If you cannot see this email, please click here_

arendt

Luxembourg Newsflash - 6 December 2023

ESAs Final Report on the review of SFDR Delegated Regulation

The ESAs have published their Final Report on the review of the SFDR Delegated Regulation. The report builds on amendments initially proposed in the Joint Consultation Paper published in April of 2023. The most notable changes include an extension of and amendments to the Principal Adverse Indicators (PAI) framework, an added product-level disclosure of greenhouse gas (GHG) emission reduction targets and significant changes to the product-level disclosure templates.

Reading time: 5 minutes and 50 seconds

Context

On 4 December 2023, the three European Supervisory Authorities (EBA, EIOPA and ESMA, together the ESAs) published their joint **final report** on draft Regulatory Technical Standards (draft RTS) on the review of PAI and financial product disclosures in the SFDR Delegated Regulation (Final Report), proposing amendments to the SFDR RTS. The publication comes in response to the EU Commission's (EC) mandate to the ESAs in April 2022 and builds on a consultation paper on these topics published in April 2023, as well as the consumer testing exercise carried out in four Member States.

The purpose of the ESAs' review is to **extend and simplify sustainability disclosures** by addressing some of the issues that emerged following the implementation of the SFDR.

This comes at a time when the EC is also actively seeking feedback on the SFDR framework to assess potential shortcomings – focusing on legal certainty, the useability of the regulation and its ability to play its part in tackling greenwashing. The EC targeted consultation on the implementation of the SFDR is set to close on 15 December 2023 but is anticipated to be only the beginning of a broader and longer assessment process that will lead to a revision of the SFDR level I rules. The ESAs' Final Report makes reference to this process and some points of the report have undoubtedly been affected by this complementary initiative.

This is notably the case with regard to the do no significant harm (DNSH) disclosure rules where "in light of the potential changes coming in the future on this topic, the ESAs have decided not to make or suggest any longer term revisions to this topic". However, the ESAs still included in their Final Report a requirement to disclose the thresholds or criteria for the Principal Adverse Impact (PAI) indicators that the financial product uses to determine that its sustainable investments comply with the DNSH principle **in the website**

disclosures. The Final Report also reconfirms the existence of a “safe harbour” for Taxonomy-aligned investments.

Until more clarity is provided on any potential SFDR level I changes, it is useful to keep in mind that on 22 November 2023, the ESMA published three explanatory notes covering key topics of the sustainable finance framework: a) definition of sustainable investments; b) application of DNSH requirements, and c) use of estimates. These notes provide helpful guidance for understanding the proposed changes of the Final Report and understanding key concepts until further SFDR level I changes are potentially implemented.

Proposed amendments

In this context, the proposed changes to the SFDR RTS in the Final Report can be grouped in four main categories:

1. Changes related to the PAI framework

2. Changes related to the GHG emissions reduction targets

3. Changes related to the SFDR templates

4. Other notable changes

Changes related to the PAI framework

This first category encompasses changes to the PAI indicators, as well as changes to the overall PAI framework:

- Changes to the PAI indicators include (i) the **addition of new** mandatory and opt-in **social indicators** (e.g. “Exposure to companies active in the cultivation and production of tobacco” and “Employees earning less than an adequate wage”, among others) and (ii) the **modification of existing social and environmental indicators** (e.g. “Rate of recordable work-related injuries” or “Exposure to companies active in the fossil fuel sector”, among others);

- Changes to the PAI framework pertain notably to the basis to be used for PAI calculation, which remains “all investments”; the disclosure of the share of PAI that is estimated (or reasonably assumed) which becomes mandatory; the treatment of derivatives which should be converted to economic exposure, and the treatment of companies’ value chains which only need to be included in the PAI calculations where the investee company reports on that value chain.

Changes related to the GHG emissions reduction targets

While the previous category of changes included evolutions or modifications of existing disclosure requirements, the changes with respect to the GHG emissions reduction targets introduce entirely new rules to the SFDR RTS. The ESAs have developed draft RTS that incorporate new disclosures for financial products on GHG emissions reduction targets, including intermediary targets and milestones, where relevant, and actions pursued.

Like the proposal in the Consultation Paper, the new disclosures apply to products having GHG emissions reduction as their investment objective under Article 9(3) SFDR, although simplified disclosures still apply to products that passively track EU CTBs or PABs [1].

These new disclosures significantly affect the pre-contractual templates and introduce many additional questions. The Final Report further specifies the technicalities in terms of metrics, baseline, and calculation methodologies for such GHG emissions targets.

Changes related to the SFDR templates

To compensate for the introduction of new GHG emissions-linked disclosures, the Final Report and the draft RTS proposed by the ESAs put forward various propositions to simplify the templates for pre-contractual and periodic disclosures.

The Final Report draws on market feedback and consumer testing to include significant changes, such as revising the front page to introduce a **dashboard**, restructuring the information provided to **avoid repetition**, removing the green colour, and generally **refocusing the templates on their four essential elements** (according to the ESAs):

- Sustainable investments;
- Taxonomy-aligned investments;
- PAI; and
- GHG emissions reduction targets.

The new proposed templates have also been designed to be delivered electronically, meaning that sections can be extended by clicking.

Other notable changes

It is important to note that this effort to simplify the pre-contractual and periodic disclosure templates leads to increased emphasis on the complementarity and importance of **product-level website disclosures**. Many references to such website disclosures are made in the Final Report regarding, for example:

- The need to disclose the thresholds and criteria for the PAI indicators in the context of the DNSH test (as referred to above);
- The need to disclose extensive information with respect to the GHG emissions reduction targets (e.g. the calculation methodologies, the disaggregation of data per asset class, transparency on the share of investments for which gross GHG emissions were estimated, the share of carbon credits that have been certified, etc.);
- The need to disclose the "dashboard" introduced as the first page of the pre-contractual and periodic templates.

This renewed emphasis on the importance of the product-level website disclosures is an important element in the context of the current EC targeted consultation, in which the question of the adequacy and relevance of such website disclosures is discussed. Although the definitive industry feedback is still being finalised, many have expressed a desire to entirely remove website disclosures from the SFDR framework. However, this would be even more difficult now due to these additional website disclosure requirements that are considered necessary additions to the "simplified" pre-contractual and periodic templates.

Other specific changes proposed in this Final Report by the ESAs include the addition of dedicated rules for financial products with underlying investment options, something that professionals handling insurance-based investment products have long requested.

Finally, it is interesting to note that the Final Report recognises that it is possible to calculate sustainable investments at the economic activity or investment level, and that it is appropriate to specify how those two calculations should be done. This is the formalisation of an existing supervisory practice in Luxembourg by which the CSSF was already asking financial product disclosures to indicate whether the calculation of the percentage of sustainable investment followed a pass/fail or proportionate approach.

Next steps

The EU Commission will review the Final Report and decide whether to endorse the draft RTS within three months. These draft RTS will then be applied independently of the EC targeted consultation on the implementation of the SFDR and before any changes resulting from that assessment are introduced.

Any amendments to the SFDR Delegated Regulation that would be adopted by the EC following this Final Report would still have to be published in the Official Journal of the EU after being subject to a scrutiny period by the EU Parliament and the Council. The revised SFDR RTS are therefore not expected to enter into effect before Q2 2024 at the earliest.

This initiative once again highlights the fast-moving nature of the sustainable finance regulatory regime. Don't hesitate to get in touch with your usual Arendt contact to stay up to date or clarify any questions you may have.

Access the full Consultation paper here_

Authors: Philomeen Haanen and Antoine Peter

[1] EU Climate Transition Benchmarks or EU Paris-Aligned Benchmarks.

your contacts

Banking & Financial Services | Insurance & Reinsurance Law

EMMANUELLE MOUSEL

Partner

Learn more_

Corporate Law, Mergers & Acquisition

PHILIPPE HARLES

Partner

Learn more_

Investment Management

ISABELLE LEBBE

Partner

Learn more_

Regulatory & Consulting

STEPHANE BADEY

Partner

Learn more_

ANTOINE PETER

Senior Manager

Learn more_

Arendt & Medernach SA
Registered with the Luxembourg Bar
RCS Luxembourg B 186371

arendt.com

41A avenue JF Kennedy
L-2082 Luxembourg
T +352 40 78 78 1