

ASSET MANAGEMENT & INVESTMENT FUNDS

## ESAs Joint Consultation on the review of the SFDR Delegated Regulation

The European Supervisory Authorities (**ESAs**) recently issued a consultation paper (**CP**) containing proposals to amend the disclosure requirements of the Sustainable Finance Disclosure Regulation (**SFDR**) Delegated Regulation<sup>1</sup> (**RTS**).

The ESAs issued the CP in response to a mandate from the European Commission (**EC**) to undertake a review of the RTS, aimed at broadening the disclosure framework and addressing the main technical issues that have emerged since the SFDR was originally agreed.

8 MIN READ

<sup>1</sup> Commission Delegated Regulation (EU) 2022/1288 as replaced by Corrigendum and as amended by Commission Delegated Regulation (EU) 2023/363



To meet the EC’s request, the ESAs are proposing:

- an extension of social indicators for Principal Adverse Impacts (PAIs)
- refinement of a number of other indicators for PAIs
- amendments regarding greenhouse gas (GHG) emissions targets

In addition to the guiding principles suggested by the EC, the ESAs have used their post SFDR implementation learnings to go further in their review of the RTS proposing:

- changes to the existing disclosures of “do no significant harm” (DNSH), currently considered as leaving too much discretion to financial market participants (FMPs)
- simplifications of the RTS disclosure templates to be more easily understood by retail investors
- other technical adjustments intended to facilitate the use of the RTS templates and the application of the RTS

Social indicators for PAIs

The ESAs propose to enhance and extend the list of social PAIs indicators in Annex I, Table I of the RTS. The ESAs address data challenges by basing the definition of the new mandatory social indicators on the first set of draft European Sustainability Reporting Standards (ESRS). The ESRS will have to be reported by all companies falling within the scope of the Corporate Sustainability Reporting Directive<sup>2</sup> (CSRD).

The ESAs have also proposed additional mandatory and opt-in indicators which are not, for the time being, reported under ESRS.

New mandatory social indicators

- amount of accumulated earnings in non-cooperative tax jurisdictions (not an ESRS disclosure)
- exposure to companies involved in the cultivation and production of tobacco
- interference in the formation of trade unions or election of worker representatives
- share of employees earning less than the adequate wage

New opt-in indicators

- excessive use of non-guaranteed-hour employees in investee companies
- excessive use of temporary contract employees in investee companies
- excessive use of non-employee workers in investee companies
- insufficient employment of persons with disabilities within the workforce
- lack of grievance/complaints handling mechanism for communities affected by the operations of the investee companies
- lack of grievance/complaints handling mechanism for consumers/end-users of the investee company

<sup>2</sup> Corporate Sustainability Reporting Directive (CSRD) – 2022/2464/EU



Other proposed changes include aligning the wording of PAI indicators to the data points under the ESRS and replacing the UN Global Compact Principles with the UN Guiding Principles and ILO Declaration on Fundamental Principles and Rights at Work. The ESAs also include a new indicator measuring the adverse impact of exposure to companies involved in the cultivation and production of tobacco in line with the exclusions under the Climate Benchmarks Delegated Regulation.

For real estate assets, the ESAs propose introducing a social PAI indicator to investment in real estate assets which would apply to the entity managing the relevant real estate asset. The ESAs suggest that this could either be the FMP or any company it hires to manage the asset. The ESAs in the CP also deliberate on the possibility of extending the definition of ‘inefficient real estate assets’ built before 31 December 2020 and to further align it with the EU Taxonomy Regulation (EU Taxonomy)<sup>3</sup>.

Finally, the ESAs seek comments about whether the definition of ‘enterprise value’ in point (4) of Annex I of the RTS has any impact with regard to the definition of ‘current value of investment’ in the same Annex.

### Derivatives calculations

The CP considers the treatment of derivatives in relation to three different calculations, which the ESAs consider paramount to avoid greenwashing:

- the proportion of taxonomy-aligned investments
- the proportion of sustainable investments of a financial product
- the information on PAIs

The ESAs highlight the risk of greenwashing in relation to these derivatives calculations. For taxonomy-alignment and the share of sustainable investments calculations, the ESAs explain that the risk arises from FMPs including derivatives in the numerator in order to overestimate the products’ taxonomy-alignment or share of sustainable investments. Conversely, for PAI indicators, the risk arises from the exclusion of derivatives from the numerator in order to underestimate the PAI indicators.

### EU Taxonomy-alignment

The ESAs clarify that in accordance with recital 22 of the RTS, 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 long net exposure on a given issuer. While the netting provision of Article 17(1)(g) of the RTS addresses this risk, the ESAs note that this currently focuses on equity and sovereign exposures only and the ESAs therefore seek feedback on whether there is a need to clarify that netting may be performed on other asset classes as well.

The ESAs are of the view that for net short exposure to an issuer, displaying a negative proportion of taxonomy-aligned investments would not fit with the actual investments. Therefore, the ESAs seek feedback on their existing published position, which provides that this proportion can never be negative at the level of an individual issuer. This question is also raised in relation to the impact of derivatives on the calculation of “sustainable investments”.

<sup>3</sup> Regulation (EU) 2020/852





***Sustainable investments***

In calculating the proportion of investments which are “sustainable investments”, the ESAs propose that the numerator should take account of short positions achieved through derivatives. Since there is currently no provision applicable to sustainable investment in relation to derivatives, the ESAs seek feedback about applying the netting methodology provided in RTS Article 17(1)(g).

The ESAs have also requested feedback on whether there is a need to extend the provisions of paragraph 1 of Article 17(g) of the RTS to other asset classes beyond equities and sovereigns.

***PAIs***

The ESAs note that, under the UCITS Directive and AIFMD, derivatives are converted into an equivalent position in the underlying asset to measure the exposure to the underlying assets and their contribution to the risk profile of the investment fund.

The ESAs proposed approach is to require the inclusion of any derivative with an equivalent long net exposure in the numerator of the PAI indicator. The ESAs approach is aimed at avoiding the circumvention of PAI reporting by FMPs who enter derivative transactions to artificially lower their PAIs. This is because in such cases the transaction would have resulted in financing the adverse impacts identified in the indicators.

Where FMPs can show the derivative does not result in a physical investment in the underlying security by a counterparty or other intermediary, the FMP would be allowed to consider that the derivative investment does not result in an adverse impact. The FMP should therefore be allowed to exclude the derivative from the numerator. The ESAs explain that this would not affect the calculation of the denominator, which should always include all investments including derivatives. The CP includes further discussion of the meaning of “all investments”.

**DNSH**

To increase transparency and support comparability between financial products, the ESAs are considering more specific disclosure requirements regarding DNSH under PAIs for sustainable investments.

The ESAs identify the current discretions around FMP’s assessment and disclosure of “sustainable investment” and DNSH as of particular concern in the case of environmental PAI indicators, due to the interlinkage with the EU Taxonomy. The ESAs highlight the difference in approach taken for the Technical Screening Criteria (TSC) for substantial contribution and DNSH of the EU Taxonomy, which are tailored to specific economic activities. Further, the TSC applies at economic activity level while the DNSH principle of SFDR applies at investment level resulting in a scenario where 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 SFDR.



Due to the inconsistencies between the parallel EU Taxonomy and SFDR concepts of environmental sustainability, the ESAs believe that Level 1 reform of SFDR is required to resolve them. The ESAs are considering contributing their view to the comprehensive assessment of SFDR announced by the EC in January 2023.

In the context of this review, the ESAs have considered several alternatives:

- no change pending the EC's assessment of SFDR
- more specific quantitative threshold PAI indicator disclosures
- optional safe-harbour for environmental DNSH of taxonomy-aligned activities
- longer-term DNSH framework issues including that Taxonomy TSCs should form the basis of DNSH assessments

### GHG emissions reductions targets

To cater to the needs of a growing number of “net-zero” commitments by financial institutions, the ESAs have proposed additional pre-contractual, periodic report

and website disclosure requirements on any product that has a GHG emission reduction target.

The suggested revised disclosure templates would include a question on whether the product has a GHG emission reduction target. If the answer is yes, then the following disclosures should be applied:

- i. Pre-contractual disclosures providing information on: the type of outcome the product is committing to achieve; the level of ambition of the target(s), in particular for Article 9, on the alignment of the target(s) with the Paris Agreement goal of limiting global warming to 1.5 degrees Celsius; the share of investments covered by the target; and an explanation of how the investment strategy will help deliver on the target(s).
- ii. Periodic reporting additional disclosures on progress to date and an explanation on how the investment strategy contributed to such progress. Periodic reports should also identify the potential delays in achieving the target(s) and potential adjustments needed.

iii. detailed website disclosures to complement pre-contractual and periodic disclosures with cross-references in those disclosures to the website.

The ESAs consider that products should calculate their GHG emissions reduction targets on the basis of all their investments. The ESAs also propose that, for comparability, all targets and measurements of progress should be disclosed as a single metric measure of financed GHG emissions.

The ESAs specify that such disclosure requirements would also apply to products having GHG emissions reduction as their investment objective under Article 9(3) of SFDR. Such products would be required to show the relevant benchmark disclosures when they passively track a Paris-Aligned Benchmark or Climate Transition Benchmark by providing a hyperlink to a description of the Benchmark methodology, which information is disclosed by the Benchmark Administrator.



### Templates simplification

To enhance comprehensibility for retail investors, the CP includes possible changes intended to simplify the language, layout and structure of the financial product templates (Annexes II-V). The ESAs also indicate that they intend to conduct consumer testing on the changes.

For this reason the ESAs have developed a dedicated “dashboard” of key information to complement the more detailed information of the pre-contractual and periodic disclosures in Chapter III and V and Annexes II to V of the RTS. The dashboard identifies whether the product has a sustainable investment objective or promotes environmental/ social characteristics, but also identifies the “minimum commitments” of:

- investments used to meet environmental/ social characteristics or sustainable investment objectives
- minimum figure of sustainable investments, and
- taxonomy-aligned investments, presented in the form of a bar chart

### Other adjustments

The ESAs have taken the opportunity in their review to address a number of technical issues that have been raised since the adoption of the RTS in October 2021 by stakeholders. These include:

- proposing and consulting on consistency in the use of colours in the templates
- allowing the display of pre-contractual and periodic disclosures in an extendable on click manner electronically
- changing the concept of “equivalent information” when the taxonomy-alignment of investments is not available from public disclosures of investee companies to “estimates”
- further specifications to calculate the proportion of sustainable investments
- amended disclosure requirements for financial products with investment options (such as insurance-based and pension products)
- machine readability of disclosures



### Responses to the CP

Responses to the CP should be provided in the reply form by 4 July 2023 and submitted on line at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’. If you would like to discuss options for responding, either directly or indirectly, please reach out to your usual contact on our Asset Management and Investment Funds team.

Following the CP the ESA’s are expected to submit revised RTS in a final report to the EC. The EC would then be expected to endorse and adopt the revised RTS before it is scrutinised by the European Parliament and the Council of the EU and then published in the Official Journal.

It is therefore possible that a Delegated Regulation could be published in late 2023 or early 2024 with an implementation date for the updated requirements to be decided.

### Conclusion

The purpose of the review is to broaden the disclosure framework and address some technical issues that have emerged since the SFDR was originally agreed. The EC suggested that the guiding principle for amendments to the RTS should be a desire to reduce the risk of ‘false certainty’ and potential ‘safeguards washing’ by requiring well-substantiated evidence that investments align with the safeguards. However the ESA’s recognise that the amended RTS should be carefully calibrated so that disclosures based on these indicators are proportionate and feasible for FMPs.

The ESA’s desire to address issues identified with the existing disclosure framework and provide clarity is welcome. However, the pattern of incremental change and the burden of compliance is bound to frustrate industry. While imperfect, FMPs

have worked diligently to adapt to the new disclosure requirements and evolving interpretations since the introduction of SFDR. We believe that industry would rather a comprehensive revision of the framework. This could be achieved by combining various legislative initiatives, such as the proposed Guidelines on funds’ names using ESG or sustainability-related terms and taking the learnings from CSRD as it is adopted and applied in practice. However, this appears unlikely and so it will be important to engage with the CP to ensure that industry views are represented.





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