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Strengthening Sustainability Regulation for Swiss Financial Market Participants: Summary for Policymakers

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Strengthening Sustainability Regulation for Swiss Financial Market Participants: Summary for Policymakers

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1 INTRODUCTION

This Summary for Policymakers presents key findings of a yearlong research project with a focus on financial market participants [1] **by the Enterprise for Society (E4S) Center**, a joint venture of the University of Lausanne under its faculty for business and economics (UNIL-HEC), the Institute for Management Development (IMD) and the Ecole Polytechnique Fédérale de Lausanne (EPFL).

The recommendations for Swiss policymakers aim at selectively upgrading the regulatory framework in view of making Switzerland a leader in sustainable finance, in accordance with the agenda set by the Federal Council [2] and Swiss commitments to the Paris and Kunming - Montreal agreements [3], [4]. This involves in particular:

- Improving transparency on financial-product sustainability through disclosure (Section 2), focusing on interoperability (2.1), data availability (2.2) and decision-useful information (2.3);
- classifying products according to sustainability characteristics (Section 3) via rules for fund names and labels (3.1), namely a definition of sustainable products and the introduction of impact and transition categories, as well as the promotion of sustainability-related bonds (3.2);
- and the integration of client preferences into advisory services and investment decision-making (Section 4).

The detailed analysis of Swiss and international regulations upon which these recommendations are based and to which they refer, can be found in the underlying report [1]. These theoretical insights must be verified and further discussed with practitioners before drafting respective policies. A forthcoming analysis will complement these recommendations with the opinions of market and policy experts.

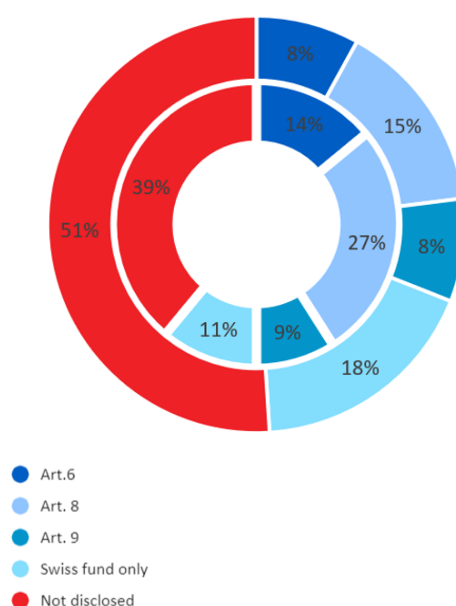
2 Improving transparency on financial-product sustainability

Despite Switzerland's subsidiary regulatory tradition, there is a margin for improving the Swiss framework on sustainability-related disclosures of financial market participants, considering foreign developments. Recommendations to the Swiss regulator include (1) considering the interoperability of disclosure frameworks across jurisdictions (Section 2.1), (2) ensuring data availability related to investee companies (Section 2.2), and (3) requiring transparency on decision-useful information (Section 2.3).

2.1 Considering the interoperability of disclosure frameworks

The Swiss regulator should focus on the interoperability with other jurisdictions. Swiss financial firms falling under the scope of a Swiss framework for sustainability-related disclosure are likely to be subject to similar regulations in other jurisdictions. Two third of Swiss banks and asset managers have the legal obligation to comply with the EU regulation, but only few disclose under the European Sustainable Finance Disclosure Regulation (SFDR) Art.6, 8 and 9 so far (Figure 1) [5, p. 46].[1] When developing its framework [1, Sec. 2.3.2.1], the Swiss regulator should therefore balance its objectives for pursuing disclosure requirements with the obligations under the SFDR and the Security and Exchange Commission's (SEC) Proposal. It should also consider developments in other markets relevant for Switzerland, while remaining suitable for Swiss market participants.

Figure 1: Classification of funds based on the EU's SFDR by Swiss asset managers (in % of AuM; n=44)



Note: **Outer** circle – data from **2022**; **inner** circle - data from 2021

Source: SSF Sustainable Investment Market Study (2023) [5].

For example, one could imagine a framework with substituted compliance with other jurisdictions, in particular the EU.[2] Swiss financial market participants

[1] Swiss financial institutions operating in the EU, i.e., that have a subsidiary, actively seek clients, or market or manage a financial product in the EU, are required to disclose under the SFDR. Financial market participants who seek clients on European soil in a passive manner are not subject to European regulation. However, the distinction between passive and active business activity is difficult to prove in practice and may represent a legal risk for Swiss companies: [6, Paras 54 and references]; [7, p. 15] , [8, p. 205], [9, p. 5].

[2] The UK, as well as Singapore, could also be sources of inspiration, given the market similarities or their relationship with the EU. The UK Financial Conduct Authority (FCA) has recently proposed Sustainability Disclosure Requirements and investment labels (SDR), intending to prevent greenwashing and help investors navigate the sustainable-product market more easily, namely through explicit labelling with an associated supervision. While this system along with the FCA's intent differs from the EU and US approaches, the FCA is "working to maintain coherence between [its] proposals, the SFDR

with disclosure requirements in the EU and Switzerland could choose to comply with the EU disclosure framework and be automatically compliant with the Swiss one as well. This would be particularly beneficial for larger asset managers under the risk of double reporting burden.[34] For small financial market participants who are not exposed to other jurisdictions, the ideal system would be a simplified local disclosure standard, compatible with international reporting requirements, such as under SFDR or the SEC Proposal (if adopted), to avoid a lack of disclosure data along the supply chain.

2.2 Ensuring data availability related to investee companies

The Swiss regulator should align timelines and scopes for the reporting obligations of investee companies and that of financial market participants. In particular, it should ensure that data related to invested companies is available at the time of reporting duties for financial market participants. This would avoid what is currently observed in the EU, where there will be difficulties for reporting under the SFDR until the full application of the Corporate Sustainability Reporting Directive (CSRD). Even after the full application of the CSRD, unclarities remain as to whether the required information from financial market participants will match the information disclosed by firms. Recommendations related to reporting obligations of companies have been proposed in previous work [12].

The regulator should also consider an approach for private funds, for which data on investee companies is more challenging to access and sustainability not always at the top of the agenda. Below are two examples of tools that could help investors collect information on the companies they invest in.

The Legal Innovation for Sustainable Investments Foundation (LISI Foundation) created the Impact Term Sheet Template, an open-source legal template for direct equity investments issued by a company to investors in exchange for growth funding [13]. Annex 2 of the Impact Term Sheet proposes transparent and harmonised reporting requirements when entering an investment deal.

Levo is an online tool for startups and SMEs to assess, monitor, and improve their sustainability and impact. Levo's Dashboard View gives investors an overview of the sustainability status of the companies they back in real time. This feature facilitates reporting by enabling investors to visualise their portfolio's sustainability and track its progress [14].

On a larger scale, Swiss regulators should further encourage Swiss companies to support the Net-Zero Public Data Utility (NZPDU) and closely follow the establishment of the European Single Access Point (ESAP). In June 2023, leading Swiss financial institutions agreed to test the NZPDU platform, which is administered by the international, multi-stakeholder Climate Data Steering Committee (CDSC). The platform aggregates corporate data on scope 1, 2 and 3 emissions, and emissions reduction

requirements and the SEC's proposals" [10]. Singapore is envisaging to explicitly accept the EU disclosures as an advanced alternative [11].

[3] The UK Financial Conduct Authority (FCA) has recently proposed Sustainability Disclosure Requirements and investment labels (SDR), intending to prevent greenwashing and help investors navigate the sustainable-product market more easily, namely through explicit labelling with an associated supervision. While this system along with the FCA's intent differs from the EU and US approaches, the FCA is "working to maintain coherence between [its] proposals, the SFDR requirements and the SEC's proposals" [10].

[4] Singapore is envisaging to explicitly accept the EU disclosures as an advanced alternative [11].

targets, which can be freely accessed [15]. In addition, the European Union has provisionally agreed on the ESAP platform in May 2023, and will publish all corporate financial and sustainability-related information about EU companies and EU investment products by summer 2027 [16].

2.3 REQUIRING TRANSPARENCY ON DECISION-USEFUL INFORMATION

Switzerland can learn from other jurisdictions how to create transparency on decision-useful information[5] and build trust in the market, while balancing financial market participants' constraints. Avenues worth exploring include (1) establishing disclosure requirements on sustainability for any type of fund at the product and provider level (2) developing science-based disclosure requirements, (3) considering engagement policy disclosures within its regulatory framework, and (4) helping provide transparency on the transition potential of investments that are not necessarily expected in sustainable finance products. These last elements would be particularly relevant if the Swiss regulator were to set an impact category and a transition category as described in Section 3.1.2.

General disclosure requirements for all funds. Any type of funds should disclose sustainability-related information because it represents information that is financially material for the investment decision-making, whether sustainability factors are part of the investment strategy or not, as is done under the European Sustainable Finance Disclosure Regulation (SFDR) [1, Sec. 2.1.1]. Additionally, the Swiss disclosure framework should consider both provider- and product- level disclosures, as they are both relevant to the investor when selecting a product. The Asset Management Association Switzerland's (AMAS) self-regulation [1, App. 3], which applies only to its members and adherents, considers both these dimensions, but does not require sustainability-related disclosures for all financial products, solely for sustainable financial products. FINMA's recognition of this self-regulation as a minimum standard could diffuse these requirements in the Swiss industry (Box 1).

Disclosures on science-based metrics. Financial products with stated environmental impact objectives should disclose science-based metrics, as they help tracking the achievement of relevant environmental impact. The EU included this specificity for taxonomy-related disclosures: financial-market participants need to publish their financial products' contribution towards science-based and Paris Agreement-aligned indicators and thresholds, as defined by the Technical Screening [1, App. 2]. The SEC Proposal for Enhanced Disclosures also requires additional requirements for ESG-Focused Funds [1, Sec. 2.2 and Table 1] although they so far appear much less extensive compared to the EU requirements. In Switzerland, the recently introduced and Task Force on Climate-related Financial Disclosures (TCFD)-inspired Swiss Climate Scores could fulfil such a role, if required for financial products with environmental-impact objectives and in particular if they comply with other jurisdictions' requirements [1, Sec. 2.3.1].[6] As of today,

[5] Decision-useful information on sustainability of financial products should follow concepts similar to those of financial reporting: the information disclosed on the product should be relevant for the client's investment decision, comparable with other products, verifiable and understandable for the client [17].

[6] If the voluntary Swiss Climate Scores cannot contribute to other jurisdictions' disclosure requirements, they might (1) not necessarily bring clarity to investors, especially non-Swiss that are unfamiliar with the framework - hence defying the purpose of understandability - and (2) be less attractive for non-Swiss market participants advertising funds in Switzerland, as they might prefer to disclose under their own jurisdictions' requirements [18].

they remain voluntary, still have limits,[7] and take a different approach - that is more climate-oriented compared to the EU's SFDR.

Disclosures on engagement policy and results. Financial products that advertise a transition objective should disclose their engagement policy and results. A Swiss disclosure framework should include obligations pertaining to active ownership, given its impact potential and predominance within sustainable investment strategies, as underlined by the Federal Council [20]. These considerations should focus on the engagement strategies and its specificities but also on the outcomes of engagement activities [21]. Such disclosures, including the escalation process in case engagement is unfruitful, is particularly important for firms targeted for their transition potential to make sure that the talk is being walked.

Disclosures on unexpected investments in sustainable products. Financial products that advertise sustainability characteristics should disclose portfolio investments that might be perceived unsustainable but are part of a transition strategy. Similar to the UK Financial Conduct Authority (FCA) [10], Swiss regulators could also consider requiring information on "unexpected investments", i.e., investments that are generally not associated with sustainability objectives such as fossil fuel companies. Disclosure obligations could include the type of investment at hand, e.g., its sector, and an explanation as to why it is held within the financial product. This type of disclosure would help build trust and provide increased transparency on the product, by avoiding mismatched expectations for the end-investors. In certain cases, it could however lead to potential greenwashing because of the lack of threshold for what might be considered "unexpected" [22].

[7] For example, the "global warming potential" indicator has been categorised as optional, and several financial market actors have stated not using it currently due to limited reliability and data weakness around forecasts [19].

Box 1: FINMA's recognition of self-regulation as minimum standards: a compromise

Self-regulations are constantly being updated, in particular to fulfil the Federal Council's expectations in accordance with the national sustainable finance strategy and to avoid further binding regulation. Contrary to binding obligations which enhance standardisation, compliance and enforcement, self-regulations remain flexible in light of constant methodological and regulatory developments.

FINMA has the authority to recognise professional organisations' self-regulation as a minimum standard [23], [24, Arts. 6 and 7 para 3]. If it does so, the self-regulation does not merely apply to members of the organisation who issued it, but becomes binding for all actors in the industry, regardless of whether they are members of the association that issued the self-regulation.[8] FINMA would consequently have to implement the self-regulation in its supervision rules. FINMA's recognition is thus a tool that can encourage the dissemination of recognised standards. It harmonises and unifies the applicable standards across the industry and requires a simple and adaptive procedure. As of today, most recognised self-regulation is issued by AMAS and the Swiss Bankers Association (SBA) ([1, Sec. 4.2.2 and Appendix 3].[9] FINMA did not yet recognise any professional organisations' self-regulation relating to sustainability as a minimum standard. FINMA can only recognise norms that constitute *minimum standards*, i.e. that are generally recognised by the industry participants. When recognising such regulation, FINMA cannot impose stricter requirements than what the self-regulation norms provide [26, p. 201 N443 and references].

FINMA's recognition could be an interesting compromise between mere self-regulation and hard law to regulate sustainability-related disclosures of financial market participants, in the short term [1, Sec. 2.3.2.1]. In particular, recognition of AMAS self-regulation on transparency and disclosure for sustainability-related collective assets would make disclosure on sustainability-related information at the sustainable financial product level and on the organisation of product management at the level of financial market participant binding for all [1, App. 3]. Such a recognition would help actors adapt to disclosure requirements in the short term without the need to resort to binding state law, which is more time-consuming and difficult to adjust. However, in the author's opinion, the absence of sustainability-related disclosure requirements applicable for any type of product in AMAS self-regulation impedes the relevance and materiality of the information in the hands of investors and is therefore not, for the long-term, the most efficient framework.

[8] For example, FINMA recognised the Guidelines of the Swiss Bankers Association (SBA) on the treatment of assets without contact and dormant assets held at Swiss banks. Consequently, these Guidelines are binding for each Swiss bank, even if they are not members of the SBA.

[9] The recognised self-regulation is available online [25].

3 CLASSIFYING FINANCIAL PRODUCTS BASED ON THEIR SUSTAINABILITY CHARACTERISTICS

3.1 RULES FOR FUND NAMES AND LABELS: IS A "SUSTAINABLE FUND" A SUSTAINABLE FUND?

In 2022, jurisdictions have proposed rules for financial products with sustainability-related terms in their names as well as labels. These proposed specifications have the objective to help investors navigate the sustainable-investment landscape and reduce greenwashing through enhanced transparency. The Swiss regulator is currently looking into the matter and should publish a proposal laying out a more precise definition of sustainable financial products and services and associated requirements in fall 2023. Considering international developments, recommendations for this proposal include (1) setting a definition with minimum standards [1, Sec. 3.1.5.1] and (2) proposing a classification system for products with an impact objective and with a transition objective [1, Sec. 3.1.5.2].

In a forthcoming analysis, the recommendations and approaches proposed below will be complemented with the position of leading industry and governmental actors.

3.1.1 Setting a definition of sustainable products with minimum standards

The definition of sustainable investments outlined by the Federal Council should be more ambitious. As it stands, the Federal Council's position does not specifically require a differentiation between environmental and other sustainability objectives, nor takes into account the potential negative effects of an economic activity in which the financial product invests in the other objectives of sustainable development (Do Not Significantly Harm (DNSH) Principle) [20, p. 3]. Hence, financial products with underlying investments aligned with one sustainability goal would be considered sustainable, regardless of their potential negative impact on one or more other sustainability goals. An example could be a fund investing in coal plants with outstanding working conditions, hence contributing to social goals while aggravating CO2 pollution [27].

To be considered sustainable, financial products could comply with minimum standards, as proposed in the European Securities and Markets Authority's (ESMA) proposal and by the Autorité des marchés financier (AMF) for the SFDR [1, Sec. 3.1.2.2 and 3.1.2.3]. By establishing environmental and social criteria for sustainable financial products, the Swiss regulator would ensure that a sustainability objective does not replace another one, while by-passing a DNSH rule which can be challenging to implement.[10] Such minimum standards can include minimum safeguards of human rights, e.g. the OECD Guidelines for Multinational Enterprises, or minimum compliance with the Paris Agreement or the Kunming-Montreal Biodiversity Convention.

3.1.2 Proposing a classification system for impact and transition financing

Aligning with other jurisdictions, Swiss regulators could propose a more precise classification of financial products depending on their objective and ambition. Regulators could introduce a category for financial products with a clear impact objective, which considers more than just

[10] The DNSH criteria as defined by the EU can present some limits namely the lack of high-quality data and the lack of defined threshold for compliance [28].

sustainability risk integration (impact category), and another with a transition objective (transition category).

An impact category could include financial products that have a clear impact objective and report accordingly. Several jurisdictions have set or are setting an impact category for financial products or related disclosures: the EU with its Art. 9 [1, Sec. 2.1.1], the US with the ESG-Impact Funds [1, Sec. 2.2.1] and the UK with the Sustainable Impact label [1, Sec. 3.1.3.1] among others. The Federal Council's condition of sustainable products contributing to the achievement of a sustainability goal, touches this aspect. An impact category specifying which objective the financial product is dedicated to, could require additional disclosure requirements depending on the stated objective, similarly to what is required in the aforementioned jurisdictions [1, Sec. 3.1.3.1]. Products in the impact category could be required to publish e.g. a theory of change[11] and an escalation plan when the expected impact no longer seems plausible, as required in the FCA's proposition of a Sustainable Impact label.

A transition category would include financial products that aim to invest in projects that might not be considered sustainable from a social or environmental perspective today but have the potential to improve over time. It aims to identify companies that are transitioning and facilitate investing in them and thus promotes and encourages firms to become more sustainable, namely through active ownership. The UK FCA has recently proposed such a category, called Sustainable Improvers. Some critics however underlined its potential for becoming a "*catch-all for ESG funds, with a related risk of greenwashing*" if no extended guidance is provided for the disclosure of active ownership actions, escalation process and results [30].

To do so, the Swiss regulator could either adopt an already-existing classification system or create its own, considering interoperability of established disclosure frameworks. The Swiss regulator should build upon existing classifications to ensure a uniform understanding of the industry and avoid constantly changing definitions and interpretations. In addition, as proposed by the UK's FCA, it should ensure the harmonisation of disclosure requirements with a classification system to avoid confusion in the market, as observed in the EU [1, Sec. 2.4.3].

This classification system could take the form of name rules or labels. In the EU and in the US, the gap between investors' expectations and the real characteristics of the fund is filled by the creation of fund name rules, which are less demanding for the industry but not as investor-friendly as labels. Labels, such as suggested by the UK FCA ("Sustainable Focus", "Sustainable Improvers" and "Sustainable Impact" [1, Section 3.1.3.1 and Table 3]), are particularly attractive if the objective of the classification system is to decrease greenwashing and help investors navigate the landscape of sustainable financial products. They require additional efforts from the industry but could bring more clarity to investors. In the absence of labels, the Swiss regulator should make sure that the classification system provides minimum safeguards of sustainability - contrary to what has been proposed by the SEC - to avoid misleading investors.

[11] A theory of change is a method that explains how a given intervention, e.g. investment, is expected to lead to a specific development change, e.g. positive environmental impact, drawing on a causal analysis based on available evidence [29].

3.2 GREEN BONDS: WHAT DOES "GREEN" MEAN?

The different green bond frameworks analysed in the underlying white paper [1] **have advantages and disadvantages**. The voluntary Green Bond Principles (GBP) are widely accepted by the industry but might mislead investors as they do not provide any guarantee on the quality of the green bond [1, p. 3.2.1.1]. The Climate Bond Standards (CBS) go a step further towards clarity and credibility: they ensure that the use-of-proceeds respect the requirements set by the CBS through certification of the green bonds [1, Sec. 3.2.1.2]. The Chinese Green Bond Catalogue provides a list of eligible activities for green-bond financing but leaves a margin of appreciation to determine whether some economic activities fall into the list. There is no general requirement for reporting or external reviews, which impedes credibility [1, Sec. 3.2.2]. The EU Green Bond Standards (EUGBS), if adopted, would constitute the most demanding framework for green bond issuance. In addition to having to contribute to an environmental objective, the eligible economic activities must respect the Do No Significant Harm (DNSH) Principle, the Technical Screening Criteria, and minimal safeguards. However, the EUGBS is a complex framework and difficult to apply [1, Sec. 3.2.3]. In this context, for the time being, Switzerland should not necessarily develop new Swiss criteria for eligible activities of corporate green bonds, but rather encourage the market-based approach applied in the issuance of the Swiss Green Sovereign Bonds and promote green-bond certifications, while closely following the international harmonisation attempts around the Common Ground Taxonomy.
These recommendations and approaches proposed below will be complemented with the position of leading industry and governmental actors in a forthcoming analysis.

Switzerland would not necessarily have to develop Swiss criteria for eligible activities. The foreign frameworks and international standards already implemented and used by the industry provide sufficient indications and flexibility to identify the projects which could be eligible for green-bond financing. Considering that Switzerland's green-bond market is relatively small,[12] the advantage resulting from developing and adopting an extended Swiss-made green-bond taxonomy would probably be low compared to the related costs [32, p. 89 ff and 93]. If it were to define such a taxonomy, it should however be based on the definition of "sustainable investment product and service" that is currently being developed by the Federal Council in order to ensure harmonisation and coherence.

The Swiss regulators should rather support the market-based approach applied in the issuance of the Swiss Green Sovereign Bonds. The Swiss Green Sovereign Bonds follow the GBP and, as such, (1) have their proceeds allocated to eligible green projects which should contribute to the achievement of an environmental objective; (2) provide a pre-issuance external review assessing the alignment with the chosen green-bond standard; and (3) provide post-issuance external reviews verifying how the use-of-proceeds have been allocated. Its pre-issuance external review also provides an indication of (4) the consistency of the green bond with the issuer's sustainability strategy.[13] This fourth aspect is particularly relevant for reducing greenwashing risk and increasing trust in the green-bond market. Without it, an issuing firm could, for instance, use the proceeds of its green bond to finance the refurbishment of a

[12] The size of Swiss green-bond market is of USD 12.1 bn, compared to USD 380 bn in the US [31].

[13] This could include e.g. the assessment of the credibility of net-zero transition plans of the issuer's verticals.

commercial building for improving energy-efficiency, while offering indoor skiing services in this same building.

The Swiss regulators should also promote green-bond certifications. Green-bond certifications set guarantees for the quality of the green bond. An additional certification targeting the issuer and not the allocation of use-of-proceeds of the green bonds, as offered by the Climate Bond Initiative (CBS Entity Certification), could provide an indication of the consistency between the issuer's strategy and the green bond. This, however, imposes an additional administrative burden.

4 INTEGRATING THE SUSTAINABILITY PREFERENCES OF CLIENTS IN THE ADVISORY SERVICES

Investors shall have access to investments that match their sustainability preferences. Regulation can help ensure that advisers require and integrate clients' sustainability preferences in the advisory process. Recommendations to the Swiss regulators include (1) introducing common requirements applicable to all financial advisers for the explicit request and integration of clients' ESG preferences in the advisory process, and (2) providing education on sustainability investment opportunities to investors. In a forthcoming analysis, we will complement the recommendations and approaches proposed below with the position of leading industry and governmental actors.

Introducing common requirements applicable to all financial advisers for the explicit request and integration of clients' ESG preferences in the advisory process. In the EU, financial advisers must explicitly inquire their clients' ESG preferences and take them into account in their activities [1, Sec. 4.1]. In Switzerland, state law does not require advisers to take into account sustainability [1, Sec. 4.2.1]. However, professional associations have issued sector-specific self-regulation explicitly requiring advisers to request and integrate client preferences into the advisory process from 2023 on [1, Sec. 4.2.2]. Yet, the SBA self-regulation does not apply to all financial advisers active in Switzerland. The inclusion of a respective requirement in the Financial Services Act (FinSA) would also increase the likelihood of an equivalency decision by the EU on MiFID II and facilitate Swiss financial advisers' activities in the EU.

Providing education on sustainability-related investment opportunities to investors. Financial advisers are mandated to provide investors the financial advice and services they need. In that regard, they may provide information and to some extent, education on ESG investment opportunities. Yet, other channels should be used to explain to investors what sustainable investment opportunities they have and how the financial system works so that they can understand its mechanisms. Further support should thus be granted to general sustainability and financial education for the general public. Respective classes in schools and public media formats should support mainstreaming an understanding of sustainable finance for all citizens, since collective efforts are needed to orient financial flows towards sustainable products.

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