SFDR Product Categorization Regime Through the Lens of EU Platform on Sustainable Finance and Recent Developments in Cyprus

By Xenia Kalogirou, Senior Associate at Elias Neocleous & Co. LLC

Proposal of the EU Platform on Sustainable Finance

In effect since March 2021, the Sustainability Financial Disclosure Regulation – Regulation (EU) 2019/2088 ("**SFDR**") – introduced transparency in the market for sustainable investment products as part of the EU's 2030 Agenda for Sustainable Development.

It requires financial market participants ("**FMPs**") and financial advisors ("**FAs**") to disclose the sustainability profile of the financial products in terms of integration of sustainability risks, consideration of principal adverse impacts (known as **PAIs**) in their processes and the provision of sustainability-related information.

On 17 December 2024, the EU Platform on Sustainable Finance ("**Platform")** published a proposal ("**Proposal"**) on the product categorisation under the SFDR. The purpose of this Proposal is to provide recommendations to the European Commission (EC) to which the Platform serves as an advisory body. The EC is currently considering a review of the SFDR and is expected to publish a proposal in the first half of 2025. This proposal will likely reflect the views of the Platform which align with separate opinions from the European Securities and Markets Authority and the European Supervisory Authorities in 2024.

The Proposal presents the categorization framework and key considerations that the Platform suggests the EC adopt during the SFDR review process.

The Platform recommends categorising products based on the following sustainability strategies, with each category adhering to minimum criteria. These criteria include a predefined proportion of investments that must fulfil the core sustainability objective:

- **Sustainable** – contributions through Taxonomy-aligned Investments or Sustainable Investments with no significant harmful activities, or assets based on a more concise definition consistent with the EU Taxonomy Regulation;
- **Transition** – investments or portfolios supporting the transition to net zero and a sustainable economy, avoiding carbon lock-ins, in line with the EC's recommendations on facilitating finance for the transition to a sustainable economy; and
- **ESG collection** – excluding significantly harmful investments/activities, investing in assets with better environmental and/or social criteria or applying various sustainability features. This category will also cover a fund that combines the Sustainable and Transition categories, either by investing in a mixed portfolio which includes investments that are eligible for the Sustainable and Transition categories or by investing (as a fund of funds) in funds in the Sustainable and Transition categories.

All other products should be identified as **unclassified products**. This category includes funds without sustainability features, those with sustainability features that do not meet the criteria for other categories, and funds that the manager chooses not to qualify —such as when all investors are institutional investors and have no preference for a specific category. While funds in this category are not required to meet the minimum criteria for sustainability features, they must explain how they address sustainability risks in accordance with the existing obligation under Article 6 of the SFDR which governs those funds that fall outside the scope of Article 8 or Article 9 of the SFDR, also referred to as "non-ESG funds".

The Platform acknowledges that FMPs will need to invest significant time and resources in adjusting and transitioning their existing products – typically classified under Article 8 (governing funds promoting environmental or social characteristics) or Article 9 (regulating funds that have sustainable investment as an objective) of the SFDR– to the categories under the new regime. It also recognizes that some Article 8 or 9 funds may not meet the new criteria. The Platform's suggestion that any product not falling under one of the established categories should be prohibited from referencing ESG characteristics in its marketing materials could force many existing Article 8 funds to either alter their ESG characteristics or cease promoting them. This highlights the need for grandfathering and transitional relief for funds that have completed fundraising, as well as those in fundraising before the new rules (if adopted as proposed) come into effect.

The Platform further suggests building the categorisation on the Sustainable Finance Framework, using tools such as the EU Taxonomy, EU Climate Benchmarks, EU Green Bond Standards, Principal Adverse Impact indicators, and the EC's recommendation on facilitating finance for the transition to a sustainable economy.

The proposed scheme focuses on aligning financial products with sustainability objectives, emphasizing the client's perspective and preferences through clear and mandatory disclosures. However, investors looking for measurable positive outcomes or impact generation will require products that fulfil additional criteria to fully meet these needs. As such, the Platform recommends that the EC develops a common understanding of how impact investing relates to the EU's sustainable finance framework and to the Taxonomy, with a view to integrating it into the categorisation regime.

SFDR Disclosures at Entity Level by Credit Institutions in Cyprus

Credit institutions providing the investment services of portfolio management and/or investment advice under the MiFID II regime, are classified as FMPs and/or FAs according to the SFDR.

As such, these credit institutions are required pursuant to the SFDR and the Commission Delegated Regulation (EU) 2022/1288 ("**SFDR Delegated Regulation**"), to comply with specific disclosure requirements based on their respective roles, including whether they consider the PAIs of their investment decisions on sustainability factors, or alternatively, provide an explanation for opting out of such consideration ("**PAI regime"**).

Credit institutions in Cyprus taking into account their size, the nature and scale of their activities and the types of financial products they advise on or make available, generally consider that complying with the PAI regime would be disproportionate. Specifically:

- Eurobank on its statement on PAIs has reported that many issuers and third-party market data providers are at present not able to provide the complete data set for the mandatory indicators, making it challenging to fully comply with the reporting requirements of the PAI regime. It was also underlined in the statement that the regulatory framework for sustainable finance is still evolving, which can create uncertainty and pose additional challenges.

- Bank of Cyprus has also explained on its statement on PAIs that it is in a transitional process of adapting and developing its internal processes and policies which will allow for consideration of the PAIs in the advisory services in a systematic manner. However, the lack of readily available and reasonably priced data makes it difficult to comply with many of the technical reporting requirements of the PAI regime.

- Hellenic Bank reported on its PAI statement that in view of the very limited investment advice offered to the clients and the products currently offered, it is unlikely to have any principal adverse impact on sustainability factors. The bank also mentioned that it provides investment advice on financial instruments/products provided by product manufacturers who themselves take into account the PAIs on sustainability factors and ensure that necessary and sufficient information is obtained from them. As disclosed in its ESG Impact Report, Hellenic Bank has expanded its partnership with a global fund manager to include thematic and sustainable funds and diversify its investment offerings.

- Astrobank has explained in its PAI statement that ESG data challenges, such as the limitation of readily available data, hinder the bank's efforts in complying with the technical requirements when considering principal adverse impacts of investment decision on sustainability factors when providing portfolio management and/or in their investment advice.

All the banks mentioned have committed to continuously reassessing how they consider adverse impacts in their processes and to regularly updating their decisions through revisions of the PAI statements.

Establishment of a Sustainability Committee at CBC

On February 3rd, 2025, the Central Bank of Cyprus (CBC) acknowledged climate change as a crucial issue impacting society, the economy and the financial system.

To address this, the CBC'S board of directors has established a Sustainability Committee, responsible for defining and reviewing CBC's Sustainability Strategy and supporting the goal of achieving net-zero carbon emissions. The Sustainability Committee is assisted by the operational Sustainability Group, which coordinates all climate-related activities and ensures climate considerations are integrated into the CBC's work.

The CBC's Sustainability and Climate Change Strategy aligns with that of the European Central Bank and follows the guidelines of the Network for Greening the Financial System (NGFS), a global network of central banks focused on scaling green finance and promoting central banks' role in climate change finance.

Sustainability-related obligations of CIFs

On February 13th, 2025, the Cyprus Securities and Exchange Commission (CySEC) issued a Circular No. C683 ("**Sustainability Circular"**) to clarify the sustainability-related obligations for Cyprus Investment Firms (CIFs). These obligations aim to support the European Green Deal and ensure CIFs comply with EU sustainability regulations.

Key requirements include:

- **SFDR:** CIFs authorised to provide the investment services of portfolio management and/or investment advice should include information with respect to the consideration of adverse sustainability impacts and the integration of sustainability risks, at entity level and at product level, as well as sustainability-related information concerning the financial products. In this respect, CIFs shall also use the templates provided in the SFDR Delegated Regulation for consistent disclosure practices.
- **EU Taxonomy**: CIFs authorised to provide the investment services of portfolio management and/or investment advice must align their sustainability-related disclosures with the EU Taxonomy Regulation by applying the technical screening criteria outlined in delegated acts by the EC.
- **MiFID II:** CIFs, regardless of the investment services they are authorized to provide or whether they offer financial products with sustainability features must incorporate sustainability risks into their processes, systems, controls and risk management frameworks. Sustainability factors taken into consideration, shall be also disclosed in the description that is provided to clients regarding the selection process of financial instruments when providing investment advice. Furthermore, CIFs must assess and document clients' sustainability preferences when determining the suitability of investment products and include possible conflicts of interest that stem from the integration of the client's sustainability preferences.
- **Product Governance:** CIFs manufacturing and/or distributing financial instruments, irrespective of whether their products have sustainability features must incorporate sustainability-related objectives in target market identification, product distribution, and periodic reviews.

CySEC stresses the importance of incorporating sustainability considerations into investment services and urges CIFs to take the Sustainability Circular seriously.

To ensure compliance with regulatory expectations and best practices in sustainable finance, CySEC provides key recommendations: First, CIFs should ensure their staff are adequately trained to understand and integrate sustainability risks, impacts, and preferences into investment decisions and advice. Clear and concise communication with clients is also essential, particularly in explaining how sustainability factors are considered, to ensure transparency and avoid greenwashing. Additionally, CIFs are advised to regularly review their internal policies, procedures, and product governance arrangements to ensure they remain aligned with evolving regulatory requirements. Finally, CIFs are encouraged to consult the latest ESMA guidance, including Q&As on SFDR and EU Taxonomy, as well as updates on MiFID II, for further clarity.

Conclusion

In conclusion, the ongoing developments in the European Union's sustainable finance regulations, particularly the SFDR and related initiatives, are transforming the financial sector's approach to sustainability. The Platform's proposed categorization framework and the increasing regulatory focus on transparency, risk integration, and sustainability considerations are pushing FMPs and FAs to reassess their services and product offerings. The Cypriot credit institutions and CIFs, are grappling with the complexities of integrating sustainability-related disclosures, managing data challenges, and aligning with evolving EU regulations.

The establishment of sustainability committees, such as the one at the CBC level, signals a broader institutional commitment to climate action and sustainable finance. Furthermore, the recent Sustainability Circular issued by CySEC emphasizes the importance of integrating sustainability considerations into investment services and product governance. As sustainable finance regulations evolve, 2025 will be a pivotal year for transparency, compliance and practical implementation. With no explicit commitment from the EC yet on whether there will be in fact an SFDR review, the potential transformation of the SFDR is one to monitor in 2025.