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ESAs Propose Changes to SFDR Level 2

April 2023

Having filed updated pre-contractual disclosures to comply with the Level 2 requirements under the Sustainable Finance Disclosure Regulation ("**SFDR**") at the end of 2022, there was no time for fund managers to rest on their laurels. Further changes to the mandatory disclosure templates to include disclosures on EU Taxonomy-aligned investments in fossil gas and nuclear energy were published in February, followed by the European Supervisory Authorities ("**ESAs**") consultation paper proposing further Level 2 changes in April.

The ESAs' consultation is based on a mandate given to the ESAs by the European Commission ("**Commission**") on 28 April 2022 to review and revise the SFDR RTS, but the ESAs' proposals go beyond the terms of that mandate. (The review of the SFDR RTS is to be distinguished from the broader review of SFDR Level 1 announced by the Commission early in 2023.) The consultation addresses proposed amendments to the regulatory technical standards ("**RTS**") on principal adverse impacts ("**PAI**") and financial product disclosures under the SFDR. The main proposals include:

- expanding the list of universal social indicators for disclosing the adverse impacts of investment decisions on the environment and society and refining the content and definitions of existing PAI indicators and calculation formulae (to better align with the European Sustainability Reporting Standards and the EU Taxonomy Regulation);
- proposed changes to the do no significant harm ("**DNSH**") test;
- changes to product level disclosures, including changes to the language, layout and structure of the disclosure templates as the current templates are considered overly complicated and lengthy; and
- adding product disclosures concerning decarbonisation targets.

The ESAs are expected to issue their final report to the Commission in October 2023.

PAI Indicators

The ESAs have proposed changes to the wording of the PAIs which would align the wording with the data points in the draft European Sustainability Reporting Standards ("**ESRS**"). Additional social indicators have also been proposed, to include impacts relating to earnings in non-cooperative jurisdictions, the cultivation and production of tobacco and employees earning less than an adequate wage. The proposed amendments also included targeted changes to some of the existing indicators, including the introduction of new formulae for PAI that do not already have them.

The draft RTS would also propose applying the social PAI indicators to the managers of real estate assets, that is either the financial market participant (“**FMP**”) or any other company hired to manage the asset. The amendments would further align the indicators with regard to inefficient real estate assets with the EU Taxonomy Regulation technical screening criteria (“**TSC**”).

GHG Reduction Targets

Where a product has a GHG reduction or decarbonisation target, the ESAs have proposed further pre-contractual and website disclosures which would require information on intermediate targets and milestones and actions pursued to meet such targets. If a product does not have a decarbonisation target, it must disclose this. In the view of the ESAs, methodological standardisation regarding the disclosure of targets has important benefits for investors as they assess or compare products and monitor progress.

DNSH Disclosures

The ESAs note that the definition of “sustainable investment” in the SFDR leaves significant discretion to FMPs in how they assess the criteria an investment must meet in order to qualify as sustainable. In particular, compliance with the DNSH principle leaves room for discretion – financial products have to describe how they “take principal adverse impact … indicators into account” to demonstrate that their investments respect the DNSH principle, but “taking into account” remains undefined. The ESAs’ view this as potentially undermining the comparability of products and increasing the risk of greenwashing. The ESAs are therefore considering more specific disclosure requirements regarding PAIs when applying the DNSH test for sustainable investments, in order to increase transparency and to support comparability.

The ESAs point out that the approach taken in the SFDR to applying the DNSH test to assess whether an investment is a sustainable investment differs to the approach adopted under the TSC pursuant to the EU Taxonomy Regulation. The TSC are tailored to specific economic activities and apply at economic activity level whereas the DNSH principle under the SFDR is based on PAI that are sector-agnostic and apply at investment level. The ESAs observe that these differences could lead to the anomalous result that a company may have a proportion of its economic activities aligned with the EU Taxonomy, while investing in its equity does not qualify as a sustainable investment under the SFDR. The ESAs believe that Level 1 reform is necessary in order to resolve the inconsistencies between the two parallel concepts of sustainability in the SFDR and the EU Taxonomy Regulation. The Commission indicated in January 2023 that it would conduct a comprehensive assessment of the SFDR and the ESAs will consider submitting an opinion to the Commission in relation to that assessment. Various alternative approaches are put forward by the ESAs, including leaving the provisions of the SFDR RTS unchanged, providing more specific disclosures including disclosing quantitative thresholds related to the PAI indicators and introducing an optional safe harbour for environmental DNSH of Taxonomy-aligned activities. An optional safe harbour would mean that certain economic activities that comply with the EU Taxonomy Regulation do not require further DNSH disclosures.

In the long term, the co-legislators may wish to consider shifting to a single taxonomy-based system for DNSH. Should the two parallel concepts of sustainability under the SFDR and the EU Taxonomy be retained, the ESAs think that the EU Taxonomy TSC should form the basis of the DNSH assessments under the SFDR.

Derivatives

In implementing the SFDR, questions have arisen in relation to the treatment of derivatives in: (a) the calculation of PAI indicators; and (b) the calculation of the proportion of investments that are sustainable investments or taxonomy-aligned investments.

In the calculation of PAI indicators, the ESAs have proposed that any derivatives with an equivalent long net exposure would be included in the numerator of the PAI indicator, unless it can be shown that the derivative did not ultimately result in a physical investment in the underlying security by the counterparty or any other intermediary in the investment chain.

The ESAs' view is that taking into consideration derivatives in calculating the proportion of investments that are "sustainable investments" or EU Taxonomy-aligned investments is paramount to avoid greenwashing. In carrying out these calculations, the ESAs have suggested that net long positions achieved only through derivatives should not be taken into account. However, the numerator should take into account short positions achieved through derivatives to reduce the net long exposure on a given issuer.

The ESAs have proposed that net short exposure on a given issuer cannot be taken into account and therefore the proportion of Taxonomy-aligned investments can never be negative at the level of the individual issuer.

Changes to Templates

It is noted in the consultation paper that the mandatory templates have frequently been criticised for their excessive length and the complexity of the information presented. With a view to simplifying the language used to enhance comprehensibility for retail investors, the ESAs have proposed the introduction of a dedicated dashboard of key information to complement the more detailed information in the pre-contractual and periodic disclosures. The inclusion of the dashboard in the templates is intended to attract attention to vital information and avoid information overload. The dashboard would include a bar chart showing the minimum commitments of: (1) investments used to promote E / S characteristics or sustainable investment objectives; (2) sustainable investments; and (3) Taxonomy-aligned investments, as well as disclosures on PAI consideration and GHG emissions reduction (ie, decarbonisation targets). Green icons would be used by products making sustainable investments, Taxonomy-aligned investments or considering PAI whereas grey icons would be used by other products.

Technical Amendments

Feedback is sought on a number of other proposals, including:

- providing that the colours used in the templates cannot be changed;
- clarifying the test to be met in order to use "equivalent information" or estimates provided by investee companies or third party providers;
- whether further specifications are required to calculate the proportion of sustainable investments;
- allowing the display of pre-contractual and periodic disclosures in an electronic format to be extendable on click; and
- providing machine readable disclosures.

Comment

The consultation includes 43 questions in total and sets out the revised draft RTS in full. The ESAs expect to issue advice to the Commission by the end of October 2023. The advice will then be considered by the European Parliament and the Council of the EU, after which the revised RTS will be published in Official Journal of the EU. The deadline for responses to this consultation was **4 July 2023**.

Clarifications of key requirements under the SFDR and efforts to ensure consistency between the EU Taxonomy, the SFDR and the reporting data points in the CSRD are all to be welcome, although the misalignment of timing of the various requirements continues to cause issues and it remains the case that not all investee companies will be in scope of the CSRD. However, further changes at this stage, before sufficient time has passed to assess the initial implementation of the requirements, causes market disruption and presents challenges. The ESAs acknowledge in the consultation that the SFDR RTS only became fully applicable on 1 January 2023, FMPs may not have had an opportunity as yet to become used to the disclosures and the EU Taxonomy needs more time to become more usable and used by companies. The incremental nature of the changes requires FMPs to revisit their disclosures on multiple occasions, whereas holding off on further Level 2 changes until a full comprehensive assessment of the SFDR has taken place may be the preferred option. At a minimum, any changes to the RTS should be timed to align with the application of the reporting requirements under the CSRD.

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