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Alert | Environmental, Social & Governance

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SFDR Update: European Regulators Issue New Consultation & European Commission Provides New Guidance

On 12 April, the European Supervisory Authorities (ESMA, EBA, and EIOPA [1]) published a Consultation Paper proposing amendments to the European Commission's Regulatory Technical Standards that implement Europe's comparatively new environmental, social, and governance (ESG) regime – the Sustainable Finance Disclosure Regulation (SFDR).

European financial market participants (including non-European fund managers marketing funds into Europe) have taken some time to get comfortable with the interpretation and application of a regime which, although never intended to be a labelling regime for different funds, has become exactly that. The differences and overlap between the:

- article 8 SFDR (very broadly "light green" funds which take ESG factors into account alongside other considerations); and
- article 9 SFDR (again, very broadly, "dark green" funds whose objective is to pursue an ESG investment strategy)

[1] European Securities and Markets Authority; European Banking Authority; and European Insurance and Occupational Pensions Authority.

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regimes and some of the challenges associated with complying with the article 9 regime, have led to fund managers exercising caution. Indeed, some dark green funds have been downgraded to article 8 status by their managers. At the same time, market participants have expressed concern about the extent to which some article 9 funds are pursuing sustainability investment objectives.

The Consultation Paper does not attempt to deal with the fundamental market issues around the nature and status of funds which fall within article 9 but it contains 43, often thought-provoking, questions relating to several important topics including:

- adding new social indicators to Principal Adverse Impacts (PAI);
- clarification around the "Do No Significant Harm" Principle;
- Greenhouse Gas Emissions Reduction Targets; and
- changes to the article 8 & 9 disclosure templates.

Adding New Social Indicators to PAI

Financial market participants (including fund managers) are required to disclose PAI which have a negative effect on sustainability in their pre-contractual materials and on their website. Currently many of these PAI indicators focus on environmental matters rather than other ESG strands. The Consultation Paper tackles this by proposing to expand the list of PAI to include new mandatory "social" indicators including:

- accumulated earnings in non-cooperative tax jurisdictions;
- exposure to companies in the cultivation and production of tobacco;
- a lack of procedures to support the formation of trade unions; and
- employees earning less than the "adequate wage" specified by the European Sustainability Reporting Standards.

In addition, new opt-in indicators (which are largely, as with all PAI opt-in indicators, at the discretion of the manager as to whether to report against):

- excessive use of staff who are not on guaranteed hours;
- excessive use of temporary contract employees in portfolio companies;
- excessive use of non-employee workers in portfolio companies;
- insufficient numbers of staff employed with disabilities;
- lack of complaint mechanisms available to communities impacted by the operations of portfolio companies; and
- lack of complaint mechanisms for consumers and end users of the products and services provided by portfolio companies.

The Consultation Paper contains detail as to how each of these PAI factors will be calculated.

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The Consultation Paper also observes that the current framework does not apply Social PAI indicators to investments in real estate assets. It is proposed that the Social PAI indicators should instead apply either to the relevant financial market participant (in the case of real estate funds – the alternative investment fund managers (AIFM)) or to the property manager of the real estate asset held by a real estate fund.

In addition, the Consultation asks the open question as to whether the PAI definition of "*inefficient real estate assets built before 31 December 2020*" should be expanded to align with the EU Taxonomy Criteria designed for climate change mitigation by meeting both of the following requirements:

a) a building has an Energy Performance Certificate (EPC) below C; and also

b) is not within the top 30% of the national or regional building stock expressed as operational primary energy demand.

Clarification Around the "Do No Significant Harm" Principle

Under SFDR an investment may be "sustainable" if it contributes to an environmental or social objective; takes PAI indicators into account; and does not significantly harm any other environmental or social objective in the SFDR regime. The Consultation Paper recognises that there has been a significant divergence "*and room for divergence*" by financial market participants (including fund managers) as to how they assess the requirements an investment has to meet to qualify as sustainable and how they disclose it.

The Consultation Paper seeks comment on the merits of creating more granular disclosures around how the Do No Significant Harm Principle has actually been complied with and the potential for investments into some assets considered to be environmentally sustainable to benefit from a safe-harbour, from having to detail how they meet the Do No Significant Harm Principle.

Greenhouse Gas Emissions Reduction Targets

The Consultation Paper raises a number of questions about how greenhouse gas emissions targets should be detailed in financial products and proposes clear disclosures about the way in which a target will be achieved and whether a greenhouse gas emissions reduction target is:

a) a commitment to reduce the financed emissions of a product through divestments from portfolio companies with high emissions and reallocation to those portfolio companies with lower emissions; and/or

b) a commitment that portfolio companies invested into will deliver reduced greenhouse gas emissions over time.

The purchase of carbon credits is treated quite separately from the actual reduction of greenhouse gas emissions with separate clear disclosures regarding carbon credits being recommended.

Changes to the Article 8 & 9 Disclosure Templates

Both article 8 and article 9 SFDR funds currently need to provide investors with "pre-contractual" disclosures before they invest and ongoing disclosures on an annual basis. These required disclosures follow different templates and the European regulators have proposed a simplification of these templates for retail investors along with the creation of a dashboard to complement the templates.

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Next Steps

The Consultation closes on 4 July 2023, and it is expected that, given the importance of ESG feedback, recommendations will, once the feedback to the Consultation is considered, be given to the Commission later this year with implementation of the updated SFDR regime at the end of 2023/early 2024.

While this Consultation is welcome, it is inevitable that there will be further reform of the SFDR regime in the coming years as regulators seek the right balance between preventing greenwashing and creating ESG disclosures for investors which are relevant to their decision-making process and which are also comprehensible.

New European Commission Guidance Issued

In a separate development, on 14 April the European Commission issued long-awaited guidance (in the form of Q&A) to answer questions raised by European Supervisory Authorities in September 2022 regarding what is a "sustainable investment" for the purposes of SFDR. In particular the Commission was asked to consider whether a portfolio company which has several different objectives but only one of which contributes to an environmental or social objective could be a "sustainable investment". The Commission replied that such a portfolio company could qualify (provided it does not offend the Do No Significant Harm Principle) and stated that SFDR does not prescribe any specific approach but that the methodology being deployed and how an investment has been assessed to be sustainable must be disclosed.

The Commission took a similar approach in its answer to a question regarding the extent to which a product must "contribute" to an environmental or social objective to qualify as a "sustainable investment". The Commission confirmed that SFDR does not set out minimum requirements in relation to the concepts of "contribution"; "do no significant harm"; or "good governance" which are key parameters to determining what is a "sustainable investment". Instead, financial market participants must carry out their own assessment and disclose their own assumptions.

Separately the European Commission confirmed in response to other questions from the European Supervisory Authorities that:

- funds which have an objective of reducing carbon emissions could qualify as article 9 SFDR funds irrespective of whether they adopt a passive or active investment strategy;
- funds falling within article 8 of SFDR which promote carbon emissions reduction as part of their investment strategy are distinct from funds which have an objective of making sustainable investments to reduce carbon emissions;
- PAI disclosures required under SFDR require not only disclosure of the impact of portfolio company investments but also actual actions taken to address PAI (e.g., procedures put in place to mitigate PAI within portfolio companies);
- when determining whether the fewer-than-500-employee exemption from complying with PAI reporting can be relied on the question of who is an "employee" (as opposed to a contractor) is a matter of local law; and
- the information fund managers are required to provide under SFDR should be reported on an annual basis even if the fund manager is required to make quarterly reports on other financial and regulatory matters.

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The above clarifications are welcome and give fund managers greater flexibility when determining their approach to SFDR.

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