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Take Two: The ESAs' Review of the SFDR Level 2 Rules

December 2023

The European Supervisory Authorities ("**ESAs**") have published their final report setting out proposals to amend the regulatory technical standards ("**RTS**") supplementing the Sustainable Finance Disclosure Regulation ("**SFDR**"). The publication of the report marks the end of a consultation process commenced in April 2023 following a mandate from the European Commission ("**Commission**") requesting the ESAs to review certain aspects of the SFDR RTS (see our earlier briefing note here).

Recognising the pace of developments in a relatively novel and fast-evolving area like sustainable finance, the Commission asked the ESAs to aim to broaden the disclosure framework and to address the main technical issues that have emerged since the SFDR was originally agreed, which the Commission identified as issues relating to principal adverse impact ("**PAI**") indicators. The Commission also asked the ESAs to propose amendments in relation to information provided regarding products in pre-contractual documents, on websites and in periodic reports on decarbonisation targets.

In the consultation paper published in April 2023 and in its final report, the ESAs have put forward proposals going beyond the terms of the Commission's mandate. The draft RTS published on 4 December 2023 address the topics referred to in the Commission's mandate ie, an extension of the social PAI indicators, other changes to the PAI framework and a new financial product disclosure of greenhouse gas emission reduction targets. The ESAs have also proposed amendments to the mandatory templates set out in the annexes to the RTS, including a new "dashboard" intended to provide a clear summary of key information.

Further amendments addressed in the final report include:

- enhanced disclosure of how sustainable investments comply with the "do no significant harm" principle;
- harmonised calculation of sustainable investments; and
- a requirement to produce the disclosures in a machine-readable format.

Amendments to the PAI Framework

The ESAs have extended the list of mandatory and opt-in social indicators for PAIs. It has been proposed to provide in the legal text that the share of the PAI based on data from investee companies and the share that is estimated (or reasonably assumed) should be disclosed. This reflects the best practice set out in the ESAs' Consolidated SFDR Q&As.

The draft RTS address continuing uncertainty in relation to how to treat derivatives for PAI disclosure purposes and provide that derivatives should be converted to economic exposure. The draft RTS in the final report do not include a provision carving out derivative transactions that do not result in a physical exposure to the underlying, as was proposed in the April consultation.

The ESAs have confirmed that the value chains of investee companies only need to be included in PAI calculations where the investee company reports on that value chain. This is intended to align with the position in the European Sustainability Reporting Standards ("**ESRS**").

DNSH Disclosures

The ESAs received feedback in the consultation process supporting slightly more specific disclosures about how financial products "take into account" PAI indicators for the purpose of the DNSH principle for sustainable investments. The draft RTS therefore include a requirement to disclose the thresholds or criteria for the PAI indicators that the financial product uses to determine that its sustainable investments comply with the DNSH principle in website disclosures. The ESAs note that the Commission is considering the DNSH element of sustainable investments in its review of SFDR Level 1 and, on that basis, they have decided not to make or suggest any longer term revisions on this topic.

Safe Harbour for Taxonomy-Aligned Investments

The Commission confirmed in its Q&A in June 2023 that there was a "safe harbour" in relation to EU Taxonomy-aligned investments. In order to provide legislative certainty on this point, the draft RTS provide that, in calculating sustainable investments, any investments in Taxonomy-aligned economic activities are automatically considered sustainable investments.

New GHG Emissions Reduction Targets Disclosures

The draft RTS provide for new disclosures in pre-contractual documents, on websites and in periodic reports on GHG emissions reduction targets, including intermediary targets and milestones and actions pursued. The draft RTS provide for a maximum interval of five years between targets. The draft RTS do not create any additional burden for products without GHG emissions reduction targets, as for products without such targets, the new set of disclosures does not apply.

Amendments to SFDR Templates

In tandem with the consultation process, the ESAs conducted consumer testing exercises in four member states in relation to the mandatory disclosure templates. Arising from this testing and stakeholder feedback, the ESAs have aimed to simply the language used in the annexes, have restructured the information provided to avoid repetition and have removed the green colour in all disclosures except for the Taxonomy graphs.

With the intention of making the disclosure more understandable and less complex, the ESAs have introduced a dedicated "dashboard" to provide key information in the first page of the documents, alongside more detailed disclosures in the following pages. The ESAs state that the dashboard is designed to attract readers' attention to critical information, reducing information overload while still offering detailed data for sophisticated investors. This dashboard must also be included in the summary of website disclosures of financial products.

Next Steps

The Commission will decide whether or not to endorse the draft RTS within three months. The final RTS would then have to be published in the Official Journal of the EU, which we would expect to take place in Q2 2024 at the earliest. There is no provision relating to the application date of the RTS specified in the draft, so it is as yet unclear when financial market participants would be expected to comply with the amended requirements and to use the revised templates. Indeed it is possible that there will be no appetite to update the RTS during this Commission term.

This review of the SFDR Level 2 rules is distinct from the Commission's review of SFDR Level 1, in relation to which it issued a consultation in September 2023. Legislative change in relation to the latter review is likely to take a number of years, but the changes to Level 2 requirements can be introduced in the interim. The publication by ESMA of three explanatory notes addressing: (a) the definition of sustainable investment; (2) the application of the DNSH requirements; and (c) the use of estimates is welcome, as firms continue to implement the current requirements and seek to understand the proposed changes in the final report before potentially more significant Level 1 changes are made, including the possible introduction of a product labelling regime to replace the disclosure-based framework.

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