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The Sustainable Finance Disclosure Regulation ("SFDR") – first look at the new round of the proposed changes to the RTS

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On 12 April 2023, the European Supervisory Authorities ("ESAs") published a joint consultation, proposing further amendments to the Regulatory Technical Standards ("RTS") regarding the sustainability indicators in relation to principal adverse impacts ("PAI") and product disclosures under the SFDR. Market participants are encouraged to review and comment on the proposed amendments by 4 July 2023. Feedback can be provided using the following link: https://www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation#form.

In particular, the ESAs suggest the following proposals to further broaden and clarify the SFDR disclosure framework to:

- extend the list of mandatory social indicators for PAI and supplement the list of optional indicators;
- revise and clarify the definitions, applicable methodologies, metrics and presentation of PAI indicators. A new formulae has been proposed for some of the PAI indicators;
- amend the specific disclosure process for greenhouse gas ("GHG") emissions reduction targets related to achieving net-zero commitments; and
- amend the extent of the disclosure requirements under the Do No Significant Harm ("DNSH") principle which is used to determine whether an investment falls within the definition of "sustainable investment".

The proposed changes are extensive and, if introduced, would lead to further material adjustments to managers' ESG-related frameworks and disclosures. There is a clear desire from the ESAs to ensure a more granular disclosure of information to investors, especially in the areas where managers currently have significant discretion. However, it is yet to be seen whether the proposals would be workable, considering the lack of ESG-related data available in the market.

Extending the list of social indicators for PAI

The current SFDR contains a set of mandatory and opt-in indicators that aim to show managers how certain investments pose sustainability risks and whether their investment strategies align with sustainability-related goals. The ESAs have proposed expanding both the mandatory and opt-in list and have included additional social indicators, which would be relevant from an EU and international perspective, such as the relevance of these indicators from a tax perspective.

Examples of the proposed mandatory social indicators include:

1. Amount of accumulated earnings in non-cooperative tax jurisdictions;
2. Exposure to companies involved in the cultivation and production of tobacco;
3. Interference in the formation of trade unions or election of worker representatives; and
4. Share of employees earning less than the adequate wage.

Whilst some of the new indicators are likely to align with the list of excluded investments that most managers already use as part of their investment strategies, managers would be required to revisit the documents used to collect ESG data to take into account the additional indicators.

It is also proposed to add a number of the new opt-in indicators, e.g., excessive use of non-employee workers in investee companies; excessive use of temporary contract employees in investee companies; and insufficient employment of persons with disabilities within the workforce. The addition of opt-in indicators is unlikely to cause any material issues, as it would allow managers to choose among a broader range of optional indicators.

Technical revision of the existing PAI framework

The ESAs have also proposed refining the content of other various existing PAI indicators and their respective definitions, applicable methodologies, metrics and presentation. A few of these changes include:

1. Technical changes and/or clarifications to the current indicators, which include:
    a. distinguishing between hazardous waste and radioactive waste in two separate indicators with different calculation formulae for their respective PAI;
    b. specifying metrics for the indicator on investments in companies without sustainable land and/or agricultural practices; and
    c. specifying metrics for the indicator on investments in companies without sustainable oceans/seas practices.
2. Clarifying when information on investee companies’ value chains is required – the ESAs have proposed to clarify that information on investee companies’ value chains in the PAI calculations is only required to be included where the investee company itself reports them.
3. Treatment of derivatives – the ESAs have proposed that where managers can show that a derivative does not ultimately result in a physical investment in the underlying security by the counterpart, (or any other intermediary in the investment chain), they could exclude it from the PAI calculation and not consider it resulting in an adverse impact (if it otherwise would be the case). Where the investee company is not reporting its value chain’s adverse impacts under its own regime, or it is being disclosed elsewhere, then this does not need to be accounted for in this PAI calculation.

The above is not an exhaustive list of the proposed changes, but it provides an indication of the direction that the ESAs are taking to clarify the current regime. It also demonstrates that the ESAs are keen to achieve more detailed disclosures to help investors make more informed decisions and hold managers more accountable for their investments.

Amendments regarding GHG emissions reduction targets

The ESAs have proposed amendments to fund level website and pre-contractual disclosures and periodic reports. The ESAs anticipate that focusing financial institutions on high-quality product-level disclosures will support investors who committed to GHG emissions reductions to make informed and responsible investment decisions.

The ESAs have developed the disclosures required along the following lines:

1. Pre-contractual documents – these should contain simplified disclosures and should include information on the type of outcome the product aims to achieve as well as how the investment strategy will help deliver on the target. In particular, these disclosures should include:

    a. a commitment to reduce the financed GHG emissions of the product through divestment from investments with high GHG emissions levels and reallocate those investments towards companies with a comparatively lower GHG emission level; and/or

    b. a commitment that the investments will be made in investee companies that deliver actual GHG emissions reductions over the duration of the investment, either:

        i. by investing in companies that are expected to deliver GHG emissions reductions over the duration of the investment; or

        ii. by engaging with investee companies to contribute to their GHG emissions reductions.

2. Periodic reports – these should contain additional simplified disclosures to provide consistent updates on the products and how the investment strategy has contributed to the progress.

3. Website disclosures – these should be a more detailed set of disclosures that substantiate the disclosures contained in the pre-contractual documents and periodic reports.

Although the ESAs' review highlights that these disclosures are important, they stress that their purpose is to primarily provide transparency and comparability between financial products. As with all other SFDR disclosures, these disclosures should not be considered an automatic guarantee of the robustness or ambition of the manager's strategy. It is important that the detailed disclosures for investors are balanced with information that is comprehensible and appropriate.

It is important to note that the proposed additional disclosure requirements do not provide for a specific approach on how funds can achieve their net zero commitments. There will inevitably be different approaches and methodologies, which will mean that it will be hard for investors to make informed comparisons between different funds and to decide where to invest. The ESAs propose that a single metric should be used when disclosing GHG emissions. The proposal indicates using the Partnership for Carbon Accounting Financials standard, as this has developed detailed disclosure guidance per asset class. This standard lists 7 asset classes: (i) listed equity and corporate bonds, (ii) sovereign bonds, (iii) business loans and unlisted equity, (iv) project finance, (v) commercial real estate, (vi) mortgages and (vii) motor vehicle loans, and the guidance should be consulted for asset-specific rules. The guidance can be found here: https://carbonaccountingfinancials.com/en/newsitem/pcaf-launches-the-2nd-version-of-the-global-ghg-accounting-and-reporting-standard-for-the-financial-industry.

Amendments to the DNSH disclosure design options

The SFDR currently provides considerable discretion to managers in how they assess requirements that an investment qualifies as a "sustainable investment" and how they disclose against it. The DNSH principle also provides for discretion as managers only need to describe how they "take PAI indicators into account" to demonstrate compliance with the DNSH principle. Given that "take into account" is not defined, there is considerable room for ambiguity in the disclosure process, leaving investors relatively constrained in their ability to make informed decisions regarding funds' sustainability profiles, and compare between funds with similar investment strategies.

The ESAs have proposed that the quantitative thresholds related to the PAI indicators, (which are used to determine whether sustainable investments do not significantly harm any environmental or social objectives), should be disclosed in a fund's website disclosures. Managers will still have full discretion on the methodology used to assess the DNSH, which means that they can still invest in areas that could be considered as significantly harmful by other managers. This proposal is unlikely to be welcomed by market participants, considering that most managers use proprietary developed ESG frameworks to carry out DNSH assessments and do not generally wish to publicly disclose details of their internal systems and controls.

The ESAs also considered not making any changes to the current design framework considering that the complete disclosure requirement regime has only been in place since 1 January 2023, so it is still early to analyse the impact of the current framework in its entirety. In hindsight, it may be useful to pause any further changes to the current disclosure rules to allow managers to fully test their current processes and see the results of ongoing disclosures under the current RTS regime. This would allow investors and regulators to assess the content of such disclosures against their expectations and decide on any further changes that can be necessary or desirable to ensure transparency and comparability of disclosures. Therefore, it is important that stakeholders provide their feedback and express any concerns that they may have towards the proposal to allow the ESAs to take an informed view on whether the proposed changes would be helpful and desirable at this stage.

Optional safe-harbour for environmental DNSH disclosures

As an alternative, the ESAs are proposing a potential "safe-harbour for environmental DNSH" for investments in certain categories of economic activities considered as "environmentally sustainable" under Article 3 of the EU Taxonomy Regulation ("EU TR"). The EU TR provides a classification framework to determine whether an economic activity is environmentally sustainable and works alongside the SFDR to provide transparency on sustainability, more specifically related to economic activities. For the particular investments that comply with the EU TR, they would not require environmental DNSH disclosures. However, as this "safe-harbour" would only apply to the specific part of investee companies' activities that are aligned with the EU TR, this may create an extra layer of complexity to an already complicated framework. In addition, in practice, most managers with private investment strategies are not able to gather enough data to meet the very rigid threshold requirements under the EU TR. As such, this proposal is unlikely to be used a lot in practice in the near future (until the market has access to enough data to carry out the DNSH assessment under the EU TR thresholds).

Conclusion

The purpose of this review has been to clarify the adopted RTS within the existing SFDR regime and to propose amendments where necessary. There is particular concern over the level of discretion that managers have when designing the DNSH test, which may increase the risk of greenwashing and subsequently mislead the market regarding their sustainability credentials. Therefore, the ESAs are clearly determined to tighten the requirements surrounding such discretion. Whilst some of the suggestions appear helpful and provide more certainty to both managers and investors, it is possible that many participants will not favour a substantial overhaul to the current SFDR disclosure framework at this stage, considering that the full set of detailed disclosure requirements was only introduced on 1 January 2023 and most managers are yet to produce their first ongoing reports under the SFDR RTS framework. The ESAs are expected to deliver the final drafts after the summer of 2023.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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