Is the market ready for SFDR 1.5? ESAs propose changes to SFDR RTS

JUNE 22, 2023

On 12 April 2023 – less than four months after the RTS[1] under SFDR[2] came into effect and four weeks after a further amended version of the RTS went live[3], the European Supervisory Authorities (ESAs)[4] published a consultation paper (the **Consultation**)[5] proposing further significant amendments to the RTS.

On 6 June 2023, the ESAs held an all-day public hearing on the Consultation. The overarching message conveyed – in addition to explanations and responses to questions on a myriad of topics, including many that were not actually covered by the Consultation – was that the ESAs are keen for feedback on the Consultation. If the industry believes the proposals are not workable, the ESAs are looking for alternative suggestions. In the words of Patrik Karlsson of ESMA, the ESAs are "in the market for solutions". The ESAs are aware that the RTS (and indeed SFDR) is not perfect, but they are looking to stakeholders to help them improve the RTS within the constraints of the review mandated by the Commission.

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Consultation's direction of travel are advised to consider responding – either directly or through industry associations.

The Consultation and proposed changes

The Consultation is the result of an April 2022 mandate[6] from the Commission (the **Mandate**) requesting the ESAs review specific elements of the RTS, as opposed to a general review of the entire RTS. The amendments proposed are, accordingly, constrained by the text of SFDR and the ESAs have noted that they "welcome the 'comprehensive assessment' of SFDR announced by the Commission in January 2023". Against this backdrop, it is fair to say that additional changes can be expected.

The Consultation proposes the following changes:

1. Extension of the list of the mandatory principal adverse impacts (PAI) for social indicators and of the voluntary adverse impact social indicators;
2. Refinement of the content of a number of the other PAIs and their respective definitions, applicable methodologies, metrics and presentation;
3. Introduction of decarbonisation (the ESAs' preferred term is "GHG7 emissions reduction") targets.
4. Changes to the approach to the "do no significant harm" (DNSH) principle; and
5. Simplification of the pre-contractual and periodic disclosure templates.

Some proposed areas of change to highlight

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The proposal – The ESAs are proposing additional mandatory and voluntary social indicators, covering: earnings from non-cooperative tax jurisdictions; cultivation and production of tobacco; interference in workers forming trade unions; employees earning a less than an adequate wage; excessive use of non-guaranteed hours contracts of temporary contracts workers and of non-employee workers; low number of workers with disabilities; lack of grievance/complaints handling mechanism for communities impacted by investee companies' operations and for consumers/end-users of the investee company.

The ESAs also propose technical revisions to the PAI framework including new formulae for those PAIs that did not have them, and technical changes or clarifications to the current indicators. For example, the ESAs have asked the question of whether the social PAI indicators could apply to real estate assets through the entity managing the real estate. They have also proposed a new definition of "inefficient real estate asset" to align it with the DNSH analysis under the Taxonomy Regulation[8].

The ESAs also make proposals with regard to the treatment of derivatives and how netting of derivative positions to ensure that PAI calculations reflect the investment decisions made by the financial market participant (**FMP**). The ESAs' intention is to avoid circumvention of PAI reporting by FMPs entering into derivative transactions in order to artificially lower their PAIs.

The impact – FMPs are already struggling to get to grips with the current PAIs, and changing the status quo and calculation methodology at this stage is unlikely to be welcomed. The technical revisions proposed with regards to the introduction of additional analysis and data but may also require adjustments to newly built systems and controls. This will entail a significant cost to FMPs – in terms of both time and money – without any immediately obvious benefit.

Another point to note is the increased focus on social PAI. It is interesting to see that one of the new proposed mandatory social indicators relates to the tax jurisdiction of an investee company. This indicator seeks to assess a company's profit in countries on the EU list of non-cooperative jurisdictions for tax purposes. It is not immediately apparent why this indicator is needed and arguably it seems to go more to the "G" – governance – of ESG than the "S" – social.

Real estate managers should review the proposed changes to the "inefficient real estate" PAI carefully. These proposed changes would mean that any real estate held that was built before 31 December 2020, which has an energy performance certificate (**ECP**) below C and which is not within the top 30 percent of building stock that is primary energy on demand (**PED**) (as demonstrated by "adequate guidance") would need to be reported in a negative light under PAI reporting. This could be seen to further undermine the ability for a manager to market a brown to green strategy as Article 8 compliant – a deficiency that has already been flagged as a flaw, including by the French regulator (the Autorité des Marchés Financiers (**AMF**)).[9]

In addition, although the ESAs have not, for the time being, used the ESRS[10] as a basis for the PAI formulae, it seems that the direction of travel is to use these in the future. It is not clear how global investors would be able to gather the requisite information given that the ESRS are not globally applicable.

The proposal – the definition of "sustainable investment" per Article 2(17) of SFDR leaves significant discretion to FMPs as to how they assess whether an investment qualifies as sustainable and how they disclose it. The DNSH principle also leaves room for discretion. Firstly, financial products have to describe how they "take principal adverse impact ("PAI") indicators into account" to demonstrate that their investments respect the DNSH principle. FMPs, as is noted in the Consultation, "cannot rely on predefined, common criteria in order to assess compliance of their sustainable investments with the DNSH principle". With 'taking into account' being undefined, FMPs have discretion about the criteria they will apply when conducting the assessment. The discretion means that there is limited comparability between financial products and the ESAs are concerned that this could lead to greenwashing of sustainable investments.

There is a parallel concept of sustainable under Article 3 of the Taxonomy Regulation in relation to environmentally sustainable investments. (In the absence of a social taxonomy, there is no equivalent requirement for 'social' investments.) However, satisfying the environmental sustainability criteria set by the Taxonomy Regulation does not automatically mean that the same investment is a 'sustainable investment' under the SFDR.

The ESAs are proposing a "safe-harbour for environmental DNSH" for investments in certain categories of economic activities considered as environmentally sustainable under Article 3 of the Taxonomy Regulation. The ESAs' proposal is to include a standardised statement that certain economic activities that meet the DNSH test under the Taxonomy Regulation are not required to make further environmental specific economic activities of an investment which was Taxonomy aligned, not the totality of the investment).

The ESAs are also seeking comment on whether disclosure of more granular information regarding PAI indicators, including the quantitative thresholds taken into account as part of an FMPs DNSH analysis, should be disclosed as part of a product's Article 10 website disclosure in order to permit better transparency and comparability between financial products.

The impact – With regard to the safe-harbour, the ESAs themselves note this would apply only to the part of investee companies' activities that are aligned with the Taxonomy Regulation. This proposal could therefore result in additional complexity due to the separate treatment of Taxonomy-aligned economic activities and other non-Taxonomy-aligned activities of an underlying investment. In addition, the analysis of an investment under the technical screening criteria of the delegated acts under the Taxonomy are extremely detailed and technical and the nature of the data required to undertake the analysis means that to the extent it is practical to carry out this analysis at all, it is probably only going to be achievable for investments in EU companies.

The ESAs' other proposal relating to DNSH is to require more specific disclosure, including thresholds. While discretion always raises the risk of greenwashing, it is also consistent with the fact that the strategies and jurisdictional scope of investment products is wide and varied. Requiring FMPs to predefine thresholds which do not vary across industries, sectors or jurisdictions, particularly where a strategy may provide for a global and unrestricted universe, is impractical.

complex and will not necessarily clarify matters for the average investor.

Simplification of the pre-contractual and periodic disclosure templates

The proposal – As part of the Mandate, the ESAs have once more reviewed the pre-contractual and periodic disclosure templates set out in Annexes II to V of the RTS. In the Consultation the ESAs note that the templates have been criticised frequently for the excessive length and complexity of the information presented. The proposals include further changes to the language, layout and structure.

To enhance retail investors understanding of the information being provided, the ESAs are proposing a dashboard of the of key information at the beginning of the Annexes in order to complement the more detailed information provided. The dashboard would identify whether the financial product has a sustainable investment objective (Article 9 of SFDR) or promotes environmental/social characteristics (Article 8 of SFDR), identify the "minimum commitments" of (1) investments used to meet environmental/social characteristics or sustainable investment objectives; (2) sustainable investments; and (3) Taxonomy-aligned investments, presented in the form of a bar chart. The graph in the asset allocation section of the templates would then be removed.

The impact – the templates were only introduced in January 2023 and have already been amended once. Requiring FMPs to revisit and redraft pre-contractual disclosures again in such short order will further add to the already significant cost and time that has been spent on SFDR implementation. In addition, there is a risk that attempting to simplify what, in although a dashboard may seem a small addition, it would require another significant systems uplift and further amendment to processes and controls to monitor the accuracy of the information. All against the backdrop of potentially even more changes coming from the Commission's wider review of the SFDR itself.

Conclusion

While there are arguably strong reasons for amending the RTS, there is perhaps an even stronger argument for retaining the status quo – at least until the Commission's broader review of SFDR is completed. The lack of stability of the rules and requirements – with which it is already challenging to comply – poses real issues for FMPs. Systems uplifts take time and money, and the volume of information that personnel need to absorb and apply, to say nothing of the data that needs to be obtained to properly disclose, means that a complex area risks becoming even more so without any measurable benefit to the end investor.

Footnotes

1) Commission Delegated Regulation (EU) 2022/1288, setting out the regulatory technical standards under the SFDR.

2) Sustainable Finance Disclosures Regulation (EU) 2019/2088.

3) Commission Delegated Regulation (EU) 2023/363.

4) The ESAs are the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and

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5) The Consultation is available here.

6) The letter setting out the mandate is available here.

7) "GHG" being greenhouse gas.

8) Regulation (EU) 2020/852.

9) The AMF proposals are available here. We discuss the AMF's proposals in our OnPoint, available here.

10) These are the European Sustainability Reporting Standards published by the European Financial Reporting Advisory Group (EFRAG) in November 2022, mandated by the Corporate Sustainability Reporting Directive (Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting).

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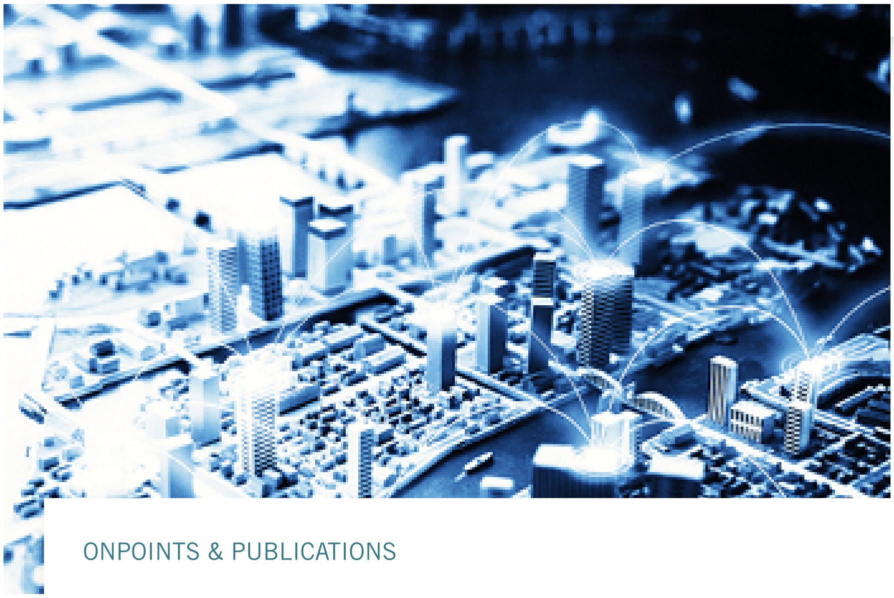

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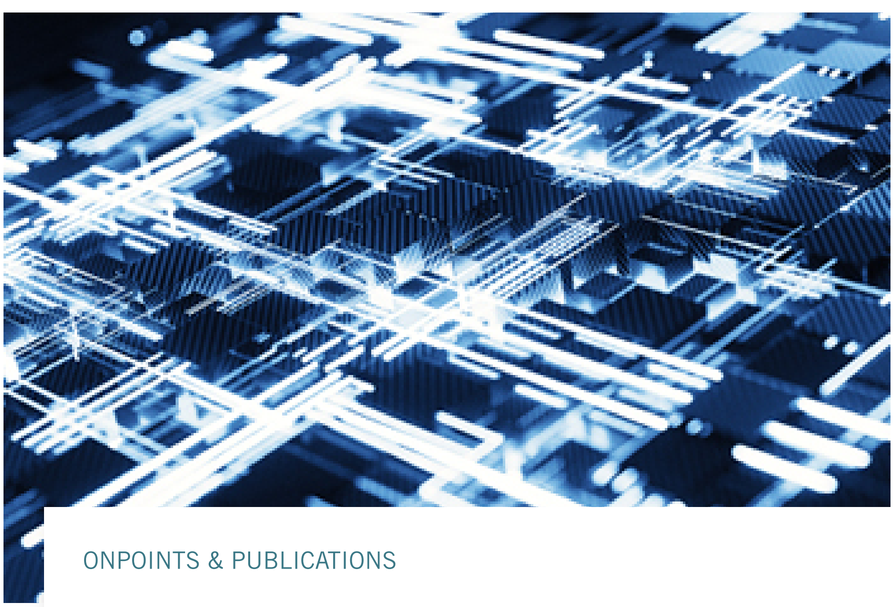

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