December 15, 2023

European Commission Targeted Consultation on the implementation of the Sustainable Finance Disclosures Regulation – MFA Response

Response to Question 1.9

MFA supports the objectives of the SFDR in attracting private investment to support the transition to a sustainable, climate-neutral economy. MFA also acknowledges that there are deficiencies in the current framework and is supportive of the Commission's efforts to address these, with a view to aligning the framework with its intended objectives.

The Commission's review of the SFDR presents an opportunity to consider more holistically the role of indirect exposure and the use of investment tools that can raise or lower the cost of capital for companies through means other than direct, long exposure. MFA believes that a legislative review of the SFDR should consider how, in addition to long equity positions, derivatives and short positions can also serve as tools that managers may use to achieve sustainability-related objectives (or to otherwise influence issuer decision-making) by raising the cost of—and contributing to the reallocation of—capital.

While many investors utilise tools such as engaging directly with corporate boards or exercising voting rights as shareholders to influence company behaviour, others gain exposure to companies through derivatives or short selling. The SFDR focuses overwhelmingly on sustainability in securities on the long side, while the role of investment tools that contribute to the reallocation of capital through other means is overlooked under the SFDR.

In the context of Principle Adverse Impact ("PAI") indicators, the lack of guidance under the current SFDR regarding the treatment of short exposures has presented an ongoing issue for investors. Where guidance has been provided in this context (notably, the statement in the European Supervisory Authorities' November 2022 Q&As that adverse impacts at the level of an individual counterpart cannot be netted below zero), it fails to reflect the benefits of short exposures. This seems contrary to the Commission's overarching goals—taking short positions on companies that are poor on key PAIs increases their cost of capital and can be an effective tool for influencing decisions within the applicable companies. Accordingly, MFA believes that it would be appropriate for the PAI framework to reflect this by allowing adverse impacts to be netted below zero where a financial market participant holds a net short position in an issuer.

MFA also wishes to highlight that acquiring the necessary data for compliance with the existing mandatory PAIs is already very challenging for financial market participants, including those in the alternative asset management sector. A significant data gap exists that greatly limits the quality of PAI reporting. We respectfully urge the Commission to keep this issue in mind when considering potential adoption of any additional PAI indicators, and to explore whether potential new indicators would have appropriate data reporting coverage and offer sufficiently clear definitions.

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Response to Question 4.1.2

There are two broad principles that the MFA considers particularly important to consider in taking forward any of the proposals discussed in the Consultation.

First, MFA's applicable members have already devoted a significant amount of time and resources into implementing the existing SFDR framework. For such members, this implementation process

has involved substantial work in embedding the regulatory concepts into their investment management and monitoring processes and systems and their internal policies and procedures, as well as client-facing product documentation and marketing materials.

Accordingly, MFA is of the view that the existing overall framework of the SFDR should be retained to the extent possible, rather than replaced with an entirely new system. Any changes should be targeted amendments within this existing framework, rather than a wholesale replacement of the current regime. We discuss this further below with regard to the specific proposal of a categorisation system.

Second, our members engage in marketing and due diligence discussions with prospective investors that are founded on the principles of the existing SFDR framework. Such discussions can frequently extend over several years. MFA considers that any revision of the existing framework (such as changes to the product-level disclosure requirements under SFDR) would change the course of ongoing discussions and would entail the risks of investment managers losing prospective investors, confusion for investors as to the sustainability profile of the relevant products given the change in direction of the discussion, and lack of confidence in the new classifications.

Accordingly, while MFA's preference would be to retain the existing framework to the extent possible, if any revision to the framework is taken forward, it would be beneficial to include a transitional period of a sufficient duration (at least 36 months) to allow for market participants to implement an orderly transition to the new regime. MFA also considers it appropriate for such transitional provisions to include grandfathering provisions to allow existing products, as well as those which are already being marketed to prospective investors at the time any changes are proposed to take effect, to continue to comply with the existing regime, with a view to mitigating the risks discussed above in respect of ongoing marketing discussions.

With respect to the potential establishment of a categorisation system, MFA acknowledges the issues that the Commission is seeking to address. MFA is cognizant of Articles 8 and 9 being used as de facto product labels by market participants, contrary to the intention that the SFDR would function as a disclosure regime, and notes the associated greenwashing risks. However, MFA would object to replacing the current disclosure regime with a formal categorisation or "labelling" system for all financial products within the scope of SFDR. Based on its market observations, MFA does not believe sustainability product labels are considered useful by professional investors, who do not see these as an incentive for investment. This contrasts with the retail investment market, where product labels can be more useful. A notable parallel can be drawn here with the Sustainability Disclosure Requirements ("**SDR**") and investment labels regime, finalised by the UK Financial Conduct Authority in Policy Statement PS23/16 on November 28, 2023. The labels under the UK SDR regime are focused primarily on retail investment products, on the basis that labels are considered more appropriate in a retail than a professional investor context.

Rather than establish a categorisation regime, MFA respectfully urges the Commission to retain the existing disclosure system at least in the context of professional investor arrangements. Any amendments should be targeted changes to clarify the concepts underlying the existing classifications (such as that of "promoting" an environmental or social characteristic). While there is guidance on these concepts, it is currently fragmented across a range of materials issued by the various EU institutions, which market participants can find difficult to navigate. Targeted changes should focus on clarifying the existing classifications, which could include codifying the existing guidance by incorporating it into the regulatory framework. MFA considers that such changes would increase the clarity of, and investor confidence in, the current classification system, and could mitigate the greenwashing risk discussed above.

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Response to Question 4.1.10

As discussed in our response to Question 4.1.2, MFA is of the view that the existing overall framework of the SFDR should be retained to the extent possible, rather than replaced with an entirely new system in the form of a labelling regime.

Should a labelling system nonetheless be taken forward, MFA considers the better option of the approaches set out in the Consultation to be Approach 2, on the same grounds outlined in our response to Question 4.1.2. Approach 1 would involve a wholesale departure from the existing Article 8 and 9 concepts that market participants have embedded into their processes and would require market participants to undertake a reclassification exercise in relation to their financial products. We consider therefore that implementing a redesign of the framework in line with Approach 1 would be the more costly and time-consuming of the two approaches, given the need to redesign investment management, monitoring processes and systems, internal policies and procedures, and client-facing documentation and marketing materials to reflect the redesigned framework.

Furthermore, certain of the proposed minimum criteria to be met in order for a financial product to fall under the different product categories in the context of Approach 1 would in our view present particular challenges.

An example is the proposal for taxonomy alignment to form one of the minimum criteria. There continue to be data gaps in relation to the taxonomy which present significant challenges for financial market participants that seek to report on, or commit to a particular level of, taxonomy-alignment in managing their products. While there may be improvements in data quality in respect of companies in scope of the EU Corporate Sustainability Reporting Directive, as this is phased in over the coming years, such companies do not represent the full universe of investments our members' financial products make.

Additionally, a criterion based on taxonomy alignment could disadvantage products that pursue a socially-focused strategy under the current framework, given the current absence of a social taxonomy in the EU. A social taxonomy would need to be implemented, and data quality brought up to a standard in line with that of the environmental taxonomy, in order to avoid such an imbalance if taxonomy alignment were to be introduced as a minimum criterion.

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