BETTER FINANCE position on the classification of investment funds regarding sustainability

Executive Summary
December 2022

BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

20 December 2022

EXECUTIVE SUMMARY

What is the SFDR?	The Sustainable Finance Disclosure Regulation[1] (SFDR), stipulates an obligation for asset managers to disclose their environmental, social and governance (ESG) investment approach and the level of sustainability characteristics, including risk and impact, of their funds and other investment products. This aims to provide transparency for individual non-professional (“retail”) investors and other stakeholders alike, as well as prevent greenwashing practices, which broadly defined are related to claims that portray financial products as having a positive effect on sustainability, when in fact they do not (*this is BETTER FINANCE’s understanding of the proposed regulation*).
What are Articles 6,8 and 9?	In broad terms, Articles 6, 8 and 9 correspond respectively to: • funds without a sustainability scope (for example investing in stocks currently excluded by ESG funds like tobacco); • funds that promote environmental or social characteristics, whereby companies into which the fund invests follow good ESG practices; • and funds that have sustainability investment as their exclusive objective and aim to make a positive impact. Since the SFDR is a disclosure related regulation aimed at increasing transparency **and not a labelling requirement with set criteria**, there are various ways in which funds may interpret the extent of promoting environmental and social characteristics, and retail investors are therefore left navigating those differences without much guidance.
How do changes to the SFDR impact current reclassification by funds?	As the European Commission mandated the European Supervisory Authorities (ESAs) to provide draft regulatory technical standards[2] (RTS) in relation to the SFDR - providing more information on content, methodologies and expected ways in which asset managers and other financial market participants have to present the required disclosure requirements, subsequent changes and amendments will apply from January 1, 2023[3]. Since Article 9 was adjusted to funds making only sustainable investments, *asset managers are re-classifying funds en masse* to Article 8.[4][5][6]

About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

[1] Commission Regulation (EU) 2019/2088 available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088
[2] European Supervisory Authorities ‘Clarifications on key areas of the RTS under SFDR’, available at: https://www.esma.europa.eu/press-news/esma-news/esas-provide-clarifications-key-areas-rts-under-sfdr
[3] Commission sustainability-related disclosure in the financial services sector, available at: https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en
[4] Bloomberg, ‘Fund Managers brace for ESG correction’, available at: https://www.bloomberg.com/news/articles/2022-12-11/fund-managers-brace-for-esg-correction-with-4-trillion-at-stake?leadSource=uverify%20wall
[5] Responsible Investor, ‘Article 9 downgrades gather pace’, available at: https://www.responsible-investor.com/article-9-downgrades-gather-pace-as-regulatory-uncertainty-continues/
[6] Morningstar, ‘The great reclassification how SFDR is changing funds’ https://www.morningstar.co.uk/uk/news/216818/the-great-reclassification-how-sfdr-is-changing-funds.aspx

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BETTER FINANCE position and recommendations

BETTER FINANCE would like to point out that there is an urgent need for:

- further clarity on definitions to enhance retail investor understanding and differentiation of requirements and content related to Article 8 & 9;
- guidance and sufficient explanations regarding the outcome of re-classifications to better inform non-professional retail investors;
- and a need to focus Article 9 on impact and engagement instead of exclusion in order to strengthen the green classification and avoid greenwashing

Clarity of definitions and classifications

The ongoing conundrum of what constitutes a sustainable investment under the SFDR, i.e., investments in companies / economic activities that contribute to an environmental or social objective, shows that there is a need for further specification. The EU Law rightly requires information provided to individual investors to be clear, i.e., "***presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received***"[7], and as such, retail investors expect definitions and classifications of funds to be understandable.

A new wave of reclassifications and what it means for retail investors

While BETTER FINANCE recognises that definitions are evolving, in view of an ongoing call for evidence on greenwashing[8] and public consultations related to guidelines on funds' names using ESG or sustainability-related terms[9], expected changes to the regulatory requirements have been confusing for non-professional retail investors. Recently a study conducted by DSW[10] found that in the case of semi-professional investors in Germany, 64% did not follow the advice from advisors due to a lack of trust.

Despite the purpose of the SFDR, to **improve transparency** in the market for sustainable investment products and to **prevent greenwashing practices**, we are witnessing the regulation's use as a labelling exercise due to the fact that funds and asset managers have plenty of leeway to interpret ESG credentials in various ways and switch back and forth between Article 6, 8 and 9 of the SFDR. If a product is labelled as Article 8 or 9, retail investors reasonably expect the product to have a certain level of ESG credentials, and the lack of clarity from the regulatory environment creates an additional barrier for retail investors and must be addressed through a legislative review. On the one hand, the market does not have a uniform interpretation, which risks being to the detriment of retail investor understanding of the financial products they are investing in, while on the other there is little support for retail investors to enable them to properly distinguish between these two categories of financial products.

The recent reshuffling of funds from Article 9 to Article 8 classification, raises the question of whether the less ambitious Article 8 funds (in comparison to Article 9) will become the new norm, and more importantly, whether expectations linked with Article 8 or Article 9 are indeed met. Retail investors are

[7] Commission Delegated REGULATION 2017(565) Article 44, Fair, clear and not misleading information requirements (Article 24(3) of Directive 2014/65/EU), 2. (d)

[8] ESAs call for evidence on greenwashing, available at: https://www.esma.europa.eu/press-news/consultations/esas-call-evidence-greenwashing#:~:text=The%20Call%20for%20Evidence%20(CfE,of%20the%20financial%20product%20lifecycle

[9] ESMA consultation on the use in funds' names of ESG or sustainability-related terms, available at: https://www.esma.europa.eu/press-news/esma-news/esma-launches-consultation-guidelines-use-esg-or-sustainability-related-terms

[10] DSW, 'Investment advice on sustainable products', available at: Investment advice on sustainable products: Investors cautious – little clarity in the specifications- DSW-Info

consequently left alone in interpreting whether or not there are intended, or even unintended, greenwashing practices, with limited guidance and support.

Aside from the reclassifications, retail investors are also left in the dark regarding the way greenwashing practices are addressed by regulators and the steps a non-professional investor should take in order to avoid being exposed to greenwashing, with the most recent example in Europe being that of investigations into alleged greenwashing practices at DWS[11], which seem to be on hold since summer 2022. Investors and shareholders are looking for answers regarding the progress made so far, but no clear and publicly available information has been made available since.

Impact and engagement focus for Article 9 funds

As far as **impact** is concerned (in general) there are clear definitions available like the one of 'Finance for Tomorrow'[12] : *"impact finance is an investment or funding strategy that aims to accelerate the just and sustainable transformation of the real economy by providing proof of its positive effects*." In a similar way, engagement is one way among others to aim at a positive ESG impact for an asset manager.

BETTER FINANCE is of the view that – for example - investments in fossil fuel companies can positively impact the environment, provided they are **engaged** ones, i.e. that they are accompanied with active share ownership aiming in particular at increasing the focus of the corporate investment plans and business model of the fossil fuel company towards a low carbon pathway and accelerate energy transition plans.

Shareholder engagement concretely means to actively participate to general meetings of investee companies, vote there and initiate or support resolutions in favour of positively impacting the environment and/or other ESG issues. While this may warrant an additional cost for fund managers, this type of investment strategy is certainly much more effective than the "exclusion" (disengagement) approach and far **less prone to greenwashing**. Sustainable investing must not be confused with the use of exclusion criteria in the SFDR and as such, strong engagement for example could benefit retail investors and companies alike.

A 2021 independent study confirmed that the investment approach focused on exclusion – encompassing negative selection or disengagement – as the least effective, while the most **effective fund investment strategy derives from engagement**. Funds must establish a measurable exercise/tool to assess this, which will enhance clarity and impact for retail investors and address reputational risk for funds. If we for instance consider the alternative, whereby European institutional investors disengage and increase their sell-off at bargain prices of fossil fuel related stocks to non-European investors who may or may not have the aim of reorienting cash flows of companies towards a green transition, it becomes clear that this poses a much greater risk for the environment in the long run. Retail non-professional investors will be better protected from greenwashing if Article 9 funds are the sole carriers of a green classification, especially if accompanied by effective engagement mechanism and impact-oriented objectives towards a green transition.

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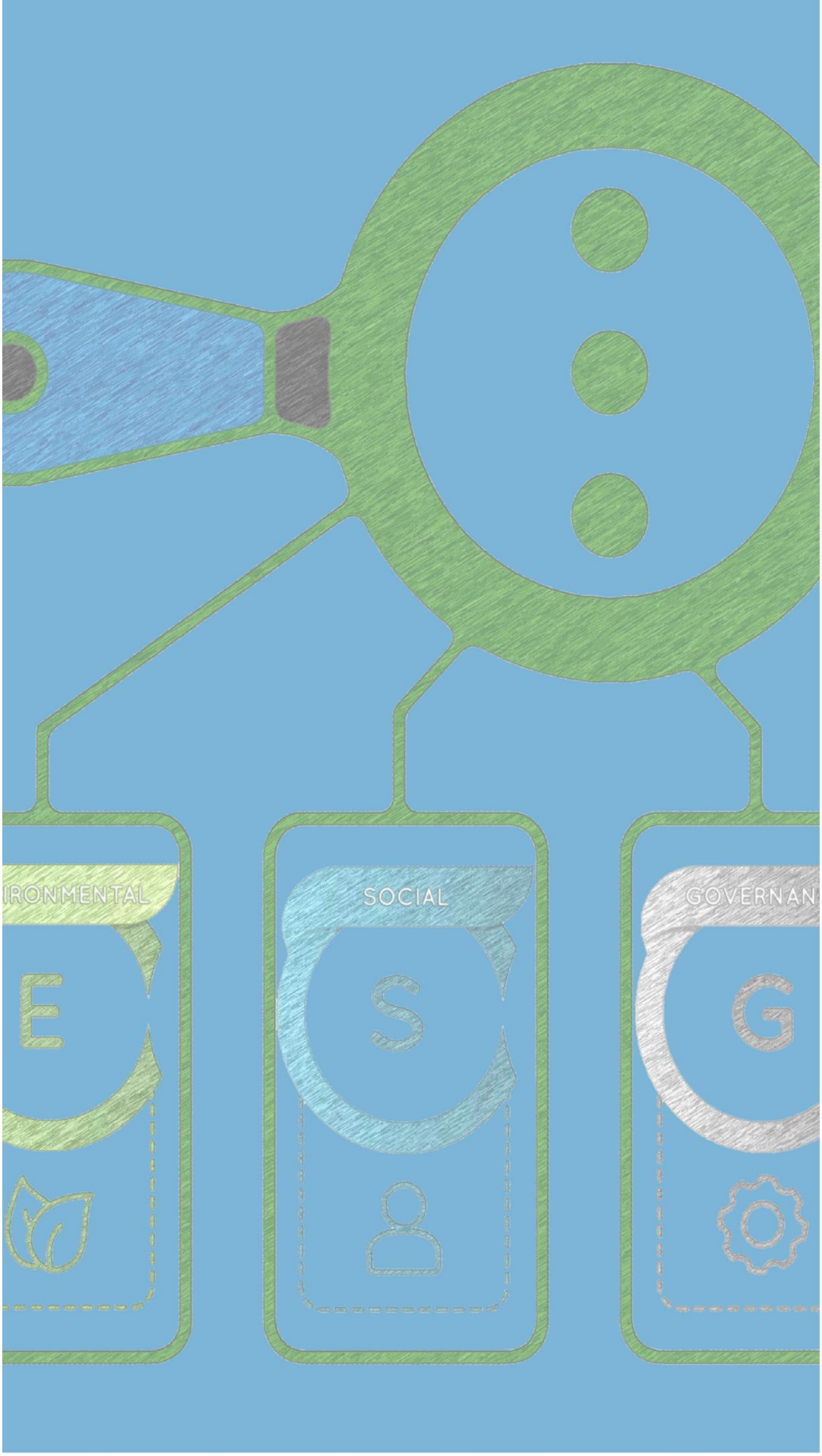
[11] DWS greenwashing investigation, available at: https://www.ft.com/content/0eb64160-9e41-44b6-8550-742a6a4b1022
[12] Finance for Tomorrow impact definition, available at: https://financefortomorrow.com/en/impact-finance/#:~:text=Impact%20Finance%20is%20an%20investment,evidence%20of%20its%20beneficial%20effects.



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