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SFDR may undergo revisions, and this is entirely justified

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The EU Sustainable Finance Disclosure Regulation (SFDR), introduced in 2021, may already undergo revisions. The sustainability classifications outlined in the regulation are being utilized, or rather misused, by market participants as green labels to promote their financial products. Originally conceived by the European Parliament to enhance transparency for clients and prospects regarding how financial entities incorporate sustainability risks into their investment decisions, the SFDR primarily aims to combat greenwashing. The regulation mandates financial service providers to report on the sustainability level of their investment funds on their websites.

Expert

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Light green, dark green, or non-green

This reporting is based on classification according to article numbers in the SFDR text. Under this system, Article 8 signifies that the investment product or fund promotes sustainability, while Article 9 indicates that the product aims to facilitate sustainable investments. There's also Article 6, encompassing all investment products not covered under Articles 8 or 9. Currently, the market seems to label these article numbers as non-green, light green, and dark green, respectively. However, this classification fails to accurately represent reality, as the reporting system is being used as a sustainability label, which it was not intended for.

Reporting system as a sustainability label

Shortly after the introduction of the SFDR regulation, market participants seized upon it for purposes entirely different from its intended use, namely, marketing their investment products. Instead of being a reporting system, they began to use SFDR article numbers as sustainability labels or certifications, with number 8 suggesting some level of sustainability and number 9 implying significant sustainability. There have even been instances where funds are labeled with the non-existent article number 8+. We understand why market participants have this inclination. If a product contains only a small portion of non-sustainable investments according to SFDR, it falls outside the reporting requirements of Article 9. This means that a fund reporting under the requirements of Article 8 could contain either 0% or 99.9% sustainable investments.

More clarity and less subjective interpretation

Additionally, the regulation operates with open norms. For instance, there's a lack of a concrete definition of sustainability. In practice, the system primarily focuses on climate aspects and pays much less attention to social and governance aspects. Moreover, fund management determines to what extent the fund meets the obligations of an article number. It's practically possible to meet the requirement of making a positive contribution with just a one-euro contribution to sustainability. More clarity and less subjective interpretation are highly desirable, albeit as part of a restructuring of the classifications.

AFM sees potential for undesirable practices

The Dutch financial overseer, AFM, also expresses concerns about fund managers potentially incorporating SFDR classification information as marketing material. Its guidance on sustainability claims indicates that SFDR classification cannot be used as a certification or marketing tool. Notably, the AFM, along with numerous other entities and parties, expressed concerns about possible misuse of terminology in the form of labels at the introduction of SFDR in 2021, emphasizing that it's merely a classification determining the transparency obligations under EU legislation.

Streamlining conflicting sustainability laws

The European Commission (EC) appears receptive to these signals. This was evident from the broad consultation held last summer regarding investor experiences and potential improvements, as well as the completed consultation on SFDR II. Responses from various European countries reflect diverse perspectives. While there's no consensus on whether a uniform European definition of sustainability should be established, several countries prefer to regulate this at the local level. However, nearly unanimous agreement exists regarding whether the current SFDR classification should play a role in this. With the exception of Finland, there's little support for this. In other words, SFDR needs an overhaul.

Not the degree of sustainability, but the approach

The consultation questions suggest that the EC may consider responding to the widespread market desire to introduce four categories. The first is **solutions**, which include products investing in sustainability-related solutions. The second is **sustainable**, comprising investments in companies already sustainable today, with stricter sustainability criteria. The third is **exclusion**, representing exclusions, and the fourth is **transition**, focusing on investment products aimed at transitioning companies towards sustainability.

Significant need for classification and clarity

At Cardano, we view these proposals positively. They represent steps in the right direction to make SFDR more logical and practical. However, we feel a fifth category is missing, which could also be a sub-category within one of the proposed four categories, namely impact-oriented products. Clarity remains a prerequisite for any new classification. There's a risk that the definition of sustainability will still be interpreted differently. The primary goal of SFDR, to prevent greenwashing and enhance transparency for investors, would still not be achieved. The market would benefit from a clear definition of what constitutes sustainability and what can be designated as such.

Supporting the transition has greater impact

For Cardano, sustainability is the foundation of everything we do because we believe in the transition to a sustainable society. According to us, a sustainable society operates within planetary boundaries and a social foundation, including aspects such as a living wage, housing, access to clean water, and medication. Companies contributing to these aspects fit within our definition of sustainability, and we invest in them. To this end, we employ a self-developed framework with a classification system categorizing investments as harmful, non-adaptive, adaptive, sustainable, and impactful. This system resembles what is currently proposed for SFDR, albeit lacking a focus on making an impact. Emphasizing transition and adaptability (the ability of a company to adapt) deserves more attention and should be a guiding principle. While we have a clear vision of a sustainable society, we acknowledge that we are still far from it. Transitions are needed, not only on paper but in the real world and economy. Ultimately, changing the behaviour and actions of companies has more impact than just investing in those already sustainable. Laws and regulations, such as the revised SFDR, should pay more attention to this to fulfil their primary objective: the sustainability of the European economy.