Summary of Florian Heeb/Harald Walkate articles

Early 2022, Florian Heeb and Harald Walkate, both associated with the University of Zurich – Center for Sustainable Finance and Private Wealth (CSP) published three articles, mostly about how EU regulation relates to sustainable finance and how effective it is likely to be. Below are brief summaries of the articles. The articles were published by Illuminem; links are in the titles.

MiFID Misses Mark: ESG Motivations Matter

Instead of asking clients about their ESG 'preferences', as MiFID now requires, financial institutions should be having conversations with clients about their underlying objectives, or motivations.

The EU Markets in Financial Instruments Directive (MiFID II) requires financial firms to collect information on their clients' sustainability 'preferences'.

- This has two goals:
    - Direct capital towards sustainable purposes such as SDGs or climate action; and
    - Prevent greenwashing.
- But while many consumers have a 'preference' for sustainable products, mapping these preferences has little value unless the underlying objectives, or consumers' motivations are also exposed, which can be very different:
    1. 'impact' – contributing to a better world through investments;
    2. 'values-alignment' – avoiding association with 'bad' companies through investments; or
    3. 'performance' – optimizing financial risks and returns by considering sustainability aspects.
- Research suggests that for most consumers with a preference for sustainable finance, the underlying motivation is 1: having 'impact'.
- MiFID should require financial firms to discuss these three motivations with their clients in order to better understand what's driving their sustainable finance 'preferences'.
- This is also because funds marketed today as 'sustainable' or 'impact', actually have very little meaningful impact. Having more clarity on these motivations will also require firms to demonstrate 'impact' in order to avoid greenwashing, and should spur competition and innovation in impact investment.
- But the EU should also understand that, even if more funds would have meaningful impact, this would still leave many societal problems unaddressed, because most don't come with simple, investable, solutions today.
- In sum, with the current MiFID rule, it is exceedingly unlikely that the EU will meet either of their goals: directing capital towards sustainable purposes or preventing greenwashing.

A-B-E-G-L-N. How adding six letters to SFDR can make it 'work'.

SFDR article 9 is known as the "impact fund" classification. But the way SFDR is written, "enabling impact" is not actually needed for a fund to claim it is "article 9". We propose a simple fix.

- The Sustainable Finance Disclosure Regulation (SFDR) has two key goals:
    - Direct capital towards sustainable purposes such as SDGs or climate action; and
    - Prevent greenwashing.
- SFDR has been enthusiastically adopted by the asset management sector, who try to classify as many funds as possible as article 8 ("promoting ESG") or 9 ("impact").
- Consumers have different objectives, or motivations, in looking for sustainable funds:
    1. 'impact' – contributing to a better world through investments;
    2. 'values-alignment' – avoiding association with 'bad' companies through investments; or

3. 'performance' – optimizing financial risks and returns by considering sustainability aspects.

- Research suggests that for most consumers the underlying motivation is 1: having 'impact'.
- Article 9 is the "impact" classification in SFDR: it defines "sustainable investment" as an "investment *in* an economic activity that contributes to an environmental objective or a social objective".
- There is a difference between *company impact* (where a company undertakes impactful activities) and *investor impact* (the change in company impact the investor induces, or *enables*, through investing). This is also called 'additionality' – the investment should allow something to happen that would otherwise not happen.
- Most funds classified as Article 9 are about company impact, not about investor impact – there is no or very little additionality; this is because in most cases those funds invest "in" listed companies, but do not *enable* those companies to become (more) impactful.
- We suggest a very simple change to the SFDR text: "'sustainable investment' means an investment **ENABL**in**G** an economic activity that contributes to an environmental objective, (….) or an investment in an economic activity that contributes to a social objective, etc." In other words, change the "investments **in** an economic activity" to "investments **enabling** an economic activity". This would incorporate the requirements of investor impact and additionality into SFDR.
- This would help meet SFDR's goals: (1) article 9 funds would need to demonstrate they are directing capital towards sustainable purposes and (2) consumers looking for additional impact would know they would get it by investing in article 9 funds, which reduces greenwashing.

What Fake Suede and the Future of Impact Investment Have to Do With One Another

Many of the rules needed to act on greenwashing already exist; they offer a plethora of sensible requirements. But we should not let them stifle the (also much-needed) innovation in impact investing.

- There was a court case this year where a company called Miko was accused by a competitor of greenwashing by arguing that Miko, in describing its suede-like microfiber product *Dinamica* as "green", was competing unfairly. The accusation of "misleading advertising" was based on the EU's Unfair Commercial Practice Directive (UCPD). Miko was instructed by the court to immediately change its marketing pitch, or face hefty fines.
- This is interesting because:
  - This is the first time that a civil court orders a company to stop greenwashing and it based its decision on 'soft law' – guidelines on how to implement an EU directive.
  - This could also happen to investment funds, at the request of a competitor, a customer or regulator.
  - This is good from a consumer protection point of view, but in light of the need for more innovation in the market for impact investment it provides challenges.
- This document: Compliance Criteria on Environmental Claims – Multi-stakeholder advice to support the implementation/application of the Unfair Commercial Practices Directive 2005/29/EC, developed by the Multi-stakeholder Dialogue on Environmental Claims (so also known as MDEC), sets out a large number of criteria whenever "environmental claims" are made (i.e. claims that a product or service has a positive impact on the environment). Claims should:
  - reflect a verifiable environmental benefit or improvement
  - be communicated in a precise manner to consumers
  - be clear and unambiguous
  - be meaningful and relevant to the environmental performance of the product

    - reflect an environmental benefit beyond what is already considered as common practice
    - be presented in a way that is accurate, clear, specific and unambiguous to ensure consumers are not misled
    - be a truthful and accurate representation of the scale of the environmental benefit
    - not overstate the benefit achieved
    - be based on robust, independent, verifiable and generally recognized evidence which takes into account the latest scientific findings and methods
    - be measured using the most appropriate methods
- These rules apply to investment funds, which means that:
    - Many of the regulations meant to counter greenwashing, like SFDR, are likely redundant;
    - The criteria suggest that products need to demonstrate a causal relationship between the product and the environmental benefit; therefore funds marketed as 'impact' will need to be 'impact-generating', as compared to the 'impact-aligned'; and
    - Developing impact investment funds that meet all these requirements is a tall order.
- This might stifle innovation, which is by definition a messy process with lots of experimentation, even though we very much need innovation in impact investing.
- What are the implications?
    - *Banks & asset managers* should involve investment teams and product development capabilities in developing impact products and engage with the academic world to learn about evidence-based ways to structure impact-generating investments.
    - *Consumers* should be able to have frank conversations with their banks and financial advisors about risk/return implications of impact investments.
    - *Regulators & judges* should focus on avoiding true greenwashing while not stifling innovation in the burgeoning impact investment market.
    - *Academics* should develop practically applicable impact assessment methods for investment products, similar to life cycle assessment (LCA).