European Supervisory Authorities Publish Final Report on Revisions to SFDR Level II

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The European Supervisory Authorities (the "ESAs") recently published their final report (the "Final Report") on amending the existing Regulatory Technical Standards (the "RTS") under the Sustainable Finance Disclosure Regulation (the "SFDR Level II").[1] The RTS include the list of principal adverse impact (PAI) indicators and the templates for pre-contractual disclosure and ongoing reporting under SFDR.

Key changes to the RTS include: (i) new mandatory social PAIs; (ii) new opt-in (voluntary) social PAIs; (iii) changes to the overall PAI reporting framework, such as reporting on the use of estimates; (iv) changes to the way in which firms report on the outcome of the "do no significant harm" test; (v) a new set of disclosures for funds with greenhouse gas ("GHG") emission reduction targets; and (vi) simplifications and new lay-out for the SFDR disclosure and reporting templates. In addition, all disclosures and reports will need to be prepared in machine-readable format, with the intention that the disclosures are uploaded to the forthcoming European Single Access Point (ESAP).

This is a separate exercise to the Commission's review of the SFDR, which is at the early consultation phase. The changes to the RTS in the Final Report will likely take effect well in advance of changes to the SFDR itself.

Firms will need to plan to update their disclosures for current fundraising once the RTS comes into force next year.

Changes to the List of Social Indicators for PAIs

The ESAs have introduced several new mandatory and opt-in social indicators for PAIs. This is partly to ensure that reporting by managers under the SFDR is aligned with their investee companies' forthcoming reporting under the European Sustainability Reporting Standards (the "ESRS") under the Corporate Sustainability Reporting Directive (the "CSRD").

[1] Commission Delegated Regulation (EU) 2022/1288.

Mandatory Social Indicators

The additional mandatory social indicators comprise:

- Total earnings by companies from countries on the EU list of non-cooperative jurisdictions for tax purposes whose total consolidated revenue exceeds €750 million for each of the last two financial years. This only applies to investee companies in scope of the EU Accounting Directive.
- Exposure to companies active in the cultivation and production of tobacco.
- Average percentage of employees in investee companies who earn less than an "adequate wage" (as defined in the ESRS).

There are minor changes to other indicators to ensure consistency in the language used in the ESRS.

Opt-in Social Indicators

The additional opt-in social indicators include:

- Exposure to companies whose employees are not covered by collective bargaining agreements.
- Proportion of employees at investee companies who work on the basis of non-guaranteed hours in the entire workforce in investee companies.
- Proportion of employees at investee companies with a temporary contract in the entire workforce in investee companies.
- Proportion of "employees" at investee companies who are "non-employees".
- Proportion of persons at investee companies with disabilities.
- Investments in companies that do not have a grievance mechanism for communities affected by an investee companies' operations, and separately a grievance mechanism for consumers or end users.

The ESAs have also made changes to the existing mandatory and opt-in social indicators. The most significant of these changes relates to the indicator "Share of investments in investee companies without policies to monitor compliance with or grievance/complaints handling mechanisms to address violations of the OECD Guidelines for Multinational Enterprises or UN Guiding Principles, the ILO Declaration,

and the International Bill of Human Rights", which is now an opt-in indicator, reflecting open questions about the work required by firms to assess this in relation to investee companies. Note that the separate indicator "Share of investments in investee companies that have been involved in non-respect of the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles, including the principles and rights set out in the eight fundamental conventions identified in the ILO Declaration and the International Bill of Human Rights International Bill of Human Rights" remains a mandatory indicator.

There are also changes to the existing environmental indicators for PAIs that are expressed with new formulae and clarifications to some existing formulae.

Changes to the Overall PAI Reporting Framework

There are a few significant changes to the overall PAI reporting framework. In the new rules, managers will be required to disclose the share of PAI data based on data obtained from investee companies and the share that is estimated or reasonably assumed, reflecting best practice already contained in the ESAs' Q&A. In addition, the new text confirms that managers, when reporting on PAI data, should include the adverse impacts of investee companies' value chains as part of their consideration of adverse impacts. Although GHG emissions in the value chain are already included, as scope 3 emissions, this potentially broadens out the scope of reporting to include, for example, environmental impacts in investee companies' main supply chains. The new text confirms that this information is only required where investee companies themselves report the information under the CSRD; otherwise managers should include information on companies' value chains where the information is readily available, for example obtainable from third-party data providers.

Disclosures Relating to Sustainable Investments and Investments Aligned with the Taxonomy Regulation[2]

To date, managers have taken different approaches in reporting the results of the "do no significant harm" test required to qualify an investment as a "sustainable investment". The DNSH test is based on the PAI indicators, and the product disclosure and ongoing report now requires a description of the "thresholds or criteria used" to determine that the sustainable investment does not significantly harm any environmental or social objectives and how those thresholds or criteria are determined. This will require

[2] Regulation (EU) 2020/852.

managers to provide considerably more information on their approach to determining DNSH than they currently in practice provide.

The ESAs have also included a clarification that every investment aligned with the Taxonomy Regulation is a sustainable investment under SFDR regardless of the individual thresholds applied by the fund. That clarification is included as an explanatory text in the new templates. This reflects earlier EU guidance and supports the view that investments in transitional activities (such as “brown to green” infrastructure) that qualify under the Taxonomy also qualify as sustainable investments.

In addition, a fund that commits to making sustainable investments must now specify whether it qualifies an investment as a sustainable investment either at the level of the investment’s underlying economic activities (an assessment of which of the underlying activities qualify) or at the level of the investment itself (an assessment of the investment’s overall activities), reflecting the Commission’s guidance in its April 2023 Q&A.

GHG Emission Reduction Targets

There are new rules for funds that incorporate GHG emission reduction targets as their investment objective and a new section in the template pre-contractual disclosures, website disclosure and periodic disclosures. This is an important expansion of the RTS for funds currently in the scope of Article 9(3) of SFDR, which to date has required an explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement. The new rules do not apply where a fund (generally classified under Article 8 of SFDR) only commits to report on GHG emissions of its investee companies without committing to the objective of reducing carbon emissions.

Importantly, managers will need to specify how the fund will achieve the emissions reduction target—either through: (i) investing in assets that are expected to lower the GHG emissions of their activities; (ii) engaging with investee companies to influence their reduction in GHG emissions; or (iii) selling investments in assets to instead buy investments with lower GHG emissions. The categories specified in the template do not align to the four key financing strategies identified by the Glasgow Financial Alliance for Net Zero (GFANZ), including activities such as investing in climate solutions, although funds can describe in their own words how they intend to achieve the emissions reduction target.

Managers will need to set a baseline GHG emission intensity and show progress towards the target through ongoing reporting.

In addition, in the website disclosure, managers will need to describe "actions planned" to achieve the GHG emission reduction target, including any engagement plans with investee companies, the sources of GHG emissions data (either obtained from investee companies or estimated).

According to the ESAs, the rules on measuring and reporting on financed GHG emissions are aligned with the Partnership for Carbon Accounting Financials GHG Accounting and Reporting Standard for the Financial Industry for calculating financed emissions and are consistent with the Climate ESRS that may apply to investee companies. The financed GHG emissions target is based on reduction in emissions intensity (tonnes of CO2 relative to the value of the portfolio), and investee companies' GHG removals and storage, carbon credits and avoided emissions may not be included in the calculation. This is in line with the reporting requirement for companies' GHG emissions reduction targets in the ESRS, but not aligned to the Science-based Targets initiative (SBTi).

The relevant standard to use to measure the GHG emissions reduction target is the Global GHG Accounting and Reporting Standard for the Financial Industry, which has a methodology to measure financed emissions for specific asset classes, namely listed equity and corporate bonds, business loans and unlisted equity, project finance, commercial real estate, mortgages and motor vehicle loans ("relevant investments"). The GHG emissions reduction target will need to be set by reference to all relevant investments, which we understand to mean all investments of the type specified in the GHG standard that are held by the fund, rather than a single asset or sub-set of assets, unless that sub-set represents a particular class of assets. If the fund is investing in asset classes other than "relevant investments", it may incorporate those assets classes into an emissions reduction target and will need to specify the GHG accounting standard that it uses in that regard.

Where the fund's "investment horizon" is longer than five years, the manager is required to disclose information or estimates on GHG emission reduction targets in five-year intervals.

Simplification of Templates

Based on consumer feedback, there are various changes to the disclosure templates, including a "dashboard" that provides key information in the first page, the use of

simpler language and new icons. While there still is no prescribed template for product website disclosures, their content has been amended in accordance with the updates to the pre-contractual disclosures, including that the summary section should now include what the "dashboard" contains in the updated pre-contractual disclosures (e.g., information on promoted characteristics of the fund or commitment to investment aligned with the Taxonomy Regulation). In addition, Article 8 products must now include a "health warning" noting that the product only has limited sustainability characteristics and may be harmful for the environment or people. The ESAs also clarify that only the size and font type of the characters used in the disclosure templates may be adapted, with no changes to the colours and icons permitted.

Importantly, all disclosures and reports under SFDR must now be in machine-readable (XHTML) format, with information marked up using the XBRL markup language. A recital to the RTS states that this is to facilitate accessibility, analysis and comparability of disclosures, and in preparation for the implementation of the European Single Access Point (ESAP), with the strong implication that all disclosures and reports will be publicly accessible—a point that the private funds industry has consistently opposed to date.

Conclusion and Outlook

The Commission will review the Final Report and decide whether to endorse the new RTS within three months. There is also a period for the EU Parliament and the Council to approve the changes before the RTS is published in the Official Journal of the EU. The revised RTS are therefore not expected to enter into law before Q2 2024 at the earliest, with an application date to be confirmed.

At the point the new templates apply, funds that are currently fundraising will need to adopt the new versions. Changes to the PAI information reported on at firm level will have to be applied for the reporting period following the date the new rules apply.

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Please do not hesitate to contact us with any questions.

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