**SFDR Challenges Note**

**Overview**

As a firm which takes its regulatory and compliance responsibilities very seriously we think that it is important, at this stage, to flag up some of the practical and logistical difficulties we have experienced with implementation of SFDR and its associated regulations and legislation. We think that regulators and supervisors need to be aware that delivering what is needed in a properly controlled and overseen fashion (as we intend and you rightly expect) is proving extremely challenging given the very tight deadlines which have been imposed. This challenge has been exacerbated by the last-minute changes we have been required to make during the implementation programme.

We are concerned about the reputational risk for ourselves as a firm, but more importantly we are concerned at the potential for confusion among end investors and for reputational damage across the asset management sector and the sustainable investment market. We appreciate that regulators and supervisors share some of the strains which the timetables are imposing and that moving formal deadlines is unlikely to be an option. We do, however, think that it is vitally important, particularly during the early stages of implementation, for regulators and supervisors to acknowledge the spirit in which firms like ours are approaching compliance with the rules and also not to lose sight of the shared goals of developing an environment in which investors’ savings can be channelled into sustainable investment within a framework which instils trust and understanding.

One particular difficulty for firms, given the resource demands of implementation and the need for long term planning with strong project disciplines, is dealing with the unexpected. We would ask that, where possible, going forward, the supervisory and competent authorities provide clear indications of timetables for publication of new initiatives, including guidance, Q&As and consultations, so that they can be factored into the overall plans. Here, as with any regulatory change process, the existence of adequate implementation time usually leads to better outcomes for investors, but also for regulators and the industry itself.

**Practical implications**

The requirement to include the EU SFDR L2 pre-contractual disclosures in our prospectuses was effective from 1 January 2023, with our periodic reports to follow in annual reports produced from 1 January 2023. In order to prepare for these deadlines we needed to take a staged approach. In particular drafting, agreeing and obtaining approval for the pre-contractual disclosures had to take precedence over the periodic reports. However, we have had to prepare some periodic reports in conjunction with the pre-contractual disclosures for funds that have an accounting period ending 30 September 2022 and we had to incorporate comments from the CSSF on the pre-contractual disclosures of over 110 funds whilst preparing the periodic reports and website disclosures. The same teams and individuals had to be involved in both.

An additional challenge has been the large amount of data required for the periodic reports – we have encountered practical difficulties in sourcing and translating this raw data into a format relevant for the reports. Often the data is not replicable and relevant for certain asset classes so requires (manual) intervention on a fund by fund basis. By way of example, the introduction of the revised Taxonomy Alignment graphs (to include fossil gas and/or nuclear energy related activities) are being manually constructed and copied into the disclosures due to the short implementation timelines.

We are drafting 11 fund disclosures completely manually, 22 fund disclosures largely manually with limited standardised narratives/data and for 76 fund disclosures there will be manual edits such as including a table on engagements data and the taxonomy graphs (with accompanying guidance and footnotes) referenced above.

The majority of the complexity and effort has been working through the required calculations and narratives and coding these where required so that we can deliver an automated solution where possible. Over the course of 2022 and 2023 Schroders is expected to spend in excess of £2 million to implement the SFDR requirements.

The proliferation of different sustainability requirements across the EU has added complexity requiring resource. As we understand it, the EU SFDR was meant to be a standardised regulation for the EU member states. However, there have been instances whereby certain EU countries have deviated from the standardised approach. For example, France and Germany have introduced obligations above and beyond the EU SFDR[[1]](#footnote-2) and we have also had to take into account additional labelling considerations e.g., Febelfin. This is of particular concern to asset managers like us with a large product range sold across the EU and outside the EU.

**Additional pressures of implementation due to evolving regulation and guidance**

* 1. **Incremental issuance of guidance and regulation, such as Q&As:**

Implementation programmes to comply with new rules of this complexity are long and expensive. They have to be phased and planned a long time in advance and there are frequently significant dependencies across different workstreams. We have had to materially update the original planned approach and/or disclosures mid-programme following further guidance at EU level (for instance as to what constitutes a sustainable investment or an E/S characteristic) which adds complexity, cost, risk and oversight challenges. Where Q&As (for example EU 2022/1288 published on 17 November 2022) are immediately effective, this can challenge the important project disciplines that we seek to apply to a large implementation project of this nature. Particular challenges arose from the fact, for example, that clarification was issued that specific sections of the RTS templates can be deleted when not deemed applicable, however prior to this guidance, we were instructed by the CSSF to leave in all sections even when n/a (and we are likely to engage with the CSSF on this again). We think that, in order to maintain appropriate disciplines, there should be a grace period to scope and implement required updates.

* 1. **Inclusion of nuclear and natural gas in the EU green taxonomy**

Further complexity arises from the uncertainty on exactly when the EU Taxonomy Complementary Climate Delegated Act covering certain nuclear and gas activities comes into force (our understanding is some time in February 2023) and consequently when we should be using the updated templates for our pre-contractual and periodic disclosures. In particular, updating the pre-contractual disclosures is a significant exercise that cannot be quickly executed and it will also need to go through the regulator review process.

* 1. **ESMA Consultation on guidance for funds’ names using ESG or sustainability related terms**

While significant effort has been made by the industry to increase capabilities and invest in systems and in people who have an understanding of sustainability issues and regulatory requirements, it is frequently the same people who need to focus on implementation as on new policies, and careful resource planning and project disciplines are required. Any unplanned or unexpected initiatives add significantly to the strain and risks and there is a danger of responses to consultations not being as considered and carefully thought through as they should be. The consultation on sustainability related terms in funds’ names falls into this category (exacerbated by the parallel, very short consultation period on greenwashing). Assessment and possible implementation of this guidance within 6 months between publication of the final guidelines and entry into application would be a complex exercise, requiring to re-assess potentially even those funds outside Art. 8 and 9 SFDR, that has not been scoped for in the sustainability project due to its unexpected nature. We would ask that the authorities offer clear forward plans as to when they will be issuing new guidance or consultations so that they can be taken into account in our own planning.

* 1. **Inclusion of minimum commitments to environmental and social sustainable investments in the pre-contractual templates for Article 8 Funds (for funds which have Sustainable Investments with environmental and social objectives)**

During the review of our pre-contractual templates the CSSF requested that we include minimum commitments to environmental and social sustainable investments in addition to the overall commitment to sustainable investments. We prepared our pre-contractual disclosures for our Article 8 funds on the basis that including specific minimum commitments for environmental and social sustainable investments separately would not be relevant or necessary for many of our funds and we consider this is not an explicit requirement of SFDR Level 2. While we have received a temporary derogation from the CSSF, we understand that this may be something we have to include in the future.

We believe that it is important to be able to assess the social and environmental characteristics and impacts of an asset in which an Article 8 or Article 9 SFDR product is invested.

The extent to which it is desirable to focus on environmental or social characteristics separately depends in our view, on the strategy in question, in particular its stated investment objective and its ESG characteristics.

The proprietary tool that we use for the majority of our Article 8 funds assesses environmental and social “benefits” and “costs” by considering a range of social and environmental metrics. However, these metrics are currently assessed in aggregate for any given issuer, and our fund criteria has been thoughtfully developed based on that aggregate view so it is a significant operational challenge for us to commit to a minimum environmental and/or social proportion of sustainable investments for many of our Article 8 funds. Nor is such a commitment necessary for those funds to meet their primary ESG characteristic, which in many cases is to score higher than their respective benchmark using the Investment Manager’s proprietary tool.

We prepared our pre-contractual disclosures for our Article 8 funds on the basis that including specific minimum commitments for environmental and social sustainable investments separately would not be relevant or necessary for many of our funds.

We do not believe that undertaking an exercise to determine a minimum environmental or social sustainable investment commitment percentages for many Article 8 products is in the best interests of investors in our funds. We became aware of the CSSF’s stance was for at least a 1% in Environmental and 1% in Social for funds with sustainable investments that had both environmental and social objectives in December 2022. Following engagement which involved an explanation of our process as detailed in the preceding paragraphs, the CSSF approved our L2 SFDR RTS templates, and granted us a temporary derogation for certain Article 8 funds which had no minimum environmental or social commitment percentages.

We consider that providing a very small environmental and/or social percentage, for example 1% social for a fund that has committed to 50% sustainable investments, which we understand would be acceptable, will not be a meaningful representation for that fund and, in our view, such a figure may confuse or even mislead investors. Instead, we believe investors should focus on the overall minimum proportion of sustainable investments.

We understand that this is an industry wide issue and have learnt that not all NCAs are applying the Level 2 rules in this way, and we request this is clarified at the EU level.

**Conclusion**

We would repeat that while we are concerned about our own reputation, our main concern is the end investor. Constant “chopping and changing” does not instil confidence. In part this has already occurred with the numerous Article 9 funds reclassifying to Article 8 over the last few months. Clarity as to expectations, the ability to explain what is happening and why, and careful planning will support the aims we all share in terms of ensuring that the financial sector, and asset managers, in particular, can play their full part in channelling savings into sustainable investment.

1. For example the ‘20% universe reduction’ test for the AMF’s ‘Significantly Engaging’ approach [↑](#footnote-ref-2)