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THE ESMA SETS OUT ITS LONG-TERM VISION ON THE FUNCTIONING OF THE SUSTAINABLE FINANCE FRAMEWORK

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On 24 July 2024, the European Securities and Markets Authority ("**ESMA**") published an [opinion on the sustainable finance regulatory framework](#) (the "**ESMA Opinion**"), which outlines the ESMA's long-term vision for the functioning of the EU's sustainable finance framework (the "**Framework**"). The ESMA Opinion builds on the findings of the ESMA's [progress report on greenwashing](#), published on 31 May 2023, and the European Supervisory Authorities' ("**ESA**") [joint opinion on the assessment of the EU Sustainable Finance Disclosure Regulation](#) (the "**SFDR**"), published on 18 June 2024 (the "**ESA Opinion**"). Through these publications, the ESMA has acknowledged that although the Framework is relatively well developed and already contains safeguards against greenwashing, the Framework should evolve to facilitate investors' access to sustainable investments and support the effective functioning of the sustainable investment value chain.

BACKGROUND

In September 2023, the European Commission published two consultation papers (which you can read [here](#) and [here](#)) on its sustainable finance disclosure practices. The consultations were predominately focussed on gathering information on stakeholders' experiences with the implementation of the SFDR, but they also asked for feedback on more general topics, such as introducing sustainability-related disclosure requirements for all financial products offered in the EU, regardless of whether such products include sustainability-related claims.

On 3 May 2024, the European Commission published a [summary of the consultation](#), which highlighted that although the majority of stakeholders favoured a categorisation system of financial products with sustainability-related investment strategies in the SFDR, opinions were divided on whether the categorisation system should be based on new criteria or related to the existing SFDR categories (for further information on the existing SFDR categories, [read our earlier update here](#)). The ESAs have responded to this in the ESA Opinion, which showed that the ESAs favour creating a categorisation system based on new criteria.

The consultations also showed that the Framework could further mature and evolve to facilitate investors' sustainable investment journey. The ESMA has attempted to create a path for such maturation and evolution in the ESMA Opinion.

KEY RECOMMENDATIONS OF THE ESA OPINION

In relation to the future of the SFDR, the ESAs have made the following key recommendations to the

European Commission in the ESA Opinion:

1. Introducing a new product classification system based on regulatory categories and/or sustainability indicators to help consumers navigate the broad selection of sustainable products and support the full transition to sustainable finance

The ESAs are of the view that the introduction of categories of SFDR products that have sustainability features will improve consumer understanding of the sustainability features of financial products. Such categories would replace the current practice of categorisation in Article 8 and 9 of the SFDR, i.e., products would no longer be differentiated between those promoting environmental / social characteristics and those with sustainable investment as their objective. The ESAs suggest that product categories should be simple with clear objective criteria or thresholds, to identify which category the product falls into. The ESAs recommend, at a minimum, products to be split into: (1) sustainable products, for products that invest in economic activities / assets that are already environmentally and/or socially sustainable; and (2) transition products, for products that invest in economic activities / assets that are not yet sustainable, but which improve their sustainability over time to become environmentally or socially sustainable. The ESAs also recommend that the options for product categorisation and / or sustainability indicators should be consumer-tested and consulted on.

2. Revisiting the coexistence of the concepts of "sustainable investment" and "taxonomy-aligned investment" (as defined in the SFDR and the EU Taxonomy Regulation, respectively)

The EU Taxonomy Regulation constitutes a science-based reference point against which to measure environmental sustainability, whereas the SFDR is more principle-based and less prescriptive than the EU Taxonomy Regulation in terms of measuring sustainable investments. The ESAs are of the view that the European Commission should prioritise completing the EU Taxonomy Regulation and extend it to social sustainability.

3. Ensuring that sustainability disclosures cater to different investor needs, as well as considering different distribution channels

The ESAs want the European Commission to prioritise essential information for retail investors, whilst professional investors may benefit from more detailed information.

4. Considering whether other products should be brought into the SFDR's scope

The ESAs are of the view that the European Commission could carefully reflect on whether to include other products in the scope of the SFDR to ensure harmonised disclosures for both products currently in the scope of the SFDR and any other products that could be brought into scope.

5. Introducing a requirement to disclose information on key adverse indicators for all financial products

The ESAs want the European Commission to consider information on key adverse indicators for all financial products, based on a cost-benefit analysis.

KEY RECOMMENDATIONS OF THE ESMA OPINION

In relation to developing the Framework, the ESMA has made the following key recommendations to the European Commission in the ESMA Opinion:

1. Making the EU Taxonomy Regulation the sole, common reference point for assessing sustainability

The ESMA wants the EU Taxonomy Regulation to become the sole, common reference point for the assessment of sustainability performance across the Framework. In order to achieve this, the ESMA has recommended that the EU Taxonomy Regulation should cover all economic activities that could

substantially contribute to the EU's environmental objectives, as well as covering transition activities. The ESMA has also recommended developing a social taxonomy.

2. Phasing out the SFDR's definition of "sustainable investment"

The ESMA *"believes that the SFDR approach of defining environmental sustainability should be phased out in due course as the EU Taxonomy is being completed"*. The SFDR definition of "sustainable investment" provides a high level of flexibility regarding contribution to sustainability objectives and the application of the 'do no significant harm' principle. In the absence of thresholds, supervised entities are therefore given discretion on how to apply the key parameters of "sustainable investment". The ESMA is of the view that this does not ensure a consistent minimum sustainability ambition of financial products and hampers comparability between them. As a result, the ESMA believes that using the science-based EU Taxonomy Regulation to assess sustainability would bolster robust assessments and mitigate greenwashing risks.

The ESMA does, however, acknowledge that fully deploying the EU Taxonomy Regulation will take time. Therefore, the ESMA supports the approach proposed in the ESA Opinion of introducing a new SFDR product classification based on regulatory categories and/or sustainability indicators in the meantime.

3. Effectively supporting the transition

The ESMA is of the view that a definition of "transition investments" should be incorporated into the Framework to support the creation of transition-related products. Other transition investment-related recommendations include introducing a requirement for companies to disclose information on the revenue share and CapEx associated with harmful activities that are on a transition trajectory or are being decommissioned on the basis that their environmental performance cannot be improved, as well as developing a broader set of transition benchmarks and creating labels for "transition bonds" based on the EU Green Bond Standard (for further information on the EU Green Bond Standard, read our earlier [blog here](#)).

4. Sustainability disclosure requirements for all financial products

The ESMA has recommended the implementation of minimum sustainability disclosure requirements for all financial products in-scope of the SFDR, including those that do not have stated sustainability-related ambitions. The ESMA has made such a recommendation to *"improve transparency and facilitate comparability between financial products"* and to allow *"comparability between products with an ESG objective, products with smaller ambition and products without such ambitions"*. The ESMA noted that these minimum disclosures could consist of a small number of sustainability metrics in the form of KPIs covering basic socio-environmental indicators, such as greenhouse gas emissions, human rights, and EU Taxonomy Regulation-alignment.

5. Enhanced data quality

The ESMA is of the view that data products should be brought into the regulatory perimeter, to ensure that ESG data is reliable and comparable. The ESMA suggests doing as such by defining the duties and responsibilities of ESG data providers, whilst also setting out disclosure, conflict of interest and data quality requirements.

6. Consumer and industry testing

The ESMA has recommended that consumer and industry testing should be carried out before implementing policy solutions to ensure their feasibility and workability for retail investors.

NEXT STEPS

There is no set timeline for the European Commission to publish a revised SFDR, so it is unclear if and

when such a revision will take effect. Nor is there a set timeline for the more general recommendations made in the ESA Opinion and the ESMA Opinion, but they are now with the European Commission for consideration.

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