SFDR 1.5 – major amendments proposed to SFDR RTS

Top 10 talking points

April 2023

On 12 April 2023, the European Supervisory Authorities (the ESAs) published an important consultation paper, "*Review of SFDR Delegated Regulation regarding PAI and financial product disclosures*" (the CP).

The CP proposes material changes to the existing disclosures required under the SFDR Regulatory Technical Standards (RTS), which came into force on 1 January 2023. The proposed changes include revising the PAI indicators, new decarbonisation disclosures, enhanced DNSH disclosures, and broader amendments to the Article 8/9 disclosure templates.

While this isn't quite SFDR 2.0, the CP includes major changes to the RTS, and we can perhaps see it as SFDR 1.5. Firms subject to SFDR - and in particular to the regimes covered by the RTS - will need to engage with these proposals and their likely practical impact.

Given the very significant effort across the asset management industry ahead of January 2023 to achieve compliance with the RTS, firms will likely be surprised by the extensive range of newly proposed amendments to the RTS, particularly as only three months have passed since the initial compliance deadline for the RTS.

This note provides our summary of the top 10 things that firms need to know about the CP.

1. What is covered in the CP?

The formal purpose of the CP is to propose revisions to the SFDR RTS, in response to an April 2022 mandate from the European Commission. The April 2022 mandate required the ESAs to propose amendments in relation to the principal adverse impact regime and new disclosures on decarbonisation commitments. (For background on the April 2022 mandate, please see our briefing note published at the time.)

However, the CP in practice strays significantly beyond that mandate, covering additional topics too:

- Most importantly, the CP includes a detailed discussion on the "do no significant harm" (DNSH) aspect of the definition of sustainable investments, and requires additional disclosures around a firm's approach to DNSH.
- The CP also proposes extensive amendments to the mandatory disclosure templates for Article 8/9 products, including a new retail-friendly "dashboard".

- Finally, the CP includes a range of additional amendments which are described as "technical". Some of these are likely to have significant practical consequences for firms, including amendments to how derivatives and short positions are treated under certain SFDR calculations.

We summarise each of these proposals at sections 3 to 8 of this note, below. However, the CP is a lengthy document (clocking in at more than 150 pages) and as such this document is not intended as a comprehensive statement of all changes in the CP.

Structure of the CP:

The CP broadly divides into three parts:

- A narrative discussion of the proposed changes and related commentary, and questions for feedback on the proposals (pages 1 to 41 of the PDF).
- A list of amendments to the main body of the existing RTS (pages 42 to 74 of the PDF). These take the form of clause-by-clause described amendments. The CP does not include either a redline or a clean version of the proposed updated RTS. As such, we have prepared a redline document showing the cumulative effect of the changes. This redline is provided for information only and is not intended as a formal legislative document.
- Updated versions of the five annexes to the RTS (pages 75 to 149 of the PDF). These take the form of updated clean versions.

Status of the proposals in the CP:

It's important to emphasise that the changes outlined in the CP are proposals at this stage. The ESAs are seeking feedback on the proposals, certain of which are open-ended. We therefore believe that there is an opportunity for the industry still to influence the progress of these proposals.

2. Which firms would be subject to the changes proposed in the CP?

The CP proposes a range of amendments to the SFDR RTS (which has been in force since 1 January 2023). As such, if implemented, the proposed amendments in the CP would therefore apply to any firm which is already a financial market participant subject to the RTS.

In particular, the RTS applies to financial market participants under SFDR which:

a) are subject to the firm-level PAI regime under Article 4 of SFDR, and/or

b) manage financial products falling under Article 8 or Article 9 SFDR.

The CP does not propose amendments to disclosures for financial advisers.

Is any of this relevant to non-EU firms?

Non-EU firms are not generally subject to SFDR or the RTS, and so would not be directly impacted by the proposed amendments to the RTS.

Exceptions to this general approach, though, include (i) where a non-EU AIFM markets a fund in the EU under AIFMD national private placement regimes, or (ii) where a non-EU firm voluntarily opts-in to aspects of SFDR compliance. Non-EU firms falling into those categories will need to consider the impact of these changes.

3. What changes are proposed to the PAI regime?

By way of background, SFDR requires firms which are complying with the PAI regime (under Article 4 SFDR) to disclose the principal adverse impacts of their investment decisions on sustainability factors. The disclosure regime is fleshed-out in the RTS, and is based around a mandatory disclosure template, by reference to prescribed metrics of environmental and social harm specified in Annex I to the RTS (some of which are mandatory, some of which are opt-in). The existing PAI regime has been widely criticised for the scope and breadth of the metrics, and lack of clarity on how to calculate the disclosures.

The April 2022 mandate expressly required amendments to the PAI regime. The ESAs were instructed to:

- streamline the PAI framework and develop it further;
- consider extending the lists of universal indicators for PAI, along with other indicators; and
- refine the content of all the indicators for adverse impacts together with their definitions, methodologies, metrics and presentation.

A guiding principle for this work was "*to reduce the risk of 'false certainty' and potential 'safeguards washing' by requiring well-substantiated evidence that investments align with the safeguards, and that implementation and application efforts do take place*".

Any firm hoping that the mandate to "streamline" the PAIs would result in a reduced burden when complying with the PAI regime has seen those hopes dashed....! As we summarise below, the PAI regime would be further complicated, through additional PAI indicators, and new or revised mandatory calculation methodologies.

Extension of the list of social PAI indicators:

The PAI indicators in Annex I of the existing RTS are somewhat skewed towards environmental harm indicators. The CP proposes to redress this balance by including ten new harm indicators which relate to social matters, in respect of investment in corporates. Four of these would be mandatory, and the remaining six are opt-in, as summarised in the two tables below.

New mandatory indicator	Description
Amount of accumulated earnings in non-cooperative tax jurisdictions	Amount of accumulated earnings by undertakings where the consolidated revenue on their balance sheet date exceeded for each of the last two consecutive financial years a total of € 750 million at the end of the relevant financial year in jurisdictions that appear on the revised EU list of non-cooperative jurisdictions for tax purposes
Exposure to companies involved in the cultivation and production of tobacco	Share of investments in investee companies involved in the cultivation and production of tobacco

Interference in the formation of trade unions or election of worker representatives	Share of investments in investee companies without commitments on its non-interference in the formation of trade unions or election of workers' representatives
Share of employees earning less than the adequate wage	Average percentage of employees in investing companies earning less than the adequate wage

New optional indicator	Description
Excessive use of non-guaranteed-hour employees in investee companies	Average share of non-guaranteed hours employees as share of total employees
Excessive use of temporary contract employees in investee companies	Average share of own employees with a temporary contract as share of total employees
Excessive use of non-employee workers in investee companies	Average share of non-employee workers as share of total employees
Insufficient employment of persons with disabilities within the workforce	Average share of persons with disabilities amongst the workforce of investee companies
Lack of grievance/complaints handling mechanism for communities affected by the operations of the investee companies	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	Share of investments in investee companies without grievance / complaints handling mechanism for consumers or end users of the investee companies

The CP emphasises that these new indicators are largely based on the first European Sustainability Reporting Standards (ESRS) which are being produced for the purposes of reporting under the Corporate Sustainability Reporting Directive (CSRD).

The CP also seeks views on whether there should be any social indicators for real estate investments (there are not currently).

Amendments to existing PAI indicators:

The CP proposes that numerous of the existing PAI indicators are to be updated. This is principally achieved through new more formalistic definitions, technical clarifications and new or updated calculation methodology. Looking at the mandatory indicators for example, PAIs 10 and 11 would be amended for consistency with the Taxonomy and Climate Benchmark Regulation.

It is beyond the scope of this document to provide a full list of all of the amended PAI indicators, but we would be happy to discuss this bilaterally.

Amendments to PAI calculation methodologies generally:

Several other important points on calculation methodologies are covered in the CP:

- **Derivatives in the PAI indicators:** A longstanding source of uncertainty with the PAI regime is how exposure to investments via derivatives should be treated, for PAI reporting purposes. The ESAs are concerned that if derivative exposure is not included, then that could be used to circumvent PAI disclosures. As such, the CP proposes a method for including exposure held via derivatives.
    - The proposed solution is that any derivative with an equivalent long net exposure must be included in the numerator of the PAI indicator. (The only exception is if the firm can show that the counterparty to the derivative does not physically hold the underlying, which would not ordinarily be the case in practice.)
    - Somewhat unusually, the CP proposes that derivatives are to be calculated by reference to the conversion methodology under the AIFMD Level 2 Regulation. As we see it the incorporation of granular AIFMD provisions into SFDR may in practice represent a significant technical challenge for any firm subject to SFDR but which is not currently subject to AIFMD. As part of any response to the consultation, firms may wish to comment on the merits or feasibility of that approach.
    - The CP also endorses the approach from the November 2022 Q&A to the effect that netting of long and short positions must take place at the level of an individual position, without going below zero.
- **Current value of all investments:** The CP seeks feedback on whether the concept of "current value of all investments", which forms part of certain PAI calculations, should be amended. In particular, the ESAs query whether the concept of "all investments" should be sub-divided by the category of investment to which the PAI indicator applies (i.e. all investments in each of companies, sovereigns and real estate, under Annex I of the RTS), rather than referring to all investments in the denominator.

  In practice, this would amplify the impact of disclosable adverse impacts on an indicator-by-indicator basis, if a firm has positions across multiple categories of investments (because the denominator would only be holdings in that category of investment, rather than all investments in the portfolio). There is a helpful worked example of this outcome at paragraph 29 of the CP.
- **Value chains:** The CP clarifies that adverse impacts within an investee company's value chains / supply chains must be considered for PAI purposes. Specifically, firms should report PAI in value chains if either the investee company is disclosing this under the ESRS for CSRD, or that information is otherwise readily available. If not, then the value chain does not need to be taken into account for PAI reporting (other than for Scope 3 GHG emissions).
- **Proportion of information obtained from investee companies:** Firms must disclose the proportion of information which was obtained directly from investee companies. This develops a suggested approach from the November 2022 Q&A.

Does this apply to product-level PAI disclosures?

Separately from firm-level PAI disclosures under Article 4 SFDR, firms may also opt-in to the PAI regime on a product-by-product basis, under Article 7 SFDR. There are no technical standards in the existing RTS relating to product-level PAI.

As a legal matter, none of the proposed amendments would therefore be directly relevant to product-level compliance (particularly for firms which comply only at product-level, without also complying at manager level).

For a firm which voluntarily maps across aspects of the Article 4 / Annex I regime to product-level PAI, then that firm may wish to take account of the changes in the CP.

4. How does the CP approach mandatory decarbonisation disclosures?

By way of background, a growing number of firms and investment products are making net-zero commitments or have implemented other decarbonisation targets (referred to in the CP as GHG emission reduction targets). As a second area of focus beyond PAI, the April 2022 mandate expressly required the ESAs to formulate new pre-contractual, periodic and website disclosures relating to GHG emission reduction targets. This is not currently covered in the RTS.

Article 8 and Article 9 products:

The CP duly follows through on this requirement, in a manner largely consistent with the mandate. The CP proposes that new disclosures will be required in the pre-contractual, periodic and website disclosures for Article 8 and Article 9 products:

- Detailed disclosure would be required only for products which actually have a GHG emission reduction target. As such, the first new disclosure is a binary yes/no question on whether the product has a GHG emission reduction target.
- If yes, then additional disclosures will be triggered as follows.

Heading	Heading
Pre-contractual disclosure	Short-form disclosures, to provide information on: • the type of outcome the product is committing to achieve • the level of ambition of the target(s) • *(Article 9 products only)* the alignment of the target with the goal of limiting global warming to 1.5 degree Celsius • the share of investments covered by the target • how the investment strategy will help deliver on the target(s)
Periodic disclosure	Further short-form disclosures, to provide information on: • progress to date • how the investment strategy contributed to such progress

	• potential delays in achieving the targets, and potential adjustments needed
Website disclosure	More detailed disclosures required, including: • a description of the actions planned to achieve the GHG emission reduction target (including binding elements, actions planned, and engagement strategies) • a summary of the firm's own transition plan (where it has one)

- Firms will also need to disclose whether the GHG emissions reduction target relates to either:
  a) a commitment to reduce the financed GHG emissions of the product (even if no actual emission reductions are achieved in the real economy); or
  b) a commitment to invest in investee companies that actually deliver GHG emissions reductions, either by investing in companies with credible transition plans or by engaging with investee companies (via stewardship) to contribute to their emissions reductions.
- It will be mandatory for firms to use a single harmonised metric for disclosing their targets – specifically, firms must use the metric of financed GHG emissions expressed in tonnes of CO_2-equivalent per millions EUR of investments.
- Further, it will also be mandatory for firms to use the PCAF's Standard methodology when measuring emissions and setting GHG emissions reduction targets. These must be used for the product's baseline, targets, and progress reports. (This will also be consistent with the ESRS approach for disclosure under CSRD.)

Do Article 6 products need to produce these disclosures?

Although not expressly stated in the CP, it is implicit that an "Article 6" product – i.e. one not falling under Article 8/9 – would not need to make any decarbonisation disclosures.

(Presumably this is because an express product-level commitment to pursue decarbonisation goals in pursuit of climate change mitigation would push a product into at least Article 8 territory.)

5. What changes are proposed to the DNSH regime?

By way of background, Article 9 SFDR products must make exclusively sustainable investments, and Article 8 products may choose to commit to make a particular proportion of sustainable investments. One element of the SFDR definition of "sustainable investment" is that the investment must do no significant harm (DNSH) to any environmental or social objective. In practice, the SFDR regime requires firms to make a subjective assessment of DNSH by reference to the mandatory PAI indicators in Annex I of the RTS.

The CP includes a detailed discussion on the DNSH test, and how to improve that regime. Note that this was not covered by the April 2022 mandate, and may therefore be considered an example of over-reach by the ESAs.

Long-term comments:

The ESAs broadly express serious misgivings about the current structure of DNSH as a regime which is judged subjectively by firms, but acknowledge that fundamental changes would be required to the SFDR Level 1 Regulation to change this (and the ESAs don't have the power to do so). Instead, they recommend that this is addressed as part of the forthcoming review of the Level 1 Regulation.

Amendments to the RTS:

In the absence of these fundamental changes, the ESAs instead propose enhancements to the disclosure regime under the RTS:

- The CP proposes that firms will need to publish as part of their Article 8/9 website disclosures, detailed information on the quantitative thresholds adopted by the firm to assess significant harm as against the PAI indicators.
- In addition, the CP seeks views on whether there should be a "safe harbour" which effectively states that where an investment meets the separate DNSH test under the Taxonomy, it is automatically deemed to pass the SFDR DNSH test in respect of environmental indicators. It would still be necessary to perform a separate significant harm assessment against the SFDR social indicators.

It's also worth noting that (although not expressly covered in the DNSH section of the CP), the proposed extension to the mandatory PAI social indicators would also be indirectly relevant to the DNSH regime. This is because firms would also have to newly take into account those four new PAI social harm indicators, in addition to the existing mandatory indicators.

Simmons & Simmons comment: The complexity of the Annex I RTS reporting regime for firm-level PAI has been a source of significant concern for firms, and has in our experience been a barrier to firms opting-in to compliance with the Article 4 PAI regime at firm-level. Many firms had hoped that the Commission's mandate to "streamline" the PAI regime would result in a smaller number of indicators, or more optionality in which indicators are selected.

The ESAs have instead taken the opposite approach: introducing even more mandatory (and optional) indicators, and introducing further formal definitions and calculation methodologies, and not allowing any flexibility and no increased optionality.

We expect that this, in practice, will not encourage firms to seek to opt-in to the PAI regime. This is particularly the case where it remains permissible to opt-in to product-level PAI disclosures under Article 7 SFDR, without needing to comply with the full firm-level regime. Many firms find the product-level compliance approach attractive as the product-level disclosures are not subject to the Annex I technical standards.

For firms which are subject to the firm-level PAI regime, if the proposed changes are implemented, it will be necessary to update data-gathering and reporting processes, to reflect the new PAI indicators, and to include the revised calculation methodologies.

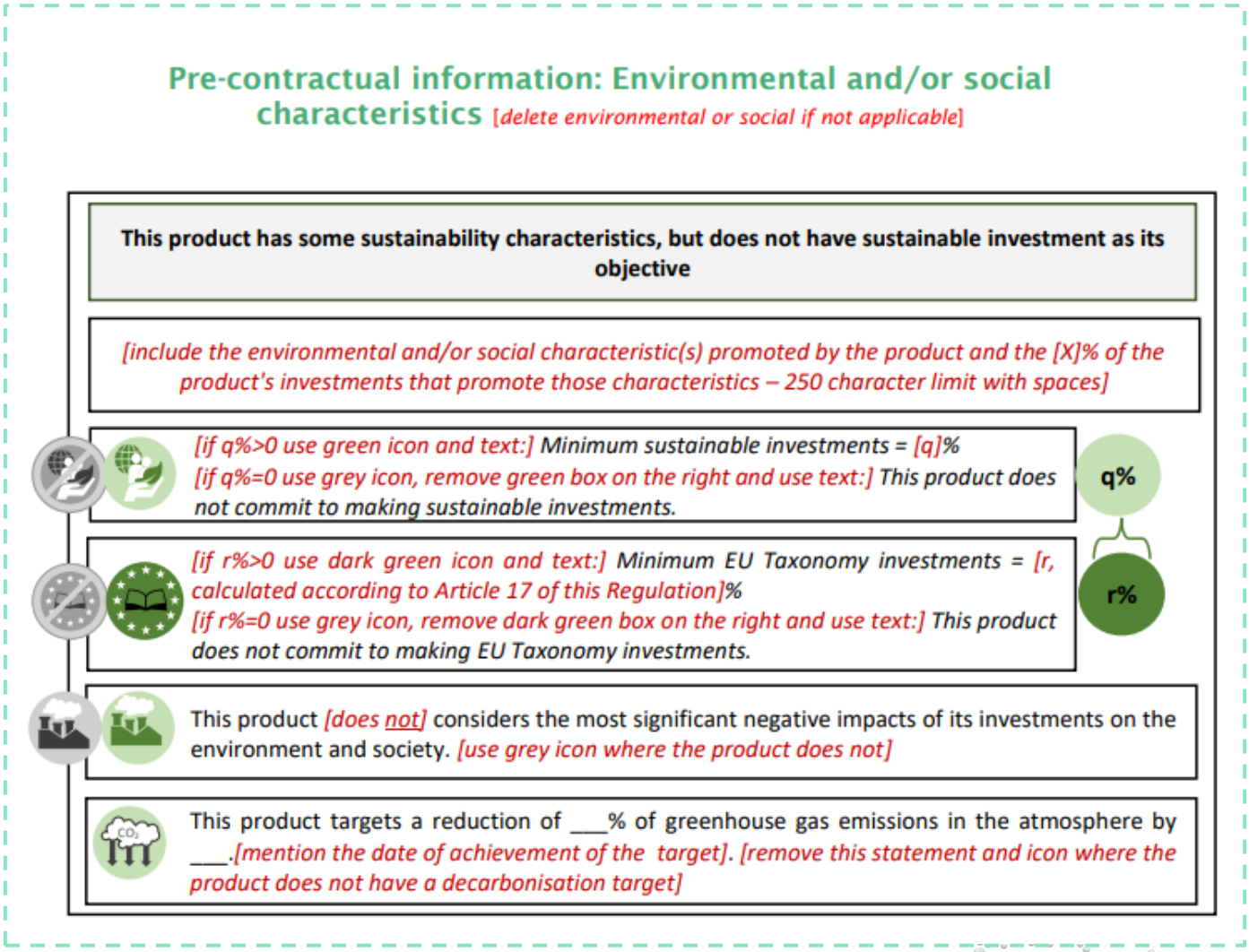
In our view, it would not be necessary to prepare the 2022 PAI disclosures (due by 30 June 2023) on the updated calculations, but firms may wish to add a disclaimer to confirm that they have not taken account of the revised calculations.

6. Will there be further changes to the Article 8 / 9 mandatory disclosure templates?

Although not expressly covered by the April 2022 mandate, the ESAs propose extensive amendments to the Article 8 and Article 9 pre-contractual and periodic disclosure templates. Again, firms may have a view on whether these proposals are over-reach.

Specifically, the ESAs propose that the disclosure templates will include a new "dashboard" at the start of the document, to summarise and outline key information. This is intended to provide simplified disclosures for retail investors (but would still be required even where distribution is limited to professional investors).

An example of the dashboard is extracted below, for Article 8 pre-contractual disclosures:



Source: extracted from JC/2023-09

The ESAs specifically intend that the dashboard should be used only for four essential elements: (i) sustainable investments, (ii) Taxonomy-aligned investments, (iii) PAI consideration, and (iv) GHG emissions reductions.

As a consequence of adding the dashboard, the ESAs propose that the "tree diagram" breakdown of portfolio allocation percentages would be removed from the template.

More broadly, we note that multiple of the questions in the template have been re-written or otherwise changed.

Simmons & Simmons comment: We worked extensively with firms completing Article 8 and Article 9 disclosures across their product range ahead of January 2023 – this was for many firms an onerous and involved process. As such, we expect that many firms in the asset management industry will be alarmed at the prospect of completely re-writing those templates again, to reflect the new model. While the current templates are notably imperfect, firms will not relish a complete re-write, with the attendant time and costs involved.

In addition, the creation of the retail-friendly "dashboard" almost seems akin to the creation of an ESG KID for retail clients. Firms which are responding to the CP may wish to consider if there is merit in pushing the ESAs to take a more radical approach, with a mandatory ESG KID in the form of the dashboard for retail investors, and then the remaining RTS disclosures to be provided in a principles-based format of the firm's choosing. This is likely a pipe-dream, but may be worth exploring further via trade associations or industry working groups.

7. What does the paper say about derivatives and about short positions in calculations?

In addition to the discussion about the treatment of derivatives and short positions in the PAI regime (see section 3 of this note, above), the CP also addresses the position of derivatives and short positions more broadly.

- **Taxonomy - derivatives:** The CP restates the position under recital (33) of the RTS, that derivatives should not be included in the numerator when calculating the Taxonomy-alignment of positions in an issuer for the RTS. Instead, net long positions achieved via derivatives should be disregarded for the numerator.
- **Taxonomy – short positions:** The CP also restates the position under Article 17(1)(g) of the RTS, that the numerator should take into account short positions, to reduce the long exposure to a given issuer. This must be done using the netting methodology under the EU Short Selling Regulation. The CP seeks views on whether this should be expressly expanded to apply to all asset classes in-scope of the Taxonomy (in other words, that it's not limited to asset classes covered by the EU SSR).
- **SFDR proportion of sustainable investments – derivatives:** The CP suggests (somewhat obliquely) that the use of derivatives should follow the approach proposed for the PAI regime, when calculating the proportion of sustainable investments. Although not expressly stated, this would presumably mean that any derivative with an equivalent long net exposure must be included in the numerator of the calculation of the sustainable investments.
- **SFDR proportion of sustainable investments – short positions:** The CP seeks feedback on whether the Taxonomy approach to netting short positions should also be extended to the calculation of the proportion of sustainable investments under SFDR. In other words, it would be mandatory to net gross long positions against gross short positions in the same issuer, to report only the net long exposure to the sustainable investment.

8. What other changes are proposed?

The ESAs also use the CP as an opportunity to clarify certain additional points in the RTS.

- **Taxonomy – use of estimates:** The CP proposes to amend Article 17 RTS, to expressly acknowledge that firms may use "estimates" when calculating Taxonomy alignment percentages (rather than the current terminology of "equivalent information"). The CP also seeks feedback on how data provided by an issuer or by a third party data provider can be used to estimate elements of the Taxonomy alignment score for an issuer.
- **SFDR proportion of sustainable investments – calculation methodology:** There is a brief reference in the CP to whether further specifications are required to calculate the proportion of sustainable investments under SFDR. The CP suggests that this could be based on Article 17 of the RTS, which sets out the calculation methodology for Taxonomy alignment.

  > ***Simmons & Simmons comment:*** At first glance, this may appear to be a relatively anodyne proposal. However, in practice many firms have used considerable subjective commercial flexibility in defining what they will or will not include in the numerator/denominator, when calculating the proportion of sustainable investments in a portfolio.
  >
  > If the ESAs adopt the approach of requiring firms to use the RTS Article 17 methodology, it would remove the commercial flexibility to define the numerator/denominator on a subjective basis. Any firm concerned with this approach may want to engage with the consultation as appropriate.

- **Machine readability:** The CP canvasses views on the impact of a rule that SFDR disclosures must be machine readable.

9. What does the CP not cover?

It's important to emphasise that the CP does not cover any of the open questions which were posed by the ESAs to the European Commission, and which were answered by the Commission on 14 April 2023. For more information on the key questions and the Commission's responses, and our view, please see our client briefing note.

10. What are the next steps and when would this come into force?

The consultation period closes on 4 July 2023.

The Commission's mandate required the ESAs to produce proposed amendments by 28 April 2023 (a year after they received the Commission's letter). However, by their letter dated 26 October 2022, the ESAs notified the Commission that 'significant challenges' meant that there would be a delay of at least six months (i.e., to at least 28 October 2023) before they could deliver the draft RTS.

These will be submitted as a final report to the Commission. The Commission would then be expected to endorse and adopt the draft RTS.

The adopted legislative proposal would then be scrutinised by the European Parliament and the Council of the EU before being published in the Official Journal.

Although difficult to speculate on how quickly the process could move, it might be realistic to expect the final Delegated Regulation to be published in the Official Journal in Q4 2023 (perhaps Q1 2024) – however, the ESAs have not included in the CP an indicative timeline for how soon after publication the new rules should come into effect. We have heard via a trade association that ESMA anticipates that firms would be required to comply with the revised RTS by 2025.

As the ESAs have not introduced a grandfathering regime, concerned financial market participants should keep this under close review. We will be keeping this under close review and reporting when there is any movement.

HOW SIMMONS & SIMMONS CAN HELP

If you require any further information on any of the issues referred to above, please contact one of the Simmons & Simmons team listed on the next page.

To see our previous client notes on ESG-related topics, please see our online resource here.

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