

ESAs Propose Amendments to SFDR Level II

21 April 2023

On 12 April 2023, the Joint Committee of European Supervisory Authorities (the “ESAs”) published a [consultation paper](#) (“Consultation”) proposing amendments to the Regulatory Technical Standards under the Sustainable Finance Disclosure Regulation (the “SFDR Level II”).¹ The Committee’s Consultation is in response to the European Commission’s (the “Commission”) request to address certain technical issues and broaden the disclosure framework under the SFDR.²

The Consultation proposes a number of changes to the SFDR Level II rules, including: (i) extending the list of social indicators for principal adverse impacts (“PAIs”); (ii) improving the definitions, methodologies, metrics and presentation for various PAI indicators; (iii) extending disclosures (and related reporting) under the “do no significant harm” (“DNSH”) principle; (iv) introducing new disclosures regarding greenhouse gas (“GHG”) emissions reduction targets and (v) proposing changes to the templates for pre-contractual and periodic disclosures.

Interested stakeholders can provide comments on the Consultation through a form available [here](#), with the deadline for comments being 4 July 2023.

Extending the List of Social Indicators for PAIs

The SFDR Level II includes a list of mandatory and opt-in environmental and social principal adverse indicators, which larger firms are required use in publishing on how they consider the principal adverse impacts of investment decisions on sustainability factors, and which all firms must use in the context of the DNSH test. The ESAs propose to extend the list of social indicators, in part to align the indicators to the information to be reported by companies under the first set of draft [European Sustainability Reporting Standards](#) (the “ESRS”) under the Corporate Sustainability Reporting Directive (the “CSRD”). Note that CSRD will only apply to large listed and

¹ Commission Delegated Regulation (EU) 2022/1288.

² Regulation (EU) 2019/2088.

private companies, meaning that funds may not be able to obtain relevant data from their investee companies.

- **Mandatory Social Indicators.** The proposed additional mandatory social indicators include:
 - total earnings by undertakings from countries on the [EU list of non-cooperative jurisdictions for tax purposes](#). Only entities whose revenue exceeds €750 million for each of the last two (2) financial years will need to make this reporting;
 - share of investments in companies involved in the cultivation and production of tobacco;
 - share of investments in companies that have made commitments not to interfere with the formation of trade unions or election of workers' representatives; and
 - average percentage of employees in investee companies who earn less than an "adequate wage" (as defined in the ESRS).
- **Opt-in Social Indicators.** The voluntary indicators include:
 - percentage of employees who work on the basis of non-guaranteed hours in the entire workforce in investee companies;
 - percentage of employees with a temporary contract in the entire workforce in investee companies;
 - percentage of workers that are not employees in the entire workforce in investee companies;
 - percentage of persons with disabilities in the entire workforce in investee companies;
 - percentage of investments in companies that do not have grievance redressal mechanisms to the material issues of its stakeholders; and
 - percentage of investments in companies that do not have grievance redressal mechanisms for its consumers or end users.

Additionally, the ESAs point out that social PAI indicators do not currently extend to investments in real estate assets and ask for views on whether these factors should apply to any entity managing real estate assets.

Improving Definitions, Methodologies, Metrics and Presentation for Various Indicators of PAIs

Under technical work to revise the PAI framework, the ESAs make a number of proposals:

- New formulae have been proposed for PAI indicators which did not previously include them. For instance, when assessing violations of OECD Guidelines, it is proposed that the fund measures compliance by “at least one international guideline or principle”. This will bring helpful clarity in many cases.
- There are changes or clarifications to some existing formulae.
- Changes to the concept of “current value of all investments”, the denominator of many PAI factors, with a proposal to define “all investments” for this purpose as investments of a particular class (investee companies, sovereigns and supranationals and real estate assets), as opposed to all investments in the portfolio.
- Clarification that information in investee companies’ value chains should be part of the PAI information that is reported, where the investee company is itself reporting impacts in its value chain under the CSRD ESRS or where the information is readily available (other than in the case of Scope 3 carbon emissions, which must be reported without regard to whether the investee company is in scope of CSRD ESRS).
- A proposal on addressing PAI reporting for net “long” exposures held through derivatives, designed to avoid circumvention of PAI reporting by firms which use derivatives “to artificially lower their PAIs”.

The ESAs also propose that a firm should disclose the percentage of investments for which it has obtained information directly (as opposed to from sources such as third party data providers) from its portfolio companies. The ESAs stated that making a similar disclosure would be a “good practice” in its November 2022 Q&As on the SFDR.

Disclosures under the DNSH Principle

The ESAs’ consultation includes some interesting discussion on the status of the DNSH disclosure under the SFDR, concerning how firms must describe how they have taken into account PAI factors to demonstrate that their investments have not significantly harmed any other social or environmental objective.

The ESAs confirm that, as “taking into account” is not defined, firms have discretion about the criteria they apply when conducting this assessment, in particular for a given PAI factor as to the threshold for when an investment is considered to cause significant harm. The ESAs state that, as the PAI factors “do not establish what level of a specific adverse impact is to be considered as causing significant harm”, there is currently limited comparability between products as to how they apply the DNSH test. In addition, the ESAs state that the SFDR DNSH test does not align to the test in the Taxonomy Technical Screening Criteria, pointing out that investing in the equity of a company whose “economic activities” are aligned with the Taxonomy Regulations may not qualify the company as a “sustainable investment under [the] SFDR”, depending on the threshold that the firms set for the DNSH test under the SFDR.

In partial response to these points (and noting that they may be addressed in due course by amendment of the Level 1 SFDR text), the ESAs propose that firms disclose the quantitative thresholds used by firms to determine “significant harm” in respect of the PAI indicators. In this regard, the amended disclosure and reporting template suggests leaves it open as to whether or not firms do set thresholds in respect of all PAI indicator (or all relevant PAI indicators).

The ESAs have pointed out before that investments that are aligned with the EU Taxonomy are not automatically classified as “sustainable investments” under the SFDR depending on the DNSH criteria that a firm sets. In that regard, the ESAs have proposed an optional “safe-harbor for environmental DNSH”, which would apply to investments that are aligned with the EU Taxonomy and would not require the investor to disclose further information on the DNSH test, as it applies to environmental objectives.

Revising GHG Emissions Reduction Targets

The ESAs propose amendments to the disclosure templates for funds that promote GHG emissions reduction targets. To address greenwashing risk and improve comparability of information for investors, the ESAs propose that the pre-contractual and reporting templates include new questions on whether the product has a GHG emissions reduction target (which may relate to emissions reductions, emissions removals and storage and carbon credits used by investee companies), how that target will be achieved (through divestment from companies with higher emissions, investment in companies which are reducing their emissions or engagement with companies to contribute to their reductions) and relevant data relating to the target. Financed GHG emissions reduction targets (and corresponding years for those targets) must be set and disclosed according to the GHG accounting and reporting standard to be introduced under the CSRD ESRS. More details on the steps planned to achieve the

GHG emissions reduction target must also be included in a new section of the website disclosure.

Simplification of Templates

The ESAs have proposed to simplify the pre-contractual and reporting templates in some respects, to prevent “information overload” and provide the most “vital information” to retail investors. To that end, the ESAs have proposed that the pre-contractual and reporting templates include a new “dashboard” of key information on minimum investment in sustainable investments and Taxonomy aligned investments, whether the product considers the most significant negative impacts of its investments on the environment and society (consideration of PAI factors) and whether the product targets a reduction in GHG emissions. The dashboard may replace the current “asset allocation” diagram. The ESAs have also simplified the language in the templates, reducing the use of technical terms. The ESAs have also provided guidance for the appropriate responses in the updated dashboard and the templates, and proposed that (unlike at present) a prohibition on changing the colours in the template. Changes to the templates will be subject to consultation and the legislative process.

In the context of reporting on Taxonomy alignment, the SFDR Level II permits the use of “equivalent information”, which is information on Taxonomy alignment obtained from sources other than public disclosures of investee companies. The ESAs propose to use the term “estimates” in place of “equivalent information” and set out some helpful criteria for the basis of accepting such estimates.

The Commission is expected to undertake a comprehensive assessment of the SFDR, commencing later this year. This may well introduce a “labeling” regime and more precise definitions of concepts such as “sustainable investment”. As part of its impact assessment, the ESAs note the possibility of maintaining status quo with regard to the SFDR Level II until the SFDR has been reviewed by the Commission. However, we would expect the ESAs’ proposed changes to the SFDR Level II to come into force later this year, before the Commission does significant work on its review of the SFDR.

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Please do not hesitate to contact us with any questions.

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