustainable investments that takes greater account of investments in the transition to a climate-neutral economy and that includes these in social investment products and services.
2. The assessment of sustainability preferences should be made more straightforward. This requires a clearer regulatory framework, on the basis of which investors can reach a well-

[8] https://www.europarl.europa.eu/RegData/etudes/STUD/2024/754212/IPOL_STU(2024)754212_EN.pdf (see section 4).

[9] "(17) 'sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;"

[10] See: https://wpsf.de/wp-content/uploads/2024/10/WPSF-PB-4-2024-Does-MiFID-II-enable-private-investors-to-invest-sustainably.pdf
https://www.iff-hamburg.de/wp-content/uploads/2024/10/Policy-Brief-2_Beratungsgespraech.pdf (in German only)
https://sustainablefinancealliance.org/wp-content/uploads/2024/02/Do-advisors-respond-to-investors-preferences_-_Grasfi-2024.pdf

informed decision more easily. At the start of the assessment process, we recommend asking just one general question that does not imply that sustainable investments are a complicated special option. This question could be: **"To what extent should sustainability be taken into account in your investment?"** The questions that follow this one should not be defined. However, the discussion must also touch on the characteristics of the different categories set out in the SFDR. The suggested question and the precise configuration of the product categories should be tested in a market study before being implemented in the Regulation.

3. Market demand for a type of label in the form of a categorisation of sustainable investment products should be met, for example by defining categories of sustainable fund-, insurance- and securities products that integrate products previously disclosed pursuant to Articles 8 and 9. These should also take into account issues such as investments in social products and services and the transition to a climate-neutral economy.

These changes should support the objective of steering more capital into sustainable companies and activities.

Suggested solution: Definition of sustainability on the basis of existing indicators

Sustainability is defined in more detail in different parts of the EU's sustainable finance framework. Level 2 of the SFDR uses PAIs to define negative environmental and social impacts that financial market participants with more than 500 employees are required to disclose. The EU Benchmark Regulation defines environmental and social exclusions for the Climate Transition Benchmarks (CTBs) and for the Paris Aligned Benchmarks (PABs). The EU taxonomy defines the above-mentioned environmental objectives and criteria for the relevant sectors, as well as minimum social standards. Data on these criteria is available at the EU and international level to varying degrees and in varying quality. [11]

The SFB proposes using the existing definitions and criteria to define sustainable investments in more detail. More detailed definitions should therefore be developed for individual sustainable product categories, but not necessarily for sustainable investments overall.

Investments in the transition and in socially positive activities

Currently, the EU's sustainable finance framework contains only limited guidance to help define investments in the transition to a climate-neutral economy in more detail. The PAIs and PABs contain indicators for negative social impacts, and a company's investments that contribute to a reduction in climate emissions and the mitigation of environmental degradation can be quantified via the EU taxonomy. However, a more detailed definition of investments in the social transition or in social products and services is lacking. For these areas, the SFB proposes the following:

Transition

A good basis for defining which investments can be designated as investments in the transition to a climate-neutral economy are the transition plans of the companies that are being invested in.

[11] The availability of data outside of the EU is of significance for publicly offered investment funds and needs to be taken into account. Verified data on the EU taxonomy is available only to companies affected by the CSRD and Taxonomy Regulation. It is therefore difficult for companies outside of the EU to access detailed data on the EU taxonomy. The situation is different for PAIs and PAB criteria, because this data was already used or disclosed by asset managers resident in the EU for their global investors and corresponding financial products before entry into force of the CSRD. PAI- and PAB-related data is already globally available, for example through ESG rating agencies. However, as of 2025 a distinction will be made between verified data from CSRD companies and unverified or voluntarily verified data from non-CSRD companies.

The content of transition plans can be determined in different ways. The Transition Pathway Initiative (TPI) approach is currently developing into an internationally recognised standard. The international standard-setter IFRS has integrated the work of the Transition Plan Taskforce (TPT) for sustainability reporting in line with ISSB standards. An investment category's definition of "transition" should not fall short of these standards. However, other standards that are aligned with TPI/ISSB requirements and that take account of the specific situation of SMEs can also be used.

The EU's Corporate Sustainability Due Diligence Directive (CSDDD[12]) requires companies above a certain size to draw up transition plans. These must contain interim targets, the company's key actions and an investment plan. This is in line with TPI requirements. If a transition plan already exists, the CSRD requires it to be published.

Social sustainability

On the basis of Article 25 (1) of the Universal Declaration of Human Rights[13], socially sustainable investments contribute to affordable social services (healthcare, education and vocational training), to accessible and affordable housing, to food security and to accessible and affordable basic infrastructure (clean drinking water, sewage systems, sanitary facilities, public transport, energy), as well as to programmes to prevent and/or mitigate unemployment, including associated financial services. These include investments to mitigate the social costs of transitioning to a climate-neutral economy.

In addition, the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises, which are already referred in the EU taxonomy's minimum standards, can be used as a basis to define investments in a social transition. Companies that adhere to these principles and guidelines to a significant extent, for example by systematically changing their supply chains, contribute to a social transition.

Problem of assessing sustainability preferences

In view of (a) the complexity of the issue and the different regulations and rules that already exist and (b) indications that the current process for assessing sustainability preferences in fact hinders the sale of sustainable financial products, the **most important task of the revision of the SFDR and the MiFID II/IDD is to find a workable solution for the advisory process**. All efforts to develop appropriate definitions, criteria and categories for sustainable investment products are to no avail if, during the advisory process, private investors are not offered clear and straightforward options on which they can reliably base their investment decisions.

Problem of Articles 8 and 9

Although this was not the intention of lawmakers, the distinction between Article 8 and Article 9 products was taken as an opportunity by market participants to differentiate between more sustainable Article 8 products and less sustainable Article 8 products (labelling). While Article 9 products must specify sustainability objectives, Article 8 products only need to specify relatively flexible sustainability characteristics. The small group of comparably homogeneous Article 9 products currently stands alongside a large number of very diverse Article 8 products. The latter group, in particular, makes it difficult for investors to make an informed choice. Without a regulatory basis, the term "Article 8+" products has emerged in market practice as an alternative, which shows that a further distinction within the broad Article 8 group is needed.

[12] Directive (EU) 2024/1760 on corporate sustainability due diligence

[13] https://www.ohchr.org/en/human-rights/universal-declaration/translations/english

More clearly defined categories of sustainability products would significantly improve the classification of sustainable financial products desired by market participants. Based purely on a distinction between Article 8 and 9 products, such a classification is currently possible only to a very limited extent. To this end, already existing elements of the EU's sustainability framework, such as (a) the PAIs in the SFDR, (b) exclusion criteria in the Benchmark Regulation and the EU taxonomy, and (c) ESMA guidelines on funds' names must be taken into account, as these have already been introduced onto the market. This is the only way of ensuring that the workload for providers remains manageable following a revision of the SFDR.

In light of this problem, the SFB proposes that a revision of MiFID II and Article 8 and 9 products pursuant to the SFDR includes the following key measures:

1. Development of no more than four product categories for the first step of the advisory process that initially make no reference to aspects of the EU's sustainable finance framework. These product categories should be compatible with existing Articles 8 and 9.
2. The categories should be designed on the basis of existing data from the EU taxonomy, the Benchmark Regulation and the PAIs.

Proposal for the first stages of the sustainability preferences assessment

At the start of the advisory process, the following four categories of financial products are given as options:

1. Sustainable financial products
2. Financial products for the transition
3. Basic products with sustainability characteristics defined by the provider that meet specific social and environmental minimum standards
4. Products without sustainability characteristics that are obliged to report on environmental and social minimum standards.

Proposal for defining the categories:

We propose the following categories for investment funds, but only by way of example. They can be used for almost all investment products if specific factors relating to the respective product are taken into account.

However, the categories can be used only to a limited extent for government bonds, among other things because the EU taxonomy does not apply to government bonds, the PAB regulation does not contain criteria for governments, and the PAIs for governments are unsuitable for this purpose. The category "Sustainable Social", however, is suitable for developing appropriate exclusions for government bonds.

1. Category "Sustainable"

Environmental: 70% of investments are made on the basis of existing indicators in the EU's sustainable finance framework. Regulators set minimum thresholds for these indicators that must be reached. The indicators can be selected from the PAIs and/or on the basis of EU taxonomy requirements.

Social: 70% of all investments are made in accordance with Article 25 (1) of the Universal Declaration of Human Rights or the Social Bond Principles.[14]
Funds can be only environmentally sustainable, only socially sustainable, or take both aspects into account.
PAB exclusions apply in both cases.[15]

2. "Transition" category

Environmental: Transition plans that meet TPI/IFRS standards are available for 70% of the investments. Investment plans in accordance with the EU taxonomy can also be taken into account.
Social: 70% of the investments are in companies that comply with the UNGPs and OECD guidelines to a significant extent. PAI 10 and PAI 11, adjusted accordingly, can be used as indicators.
The exclusions for the Climate Transition Benchmarks[16] and the exclusion of new projects to promote fossil fuels apply to both variants.

3. "Basic" category

Investment products with freely defined sustainability characteristics that meet specific social and environmental minimum standards. An investment product's sustainability characteristics must be disclosed and explained to investors. In addition, the sustainability characteristics must be verified through the disclosure, for example with sustainability ratings or second party opinions, for all securities.
The exclusions for the Climate Transition Benchmarks and the exclusion of new projects to promote fossil fuels apply to both variants.

4. No sustainability characteristics

Investment products with no sustainability characteristics must report on a selection of environmental and social indicators.

The selection is based on existing, widely used indicators, since it can be assumed that a good amount of data exists for these indicators. Furthermore, with the exception of the third indicator, the selected indicators were chosen on the basis that they can be found in all parts of the EU's sustainable finance framework. The proportion of companies active in fossil fuels was included as it is very relevant for climate action and is easy to determine. The following indicators were selected:

1. Controversial weapons (PAI 14)
2. Respect for human rights (PAI 11)
3. Proportion of companies active in the fossil fuels sector (PAI 4)

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[14] Accessible and affordable healthcare, education and vocational training, accessible and affordable housing, food security and more accessible and affordable basic infrastructure (clean drinking water, sewage systems, sanitary facilitie s, public transport, energy).
[15] PAB exclusions (a) companies involved in any activities related to controversial weapons; (b) companies involved in the cultivation and production of tobacco; (c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises; (d) companies that derive 1 % or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; (e) companies that derive 10 % or more of their revenues from the exploration, extraction, distribution or refining of oil fuels; (f) companies that derive 50 % or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels (g) companies that derive 50 % or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO_2 e/kWh.
[16] (a) companies involved in any activities related to controversial weapons;
(b) companies involved in the cultivation and production of tobacco;
(c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

4. CO_2 emissions, scope 1–2 (PAI 1)

Article 8 and 9 categories

Products that currently correspond with the definitions in Article 8 and Article 9 of the SFDR can be allocated to the categories outlined above:

Current Article 9 products and products that are informally described as Article 8+ products can be included in the Sustainable category. Article 8 and 9 products are suitable for the Transition category if the transition is their main focus. All other Article 8 products that fulfil the minimum requirements can be included in the Basic category.

The proposed categories ensure that providers will find products previously reported in accordance with Article 8 or 9 in one of these categories.

Changing the PAB and PAI indicators for human rights

The UN Global Compact (UNGC) currently referred to in the CTBs, PABs and PAIs is not suitable as an indicator for the exclusion of human rights violations and corruption in sustainable investments. The UNGC is not a standard but a network of businesses and entities that voluntarily commit to implement sustainability principles. There is no body monitoring these principles and the network does not check that they are being complied with. If a business violates the principles it can remain a participant.

For this reason, and to improve coherence across the EU's sustainable finance framework, the SFB recommends using the UNGPs and the OECD Guidelines for Multinational Enterprises as indicators in the areas of human rights and corruption. These are referenced and incorporated in the CSDDD as well as in the CSRD and the EU taxonomy in the minimum safeguards.

The SFB proposes revising the wording on exclusions in the PABs and PAIs as follows:

"exclusion of companies that do not respect human rights within the meaning of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises."

Explanation of the Sustainability, Transition and Basic categories

The main difference between the first two categories and the Basic category is that the first two are based on the existing indicators in the EU's sustainable finance framework and have to comply with the stipulated thresholds or be defined in relation to the criteria for transition plans outlined above. This makes it easier for providers to put together investment funds. They no longer need to explain why the indicators are relevant for the sustainability of an investment as this has already been decided by the EU. At the same time, it gives investors the assurance that the indicators on which the products are based were defined by regulators. In addition, we propose that the pre-contractual information and the advisory process is simplified. It should be sufficient to mention the regulatory framework in the pre-contractual documents and during the advisory process, and to explain it in more detail only if the client requests it.

Regular reporting relates to the selected indicators, for which verified data is available within the EU.

The Basic category is not based on specific definitions of sustainability in the EU's sustainable finance framework, and therefore needs to be explained and justified. The selected indicators need to be disclosed and justified to investors. The category can include funds with comparably low sustainability requirements as well as innovative funds that, for example, measure the effect of the investments on

biodiversity and for that purpose use indicators that are not found in the EU's sustainable finance framework.

Regular reports must include data on the indicators, for example from ESG ratings.

A clear distinction can thus be made between the different categories and the indicators can be verified, either via the CSRD or via a market-based publication such as a Second Party Opinion (SPO) or on the basis of ESG fund ratings.

Note on the impact of financial products

Category 1–3 products can have a positive impact on sustainability objectives. This impact will be of interest to many investors.[17] During the advisory process, there should be an opportunity to describe the impact of a particular product, as well as to assign it to a specific category. This can be done using a matrix which shows both the product category and the type of impact a product has. If a fund claims to have a particular impact, the impact must be included in the fund's reports.

Connection to the ESMA guidelines on funds' names

In its guidelines on funds' names using ESG or sustainability-related terms, the European supervisory authority ESMA sets out which characteristics a fund needs to have in order to be able to include specific terms in its name. The authority distinguishes between three categories. In all three categories, 80% of the fund assets must be invested in accordance with social or environmental characteristics or objectives. ESMA also specifies exclusion criteria in relation to particular terms:

1. If the name includes the terms "transition", "social" or "governance", the CTB exclusion criteria apply; in other words, companies involved in activities related to controversial weapons and tobacco and in companies that violate the UN Global Compact or the OECD Guidelines on Multinational Enterprises are excluded.
2. If the name includes the terms "environment" or "impact", the fund must adhere to the PAB exclusion criteria.[18]
3. If the name includes the word "sustainability", the fund must adhere to the PAB exclusion criteria. Furthermore, the investments must comply with the definition of sustainable investments set out Article 2 (17) of the SFDR.

The most striking difference between the ESMA guidelines on funds' names and the suggestions for fund categories made in this paper is that in accordance with the guidelines, 80% of a fund's investments must meet sustainability characteristics or objectives, while this paper regards 70% as adequate. 70% was chosen because for certain types of fund and asset classes it is difficult, in practice, for fund managers to comply with the requirement that 80% of a fund's investments meet sustainability characteristics or objectives. For example, this is the case for government bonds, mixed

[17] In its policy brief 2/2024, "The challenge of sustainable investment decisions", the IFF identified the type "hungry for knowledge/detail focused": Investors in this group have a strong desire for detailed and comprehensive information, on the basis of which they can carry out their own, substantiated quality evaluation of a sustainable investment. They are willing to put a lot of time and effort into finding information in order to make an informed decision.
https://www.iff-hamburg.de/wp-content/uploads/2024/10/Policy-Brief-2_Beratungsgespraech.pdf

[18] companies involved in controversial weapons; in the cultivation and production of tobacco; that violate the UN Global Compact or the OECD Guidelines on Multinational Enterprises; as well as companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels; that derive 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels; or that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO_2 e/kWh.

funds and insurances, due to the missing data, and for real-estate funds that have to maintain high cash holdings. Furthermore, in the UK, the requirement for sustainable funds is that 70% of assets are invested in accordance with sustainability objectives. Having the same percentage requirement would facilitate the sale of funds internationally.

Another difference is that EMSA's guidelines on funds' names include impact funds. As described above, we propose including impact funds in one of the categories; in other words, in the Sustainable, Transition or Basic category. These funds would have to take account of the exclusions relevant to the specific category. In the case of Transition funds or Basic funds that include the term "impact", these exclusions would be weaker than those required by ESMA. The SFB therefore proposes that the requirements for funds with "impact" in their names are adjusted accordingly.

In addition, impact funds that use the term "impact" in their reporting should explain how an impact is achieved. This reporting obligation can be met with a relevant engagement report, for example.

For socially sustainable funds, too, the PABs would apply, and not the CTBs as set out in the ESMA guidelines. For social funds in the Transition category, on the other hand, the CTBs would apply, which is line with the guidelines on funds' names.

Connection to the Sustainability Disclosure Requirements (SDR) and investment labels in the UK

The SDR framework distinguishes between four categories of funds: "Sustainability Impact", "Sustainability Focus", "Sustainability Improvers", "Sustainability Mixed Goals". The requirements to be included in a particular fund category relate to the proportion of investments that correspond with the characteristic of that category, which in all categories is 70%. The criteria selected by the fund provider in order for the fund to be included in a specific category need to be robust and evidence-based. No indicators are specified in the SDR. On this point it differs from the SFDR.

In the UK, providers freely select criteria that might fit to a particular group of investors. The EU specifies criteria that are based on research findings (Paris Agreement goals) and international agreements (Universal Declaration of Human Rights). While in the UK investors have more freedom, the EU rules are aimed not only at consumer protection, but also at steering capital to sustainable companies and activities. This is almost impossible to achieve on the basis of the SDR, which allows for considerable disparities in the criteria need to verify the sustainability of a financial product. In addition, it has become clear that the SDR categories were hardly used by product providers in the UK market due to the unclear criteria.[19]

The proposal to standardise the investment threshold to 70% allows products that are assigned to an SDR category to generally also be assigned to an SFDR category. The proposal to introduce a Basic category ensures that a sustainable product in accordance with the SDR is also a sustainable product in accordance with the SFDR if it meets the minimum criteria.

How does the SFB's proposal contribute to the objectives set out at the start?

1. Lack of clarity and missing aspects in the definition of sustainable investments

Our proposal attempts to find a solution in between a too general and too detailed definition of sustainability by referring to existing concepts (Principal Adverse Impacts, EU taxonomy, Paris Aligned Benchmark criteria, Climate Transition Benchmark criteria, transition plans and Social Bond Principles)

[19] https://www.responsible-investor.com/more-funds-meet-sdr-deadline-amid-slow-start-to-uk-label-regime/

without stipulating exactly how these need to be applied for a particular product. Our proposal provides more clarity regarding the terms without creating too many restrictions in the implementation.

2. The requirement for advisors to address sustainability issues when assessing client preferences hinders rather than supports the sale of sustainable investment products.

Our proposal is to define an initial opening question in the SFDR. This question should not imply that sustainable investments are a special option. We propose the following question: **"To what extent should sustainability be taken into account in your investment?"**. The categories' sustainability characteristics and reporting obligations in accordance with the SFDR can be addressed later in the advisory process. This should be possible for asset managers to implement, since they already have to report on PAIs. Corresponding data for these indicators is therefore already available, including internationally. Due to already existing reporting obligations, it is important to ensure that the revision of the SFDR does not lead to completely new disclosure requirements or to companies being asked to provide even more data.

As described above, we also propose that the Basic category includes more comprehensive information and disclosure obligations.

3. Use of Article 8 and 9 labels

On the one hand, our proposal tries to take account of the fact that the difference between Article 8 and 9 investment products has already become established in the market. This allows existing products to be incorporated into the new categories if they meet the defined threshold values and criteria. On the other hand, it takes account of the market demand for a clearer categorisation of sustainable financial products. In addition, our proposal broadens the scope of investment products by including the transition to a climate-neutral economy and social aspects and suggests appropriate definitions.

4. Steering capital

The simplification of the advisory process and clearer and appropriately defined categories will hopefully make it easier to steer capital into sustainable investments. Steering capital in this way is most likely to succeed, and will be easiest to measure, with the first two categories. It is less likely to succeed with the third category, which is much broader in scope. If this third category is considerably more attractive than the first two categories, it will be almost impossible to steer capital into sustainable investments.

Other issues

Verifying the categories

The current verification process should be retained. This involves the Federal Financial Advisory Service (BaFin) authorising the pre-contractual information (e.g. prospectus) and auditors auditing the regular reports, including checking that the information in accordance with Article 8 or 9 is "complete" and "correct". Should it become necessary, the auditors are also responsible for checking whether a fund belongs in a particular category. Further verification by a third party, for example in the form of an SPO, is not necessary, and would lead to additional costs and a higher workload. BaFin receives sufficient information from auditors' reports and will intervene if necessary to protect investors.

Scope of the SFDR (pension funds)

Pension funds fall within the scope of the SFDR, but compared to publicly offered investment funds, members have little or no investment choice. However, rather than creating an exception for pension funds, it seems more sensible to introduce simplifications for all investment providers, for example, by stipulating that financial market participants only need to report on the PAIs every two years.