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EU ESG: ESAs Consults on Amendments to SFDR Regulatory Technical Standards

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TO: ICI Global Members

EU Sustainable Finance Disclosure Regulation Working Group

Europe Regulatory and Policy Committee SUBJECTS: ESG

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On April 12, 2023, the European Supervisory Authorities (ESAs)[\[1\]](#) released a consultation paper[\[2\]](#) seeking feedback on amendments to the Regulatory Technical Standards (RTS) under the Sustainable Finance Disclosure Regulation (SFDR). The consultation is in response to a mandate[\[3\]](#) from the European Commission in April 2022 to review the principal adverse impact (PAI) indicators and propose amendments to the product-level disclosure on greenhouse gas (GHG) emission reduction targets. Going beyond the mandate, the ESAs also propose amendments to the "do no significant harm" (DNSH) assessment for sustainable investments, simplifications of the product-level disclosure templates, and other technical adjustments to improve the current SFDR framework.[\[4\]](#)

The consultation on the SFDR RTS amendments will close on July 4, 2023. The ESAs expect to submit the draft amendments to the Commission in Q4 2023.[\[5\]](#) This timeline could translate into new templates and reporting requirements entering into force as early as mid-2024. ICI Global intends to submit comments on this consultation.

PROPOSED AMENDMENTS TO PAI INDICATORS DISCLOSURE FRAMEWORK

Expand the List of Social PAI Indicators

In view of an environmental focus of the current entity-level PAI disclosures, the ESAs propose adding four new mandatory social PAI indicators that asset managers, among other financial market participants, will be required to disclose at the entity level,[\[6\]](#) and introduce six voluntary social PAI indicators.[\[7\]](#) The ESAs acknowledge the lack of information on social issues currently reported by companies, and note that companies captured by the EU Corporate Sustainability Reporting Directive (CSRD) will be required to report these metrics. However, the Consultation Paper does not address the obvious

additional data gaps. Companies outside of the CSRD framework will not be required to report using the European standards, and further delays to CSRD implementation will mean that even within the EU this data will not be available for several years.

Align Existing Social PAIs with the Minimum Safeguards in the EU Taxonomy

To improve consistency with other pieces of sustainable finance legislation, e.g., the EU Taxonomy Regulation, the ESAs propose amending the two existing social PAIs that are in relation to the UN Global Compact principles and Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.^[8] As a result, these two social PAIs will refer to the same international standards on which the minimum safeguards in the EU Taxonomy Regulation are based.

Provide Technical clarifications to PAI Indicators

The ESAs propose a number of technical changes or clarifications to the definitions and methodologies for calculating current indicators. They also propose new formulas for PAI indicators that do not currently have prescribed formulas.

Treatment of Derivatives. The ESAs note that excluding derivative exposure may underestimate the adverse impact of an investment decision. Hence, they propose that derivatives with an equivalent long net exposure should be included in the numerator of the PAI indicators. In other words, such exposures will be treated as having potential principal adverse impacts. Yet, where an asset manager shows that the derivative does not ultimately result in a physical investment in the underlying security by the counterparty, the asset manager may consider such derivative investment does not result in an adverse impact, and therefore, will be allowed to exclude the relevant derivative investment from the numerator. This proposed approach could have implications to the treatment of derivatives under the EU Taxonomy Regulation. Under the current Taxonomy requirements, derivatives are excluded from the numerator of key performance indicators (KPIs) of asset managers in view of their use to mitigate counterparty risk rather than for financing or investment.

Treatment of Investee Companies' Value Chain. The ESAs propose clarifying that, where either the investee company is disclosing the adverse impacts of its value chains under the CSRD, or that information is otherwise readily available, asset managers should consider the adverse impacts within investee companies' value chain in the PAI calculations. This proposed provision would not be applicable the Scope 3 GHG emissions.

PROPOSED AMENDMENTS TO DNSH ASSESSMENT

Strengthen Disclosure on DNSH Assessment based on PAI Indicators

Under the current SFDR RTS, financial market participants are required to assess the "sustainability" of an investment and describe how PAI indicators are taken into account to demonstrate compliance with the principle of DNSH. The ESAs are concerned that the current requirements leave significant discretion to financial market participants in assessing compliance of their investments with DNSH principles, which may undermine the comparability of financial products and potentially lead to greenwashing. Hence, going beyond the Commission's mandate, the ESAs propose enhancing the DNSH assessment by requiring financial market participants to disclose the quantitative thresholds they used when assessing DNSH with reference to the PAI indicators.

Optional Safe Harbor for Environmental DNSH Assessment

The ESAs are also concerned about the disconnection between the use of environmental PAIs in the SFDR DNSH assessment, which applies at the investment level and is sector-agnostic, and the DNSH criteria in the EU Taxonomy Regulation, which applies at the economic activity level and is sector-specific. The ESAs point out the result of this disconnection is that a company may have a proportion of its economic activities aligned with the EU Taxonomy Regulation, while investing in its equity does not qualify as a sustainable investment under SFDR. They propose a safe harbor such that Taxonomy-aligned investment will be deemed to pass the SFDR environmental DNSH assessment. Such provision will be optional such that financial market participants may decide whether to apply the general approach of SFDR DNSH to all activities of the investee companies.

This is similar to the proposals ESAs had consulted when preparing the draft SFDR RTS on taxonomy-related disclosures, which they later decided a derogation from general SFDR DNSH requirements for Taxonomy-aligned investment was not feasible. While the proposed safe harbor provision only concerns environmental DNSH assessment, i.e., a separate DNSH assessment against the SFDR social indicators would still be necessary for Taxonomy-aligned investment, the ESAs view the safe harbor proposal to be feasible at this time.

Suggestions for the Broader SFDR Framework Review

The ESAs note that the inherent inconsistencies between the two parallel concepts of sustainability in the EU Taxonomy Regulation and SFDR would require fundamental changes to the SFDR framework to resolve. They suggest the co-legislators consider moving towards a single taxonomy-based system for DNSH during the upcoming broader review of the SFDR. In ESAs' view, the more detailed, activity-level technical screening criteria of the EU Taxonomy Regulation should form the basis of SFDR DNSH assessment.

PROPOSED AMENDMENTS TO SFDR PRODUCT-LEVEL DISCLOSURES

Require Product-level Disclosure on GHG Emissions Reduction Target

As requested by the Commission's mandate, the ESAs propose new requirements on GHG emission reduction targets for pre-contractual, periodic, and website disclosures. Such new disclosures will only apply to financial products with GHG emissions reduction targets, and Article 9(3) financial products having GHG emissions reduction as their investment objectives.

Relevant financial products will be required to describe in the pre-contractual disclosures how the investment strategy will help deliver the GHG emissions reduction targets, and provide information on the baseline GHG emissions of the financial products, the intermediate and final targets, as well as the corresponding expected date for achieving these targets. An explanation and details of planned corrective actions will be required in cases where there are potential delays in meeting the targets. Financial products will need to provide more detailed disclosures on the actions planned to achieve their GHG emission reduction targets in website disclosures. To align with the CSRD, disclosure of GHG emissions reduction targets should only reflect the gross GHG emissions of the investments. Any GHG removals and the use of carbon credits should be disclosed separately.

Introduce a "Dashboard" of Key Information in Pre-Contractual and Periodic Disclosures Templates

The ESAs acknowledge the excessive length and complexity of the information currently required in the SFDR pre-contractual and periodic disclosure templates. Hence, despite being beyond the scope of the Commission's mandate, the ESAs reviewed the current disclosure templates, and propose adding a "dashboard" of key information at the start of the templates, which will summarize major disclosure items, for instance, the minimum sustainable investments and minimum Taxonomy-aligned investments. The proposed dashboard is intended to provide simplified disclosures to investors, along with the more detailed information available further in the document for more sophisticated investors. The ESAs also propose adjustments to the language in the templates and reduce the use of technical terms in order to enhance comprehensibility for retail investors.

Allow the Use of Estimates for Calculating Taxonomy Alignment

In the current version of the SFDR RTS, asset managers may rely on "equivalent information" from investee companies or third-party providers if the Taxonomy-alignment of investments is not available from the public disclosures of investee companies. The ESAs propose replacing "equivalent information" with "estimates," thus aligning with the wordings in the EU Taxonomy Regulation. This would also remove the implication that estimated data must be equivalent to information reported by investee companies. The ESAs further seek feedback on how the data provided by the investee companies or third-party data providers could be used to estimate the corresponding Taxonomy alignment percentages.

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Notes

[1] There are three ESAs, namely, European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA).

[2] See Joint Consultation Paper on the Review of SFDR Delegated Regulation regarding PAI and financial product disclosures ("Consultation Paper"), April 12, 2023, available at <https://www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation>.

[3] See Europe Commission Letter to ESAs on Amendments to Regulatory Technical Standards under the Sustainable Finance Disclosure Regulation 2019/2088, dated April 11, 2022, available at https://www.esma.europa.eu/sites/default/files/library/mandate_to_esas_on_pai_product.pdf.

[4] Notably, this consultation is separate from the upcoming broader review of the SFDR, announced by the European Commission in December 2022 in a hearing in the European Parliament. The review is expected to lead to a reevaluation of the framework and a more

fundamental review of Level 1 legislation. ICI Global is developing position papers to inform the Commission's work on this.

[5] See ESAs Letter to European Commission on Delay in Delivery of Mandate to Review the Principal Adverse Impact Indicators and Financial Product Disclosures in the SFDR Delegated Regulation, dated October 26, 2022, available at https://www.esma.europa.eu/sites/default/files/library/jc_2022_64_letter_notifying_of_delay_in_sfdr_mandate.pdf.

[6] The new mandatory social PAI indicators proposed are, namely, (i) amount of accumulated earnings in non-cooperative tax jurisdictions; (ii) exposure to companies involved in the cultivation and production of tobacco; (iii) interference in the formation of trade unions or election of worker representatives; and (iv) share of employees earning less than the adequate wage. See Consultation Paper, *supra* note 2, Overview of newly introduced mandatory social indicators, at p.8.

[7] The new voluntary social PAI indicators proposed are, namely, (i) excessive use of non-guaranteed-hour employees in investee companies; (ii) excessive use of temporary contract employees in investee companies; (iii) excessive use of non-employee workers in investee companies; (iv) insufficient employment of persons with disabilities within the workforce; (v) lack grievance/complaints handling mechanism for communities affected by the operations of the investee companies; and (vi) lack of grievance/complaints handling mechanism for consumers/end-users of the investee company. See Consultation Paper, *supra* note 2, Overview of newly introduced opt-in indicators, at p.9.

[8] PAI 10 (Violations of UN Global Compact principles and OECD Guidelines for Multinational Enterprises) and PAI 11 (Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises).