

# Advice to ESMA

## **SMSG advice to the ESA's Joint Consultation Paper on Review of SFDR Delegated Regulation regarding PAI and financial product disclosures**

### **1 Executive Summary**

The SMSG's advice is set against a context of uncertainty emanating from the draft Delegated Act on European Financial Reporting Standards (ESRS). The SMSG is concerned that this draft Delegated Act results, in particular through the materiality principle, in a decoupling of disclosure requirements for investee companies and for financial market players.

As a result, there are within the SMSG divergent insight with regard to the inclusion of new social PAI indicators. While not disputing the relevance of these indicators, the divergence relates to the feasibility and timing of the inclusion, some argue that no new indicators should be introduced before the ESRS is implemented and stabilised and before inconsistencies in Level 1 legislation (SFDR, Taxonomy Regulation, MiFID Sustainability Preferences, Climate Benchmark Regulation) are remedied. Others argue that no such revision is currently envisaged and that postponement risks to be sine die and hence, that for the sake of investors who are sustainability-minded, these indicators should be included now.

The SMSG is not in favour of an approach where derivatives are treated differently whether they relate to the degree of sustainability or to PAI indicators. It prefers an approach where the net long exposure is taken into account, be it floored to zero. However, as engagement through voting is not possible in case of derivatives (contrary to direct investment in equity), this must be disclosed appropriately in precontractual information on engagement. However, there was a minority view, held by particularly consumer representatives, that derivatives should not be included, neither for sustainability ratio, nor for PAI. The divergence rested mainly on different assumptions regarding the role of derivatives in financing the real economy.

Concerning quantitative PAI thresholds, the SMSG considers mandatory disclosure of quantitative PAI thresholds useful, where such thresholds are used by financial market participants. However, an obligation to set quantitative thresholds for each PAI indicator would be a bridge too far. Moreover, if quantitative thresholds are mentioned, it should be disclosed what consequences are given to these thresholds. The SMSG also considers transparency on the prioritisation of PAI indicators to be relevant, and as such agrees with the textual amendment of article 7.1c of Delegated Regulation EU 2022/1288.

The SMSG believes it is premature to say that "if two concepts of sustainability are retained, then the TSC should form the basis of DNSH assessment". The TSC defined under the Taxonomy Regulation, is often very sector specific. To the contrary, the assessment of DNSH

under SFDR today in most cases rests on generic criteria. Hence, a switch to TSC would mean a major shift in methodologies. At the same time, the TSC are still incomplete.

The SMSG is of the opinion that a hyperlink to the benchmark disclosures for products having GHG emissions reduction as their investment objective under Article 9(3) SFDR is useful to avoid lengthy disclosures on technicalities of the benchmark. While this refers to the technicalities, the SMSG believes that the precontractual information needs to provide, alongside the hyperlink, some general information about the benchmark, with focus on why a specific benchmark is chosen.

For products that focus on GHG reduction, the ESAs have introduced a distinction between a product-level commitment to achieve a reduction in financed emissions (through a strategy that possibly relies only on divestments and reallocations) and a commitment to achieve a reduction in investees' emissions. The SMSG believes that this distinction is useful because the investor has the right to know how the product intends to achieve the GHG reduction it aims for. However, a reduction target at product level may not be actionable when it requires aggregation over asset types which imply different definitions of GHG emission (for example govies vs equity). In case of a commitment through reduction targets in investees' emission engagement should ideally be aligned with the reduction targets.

For art 9 products that focus on GHG reduction, it is useful to disclose the (degree of) Paris-alignment in pre-contractual information because it helps retail investors understand how meaningful the product's reduction target is. The Paris agreement is the obvious reference because it is the globally agreed yardstick against which reduction targets must be measured. Also, the reduction target must come from effective reduction and not from netting with carbon credits.

Although the GHG Protocol's standards are the most popular globally, it could be difficult to impose a unique standard also for issuers outside the EU. Taking into account that many investment products have a global scope, the SMSG believes that alternative standards should not be forbidden. In any case, disclosure about which standard is used and why, is important.

Disclosure on the alignment of product-level target and entity-level commitment is not a priority, as investors by a product, not an entity and as product-level target could differ from entity-level targets. Something that could be useful in the future is to include information about the consistency between product level targets and the entity's transition plan for climate change mitigation under disclosure requirement ESRS E1-1.

As far as the visualisation and the presentation of sustainability information is concerned, the SMSG agrees with most of the proposals of the ESA's.

The SMSG considers the proposed dashboard to be an improvement because of its conciseness and its alignment to MiFID sustainability preferences. With hindsight, there is no

longer any need to maintain the ‘investment tree.’

The SMSG also agrees with the proposal of ensuring consistency in colour coding. Nevertheless, it warns against potential misunderstandings that can result by using colouring to attract attention. For example, a green colour, without percentage to denote taxonomy-alignment does not differentiate between 1% and 99%.

With regards to digital precontractual information, the SMSG suggests a two-steps approach where the most relevant information is visible at first glance and additional information can be obtained by clicking.

The SMSG is not in favour of estimates. The need for estimates arises because of the requirement to provide aggregate information, where in particular the entity level requires proxies but at the same time is of little relevance. With regard to cross-referencing in the context of investment products with investment options, the SMSG understands the need to address information overload and to avoid duplication of information. However, this is subject to the following conditions: (i) the cross-references should be identifiable in a straightforward way; (ii) there must be a minimum degree of available information. Situations where investors are cross-referred to another document and then need to extensively through the document to find the required information must be avoided.

On the costs of the ESA’s proposal, the SMSG voices the concern of a decoupling of SFDR on the one hand and the draft Delegated Act on ESRs on the other. It points at costs that could arise because of parallel reporting requirements. This refers in particular to investee companies, but also to the costs and uncertainties for financial market players, in particular when it comes to estimates. The dependence on primary data and the partial reversal of the draft Delegated Act on ESRs exposes the financial sector to a trade-off between relevance for the investor on the one hand and practical challenges on the other.

## General remarks

1. On 9 June 2023, the European Commission published its draft Delegated Act on set 1 of European Financial Reporting Standards. This draft Delegated Act reverses to a certain extent the EFRAG proposals. Apart from changes to particular indicators, it allows the disclosure requirements for investee companies to be subjected to the materiality principle. This is relevant for all the data points that are needed for disclosure of PAI indicators under SFDR. For financial market participants, this creates two problems. First of all, they will not be able to get the data they need. Secondly, it makes the European Single Access Point to a large extent redundant. This was to become an easy access point to obtain the primary data needed for PAI disclosure.
2. The draft Delegated Acts also created uncertainty for the SMSG in the preparation of its

advice. What will be the final version of the Delegated Act and will the required data ever be available? This uncertainty is reflected in some of the viewpoints of the SMSG. Where no consensus could be reached, the SMSG considered it useful to present the different positions and the reasoning behind it.

- I. **Question 1: Do you agree with the newly proposed mandatory social indicators in Annex I, Table I (amount of accumulated earnings in non-cooperative tax jurisdictions for undertakings whose turnover exceeds € 750 million, exposure to companies involved in the cultivation and production of tobacco, interference with the formation of trade unions or election worker representatives, share of employees earning less than the adequate wage) ?**
  - II. **Question 2: Would you recommend any other mandatory social indicator or adjust any of the ones proposed?**
  - III. **Question 3: Do you agree with the newly proposed opt-in social indicators in Annex I, Table III (excessive use of non guaranteed-hour employees in investee companies, excessive use of temporary contract employees in investee companies, excessive use of non-employee workers in investee companies, insufficient employment of persons with disabilities in the workforce, lack of grievance/complaints handling mechanism for stakeholders materially affected by the operations of investee companies, lack of grievance/complaints handling mechanism for consumers/ end users of the investee companies)?**
3. In answering these questions, the SMSG took into account but also differentiated relevance, feasibility and timing.
  4. With regard to relevance, the SMSG did not discuss each proposed indicator separately, be it the mandatory or optional ones. However, given the fact given the fact that SFDR is not only about E, but covers E+S+G, the SMSG understands the rationale behind adding these indicators.
  5. However, there were different insight with regard to feasibility and timing. Some believed that now is not the time to add new indicators. Before adding something new, the relevant Level 1 legislation (Sustainable Finance Disclosure Regulation, Taxonomy Regulation, MiFID sustainability preferences, Climate Benchmark Regulation) should be evaluated, harmonised, and simplified. Also, given data problems, new indicators should not be added before ESRS is in force and stabilised. Indicators de-fined differently in ESRS or not maintained in ESRS should be avoided.
  6. Others, however, pointed at the fact that no review of the relevant Level 1 legislation is currently envisaged. Neither do the ESA's have a mandate for another consultation at a

later stage. Also, it is far from certain that the social taxonomy will ever be realised. In other words, things being as they are, postponing carries with it the risk that it would be sine die. On the other hand, the proposed indicators are relevant from a social point of view. The focus on the disclosure problems for financial market participants is one side of the coin. The other side is the information needs of sustainability-minded retail investors.

**IV. Question 4: Would you recommend any other social indicator or adjust any of the ones proposed?**

7. Since the ESA's initiated their consultation paper on SFDR Delegated Regulation regarding PAI and financial product disclosures, the Commission published a draft Delegated Act on European Sustainability Reporting Standards. The SMSG believes that congruence between EU legislations (here: ESRS and SFRD) is key to limit investee companies' reporting burden. For example: an opt-in indicator relating to ESRS S1-12 Persons with disabilities. While the ESRS lay the focus of this indicator on employees, the proposed addition to the SFDR alters the scope for this requirement to the own workforce, which also include non-employee workers. This would require companies to report two version of the same KPI with different scopes. Furthermore, reporting on non-employee workers poses a much greater challenge with regards to data availability as for own employees. Deviations and alterations from existing ESRS KPIs pose an unnecessary increase in the reporting burden on the in-vestee company's side.
8. The example above also reflects the impact of the draft Delegated Act on ESRS. The ESA's initial proposal was based on EFRAG's draft, which required DR S1-12 to cover a company's entire work force. However, while all share the concern of misalignment between SFDR PAI and ESRS, there are divergent views with regard to conclusions and recommendations. While some believe that the SFDR indicators should be aligned with the draft Delegated Act, other believe that this would be a down-ward alignment and call for an upward alignment. This requires that the Commission's draft is restored to the level of the EFRAG draft.
9. While this problem is now being raised for this proposed social indicator, it could potentially be of relevance for all SFDR PAI-indicators. Hence, the SMSG calls on the ESAs to verify the congruence of the SFDR PAI indicators with the draft ESRS indicators. This is relevant for all indicators, not only the social ones. Where needed, the indicators should be changed to be congruent with ESRS.
10. The SMSG also notices that the draft Delegated Act on ESRS introduces a double materiality principle which will apply to all datapoints requires under SFDR. Also, the ESRS will be phased in gradually. It must be avoided that investee companies are required to disclose indicators under SFDR, which they are exempted from under ESRS. Where ESRS allows companies not to disclose an indicator, they should be given the right to also report

the immateriality of topics for the sake of SFDR. This prevents investee companies to be required to gather data and report on immaterial topics which would again increase the reporting burden. Moreover, it ensures that the results of an investee company's materiality analysis are not eroded by financial market participants requesting data on immaterial topics. This too refers to all PAI indicators, not only the social ones.

11. In an earlier advice (ESMA 22-106-2858, 14 September 2020), the SMSG already stated that PAI indicators are mostly relevant at product level, not at entity level. This rested on two principal considerations: (i) the investor buys a product, not an asset manager; (ii) “bad data drive out the goods ones”: aggregation over all products means that reliable data are lumped with incomplete data. Although the SMSG is aware that this refers to Level 1 legislation, which is not in scope in this consultation, it believes it is useful to recall the considerations, raised in this earlier advice. Since then, two evolutions have reinforced the SMSG's initial point of view:

- a) MiFIR sustainability preferences (delegated regulation 2017/566) defines as one of the options for sustainability preferences: “a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client”. This option links PAI indicators to the product;
- b) Through the double materiality principle and the phasing in of reporting standards, there will inevitably be incompleteness of data. This makes aggregations even less useful.

**V. Question 5: Do you agree with the changes proposed to the existing mandatory and opt-in social indicators in Annex I, Table I and III (i.e., replacing the UN Global Compact Principles with the UN Guiding Principles and ILO Declaration on Fundamental Principles and Rights at Work)? Do you have any additional suggestions for changes to other indicators not considered by the ESAs?**

12. The proposed indicators are also the ones used in the Taxonomy Regulation, as minimum safeguards. As such, the changes improve the alignment between SFDR and Taxonomy Regulation. While some have some reservation due to the fact that the UN Guiding Principles are more difficult to implement, the conclusion is in favour of these changes.

**VI. Question 6: For real estate assets, do you consider relevant to apply any PAI indicator related to social matters to the entity in charge of the management of the real estate assets the FMP invested in?**

**VII. Question 7: For real estate assets, do you see any merit in adjusting the definition of PAI indicator 22 of Table 1 in order to align it with the EU Taxonomy criteria applicable to the DNSH of the climate change mitigation objective under the climate change**

**adaptation objective?**

13. The SMSG has no proposals for specific real estate social indicators. The SMSG is in favour of alignment with the Taxonomy Regulation.

**VIII. Question 8: Do you see any challenges in the interaction between the definition ‘enterprise value’ and ‘current value of investment’ for the calculation of the PAI indicators?**

**IX. Question 9: Do you have any comments or proposed adjustments to the new formulae suggested in Annex I?**

**X. Question 10: Do you have any comments on the further clarifications or technical changes to the current list of indicators? Did you encounter any issues in the calculation of the adverse impact for any of the other existing indicators in Annex I?**

14. The SFDR Delegated Regulation defines enterprise value as the sum, at fiscal year-end, of the market capitalisation (including ordinary and preferred shares) and the book value of total debt and non-controlling interests, without deduction of cash or cash equivalents (Annex I). We consider that to determine the enterprise value, it would be more relevant to calculate the market capitalisation based on an average price covering a longer period (average on the last 3 months for instance) to avoid variations of carbon emissions and footprint due only to market conditions (e.g., market capitalisations of many companies have plummeted in a few weeks due to the Covid-19 outbreak). Variations of market capitalisation both up and down should, therefore, be neutralised.

**XI. Question 11: Do you agree with the proposal to require the disclosure of the share of information for the PAI indicators for which the financial market participant relies on information directly from investee companies?**

**XII. Question 12: What is your view on the approach taken in this consultation paper to define ‘all investments’? What are the advantages and drawbacks you identify? Would a change in the approach adopted for the treatment of ‘all investments’ be necessary in your view?**

15. The SMSG did not discuss these questions in depth but merely has the general comments that it is not in favour of using estimates to increase the coverage of the ratios.

**XIII. Question 13: Do you agree with the ESAs’ proposal to only require the inclusion of information on investee companies’ value chains in the PAI calculations where the investee company reports them? If not, what would you propose as an alternative?**

16. Generally speaking, the SMSG is not in favour of using estimates to boost the coverage of

ratios. Hence, it agrees with the ESA's proposal.

**XIV. Question 14: Do you agree with the proposed treatment of derivatives in the PAI indicators or would you suggest any other method?**

**XV. Question 15: What are your views with regard to the treatment of derivatives in general (Taxonomy alignment, share of sustainable investments and PAI calculations)? Should the netting provision of Article 17(1)(g) be applied to sustainable investment calculations?**

17. In answering these questions, the SMSG took into account different considerations. These included: (i) consistency and complexity of the regulation, which would be much less the case if different approaches were followed with regard to sustainability ratio and PAI; (ii) consistency with other legislation, in particular the treatment of derivatives under UCITS and AIFMD; (iii) equivalence with other financial products: if one excludes one type of product, then how to ensure consistency with other types of products; (iv) the risk side.

18. However, the principal discussion point referred to the impact of derivatives on the real economy. Here there were divergent insights: on the one hand, there was the view that derivatives do not provide direct finance to investee companies. As such, they cannot be seen as instruments that finance the transition to a sustainable economy and including them can fall short of the expectations of sustainable-minded investors. On the other hand, there was the view that indirectly they contribute to financing the transition. If the underwriter of the derivatives holds a physical position in the underlying assets (equity, bonds), this contributes to financing the transition. In this respect, it was brought to the attention that counterparties in the system need to hedge their positions and they are highly regulated to avoid speculative positions. Also, derivatives can have a beneficial role by influencing other elements, such as liquidity.

19. All members of the stakeholder group prefer consistency irrespective of whether it refers to the sustainability ratio, taxonomy alignment or to PAI. This stemmed from a concern to avoid complexity. However, there were divergent views on whether this unique approach should include or exclude derivatives in the calculation.

20. Taking the different concerns into account, the view prevailed that net long position on derivatives are to be taken into account for both the calculation of sustainability ratio, taxonomy alignment and PAI's, hence inclusion of derivatives. In line with ESMA's proposal, this position is to be floored to zero.

21. However, this view was nuanced by recognising a difference with regard to actual holdings of the assets themselves. Exposure to equity risk through derivatives does not grant voting rights in the shareholders' assembly of an investee company. As such, it may not result in



the same degree of engagement as direct holdings of equity. This should be disclosed properly in precontractual information.

22. However, a minority of SMSG members (particularly investor representatives) considered that derivatives should not be taken into account, neither for the calculation of sustainability ratio / taxonomy alignment nor for the calculation of PAI. This view rests on their conviction that most derivatives do not sufficiently contribute to the real economy, as compared to direct investment in shares or bonds. A mere disclosure on engagement does not compensate this difference. However, should the exclusion of derivatives not be possible, those members considered that the asymmetric approach proposed by the ESAs is reasonable to reduce the risk of greenwashing.
23. The remarks on the calculation in this paragraph and the following paragraph, rest on the proposal to include net long positions. For the numerator, derivatives should be integrated at delta equivalent exposure as per the UCITS and AIFMD global risk calculations. These calculations aim at the economical exposures of funds by taking into account the netted equivalent underlying equivalent of derivatives. We agree with ESMA that the net short should be floored to 0. Sectoral rules can therefore be set to take into account derivatives' exposure in a systematic manner as it is the case on the financial case. More detailed, every derivative is not used for ESG exposure purposes, a lot of them are only used for EPM (efficient portfolio management techniques) for liquidity reasons, risk management reasons, time to market reasons, and on a temporary non-structural way or for a negligible proportion. FX and interest rate derivatives for instance should be disregarded: looking through the derivative contracts to the net exposure on the underlying asset class is the reasoning that helps disregard FX and interest-rates since the notions of alignment or PAI are not applicable to the asset class. Therefore, only derivatives whose aim is to contribute to the ESG strategy (or that may distort the ESG strategy, for example by shorting a top ESG name held in portfolio) are taken into consideration. Regarding the denominator, ESMA proposes total assets, understood mostly as the NAV. First, a total assets denominator is not appropriate for all PAIs. These PAIs need an appropriate denominator on the meaningful part of the assets. In addition, actors may choose to use the appropriate part of the portfolio if they stipulate the proportion of this part with regards to total assets. This calculation has the merit of consistency. Other actors, that have limited use of derivatives or small proportion of cash and ESG neutral assets or for operational reasons, the calculation may be done on the NAV.
24. The ecosystem is currently exploring the best ways to deal with derivatives (which derivatives are ESG neutral and should be excluded from the calculations based on a taxonomy-neutral underlying such as FX and interest rates, the question of integrating the delta exposure for both numerator and denominator...), and all agree that consistency is essential. Yes, the netting provisions should be applied to sustainable investment calculations, not only in reference to Article 17(1)(g), but more appropriately calculated

consistently with the UCITS and AIFMD global risk netting.

25. The issue of derivatives should also be dealt with consistently amongst all types of retail products. For example, there should be a consistent computation of ESG exposures for retail structured products, both funds and structured notes or other types.

**XVI. Question 16: Do you see the need to extend the scope of the provisions of point g of paragraph 1 of Article 17 of the SFDR Delegated Regulation to asset classes other than equity and sovereign exposures?**

26. The SMSG did not discuss this question in depth.

**XVII. Question 17: do you agree with the ESAs's assessment of the DNSH framework under SFDR?**

**XVIII. Question 18: With regard to the DNSH disclosures in the SFDR Delegated Regulation, do you consider it relevant to make disclosures about the quantitative thresholds FMPs use to take into account the PAI indicators for DNSH purposes mandatory? Please explain your reasoning.**

27. The ESAs' assessment refers to how PAI indicators are used to take into account DNSH. It starts from the observation that SFDR introduces disclosure requirements with regard to PAI indicators but at the same time leaves considerable discretion about the criteria that Financial Market Participants use to assess DSNH. As a result, "investors have limited ways to compare financial products, and investee companies have little predictability about how PAI-based DNSH criteria will be applied by FMPs." Hence, "the ESAs are considering more specific disclosure requirements regarding DNSH under PAIs for sustainable investments, in order to increase transparency and support some degree of comparability"

28. The SMSG shares the concerns of the ESA's. There is currently a risk of methodological inconsistency among financial market participants. The SMSG believes that more specific disclosure agreements on PAI based DNSH criteria may contribute to gradually establishing a shared methodology and increase skills, experience and knowledge with regard to DNSH.

29. Nevertheless, the ESA's proposal also has its limitations. More transparency about something as technical as quantitative thresholds relating to PAI's might not be very useful for consumers, especially since that information would also not be included in pre-contractual information. In many cases, the information would be difficult to interpret even for a knowledgeable and diligent retail investor. However, the additional on-line transparency could still be useful to compare how funds are considering PAI's and maybe to incentivise asset managers to apply stricter thresholds, which could on its turn have a

spill-over effect onto investee companies to reduce adverse impacts.

30. On the other hand, some members of the SMSG fear that the transparency requirements for quantitative thresholds will mean that the use of quantitative indicators would become mandatory. While mandatory disclosure is useful if such quantitative thresholds are used, this should not be understood as meaning that there should be a mandatory quantitative threshold for every PAI indicator. The concerns are described below.

- a) Too much, too soon? One needs to question whether it is the right moment to set up yet another layer of requirements, when the financial sector is still getting to terms with the implementation of SFDR and investee companies will in the near future start the implementation of CSRD. In this respect, the issue of data availability should also be taken into account. While some data are becoming more widely available, broad and representative datasets on all PAI indicators remain challenging. Neither is there sufficient academic research on what the value of well-balanced PAI indicators would need to be.
- b) Side-effect of quantitative indicators. For some specific PAI's, quantitative indicators may actually have undesirable side-effects. Examples:
  - i. PAI indicator "operations and suppliers at significant risk of incidents of child labour" (in terms of geographic areas or type of operation"). While child labour in the supply chain is obviously to be avoided, setting quantitative criteria on geographic areas could discourage business activities with partners in countries that badly need investment and economic activity. This PAI indicator should not be judged by a mere quantitative indicator but rather in combination with other PAI indicators (for example: lack of supplier code of conduct). In this respect, reference can also be made to an earlier SMSG advice (14 September 2020, ESMA22-106-2858); "these indicators express the risk that a company is exposed, in terms of the type of its operations or its geographic areas, either directly or through its suppliers to the risks of compulsory labour or child labour. However, these regions do need more, not less investment – be it that is ethical investment.
  - ii. The PAI indicator "exposure to areas of high-water stress" points at exposure to physical climate risk but is not an indicator for DNSH. Setting a quantitative criterion may reduce the climate risk of a portfolio but has little relation with DNSH.
- c) There should be consistency with MIFID sustainability preferences. One of the options for a client to express sustainability preferences is through PAI indicators: "a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client." While reference is being made to quantitative elements,

MIFID also mentions qualitative elements. If one would make a mandatory threshold obligatory for each PAI indicator, there is a risk that that would result in an extreme quantification of the methodology, to the detriment of qualitative elements. Here too, reference can be made to the earlier SMSG report referred to above: “Thresholds are but one of several possibilities to do so. For example: the exposure to high-risk areas regarding compulsory labour/child labour could be mitigated through alignment with OECD guidelines for MNC’s, ILO recognised Global Framework Agreements, suppliers Codes of Conduct or else...”

- d) Disclosure of quantitative thresholds could contribute to enhancing one element of comparability. Nevertheless, this further transparency on its own will not allow for a perfect comparability between products:
- i. The “contribution part” (see SFDR, art 2.7; “‘sustainable investment’ means an investment in an economic activity that contributes to...”) of the sustainable investment definition is not harmonised, leaving substantial discretion to FMPs for interpretation.
  - ii. Disclosure of quantitative thresholds could facilitate comparability between the PAI indicators used in different investment products. However, the selection and prioritising of PAI indicators may still be different (see art 7.1c of Delegated Resolution EU 2022/1288).
  - iii. Even if thresholds can be compared, there is another element of differentiation: what action is taken on these thresholds: exclusion, engagement, alarm light where the threshold of the investee company is seen in the wider context of the other PAI indicators of the investee company...?

31. Taking into account all of the above, both pros and cons, the SMSG finds mandatory disclosure of quantitative PAI thresholds useful, where such thresholds are used by financial market participants. However, an obligation to set quantitative thresholds for each PAI indicator would be a bridge too far. The SMSG interprets the draft text as such that it does not make a quantitative indicator for each PAI mandatory. The draft requires to disclose “how the indicators for adverse impacts in Table 1 of Annex I, and any relevant indicators in Tables 2 and 3 of that Annex are taken into account, *including the description of the thresholds used to determine that the sustainable investments do not significantly harm any environmental or social objectives and how they are determined;*”. Hence, the SMSG supports the proposal.

**XIX. Question 19: Do you support the introduction of an optional “safe harbour” for environmental DNSH for taxonomy-aligned activities? Please explain your reasoning.**

32. Theoretically, a safe harbour would have several advantages. For investee companies, it could reduce the administrative burden as they would know that by aligning themselves with Taxonomy defined Technical Screening Criteria the likelihood increases that they are also considered as sustainable investments under SFDR. For investors, it is difficult to explain that an investment which is taxonomy-aligned would not fulfil the 'DNSH' principle under SFDR.
33. The SMSG is aware of the Commission Notice 2023/C 211/01, on the interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation. In this context question 4 is relevant (do Taxonomy-aligned investments qualify as 'sustainable investment' under the SFDR. *"Therefore, such investments in Taxonomy-aligned 'environmentally sustainable' economic activities can be automatically qualified as 'sustainable investments' in the context of the product level disclosure requirements under the SFDR. This means that investments in specific economic activities can be considered to be sustainable investments. However, if a financial market participant (FMP) invests in an undertaking with some degree of taxonomy-alignment through a funding instrument that does not specify the use of proceeds, such as a general equity or debt, the FMP would still need to check additional elements under the SFDR in order to consider the whole investment in that undertaking as sustainable investment. This means that the FMP would still need to: (i) check whether the rest of the economic activities of the undertaking comply with the environmental elements of the SFDR DNSH principle; and (ii) assess whether she/he considers the contribution to the environmental objective sufficient."* This notice has as publication date 16.6.2023, hence after the launch of the ESA's consultation.
34. The SMSG is unsure about whether the safe harbour question is still relevant, given the Commission Notice. What does the safe harbour proposal mean? Does it mean that companies that are partially taxonomy-aligned are considered fully SFDR sustainable? Or is it in line with the notice of the Commission, i.e., sustainability of the non-aligned part still has to be assessed? In the former case, there is a mixing of two concepts which is confusing. Also, in that case the safe harbour provision goes beyond the Commission Notice. In the latter case, the question in the consultation paper has not longer any purpose as an interpretation is already available.
35. Also, the SMSG notes the conditionality in case of undertakings with only a degree of taxonomy-alignment. As a result of this conditionality, the automatic qualification of an investee company as SFDR sustainable because of taxonomy alignment will be limited to only a niche of companies, being the ones that have 100% taxonomy-aligned investments.
36. Finally, the SMSG points at some major challenges. Apart from that, there are some general remarks.

- a) this will only be useful for environmental activities as the taxonomy has not yet been defined for social activities.
- b) FMPs will need to have two different systems to handle taxonomy-aligned products and other products. This may raise some operational challenges.
- c) as the safe harbour would be optional, investee companies do not have full certainty. Some financial market participants may apply the optional safe harbour; other would not.

**XX. Question 20: Do you agree with the longer term view of the ESAs that if two parallel concepts of sustainability are retained that the Taxonomy TSCs should form the basis of DNSH assessments? Please explain your reasoning.**

37. It is very confusing that two systems exist alongside one another. An evolution towards one system would reduce the administrative burden for investee companies as well as be more comprehensible for the investor. As the Taxonomy is designed to become a European standard, it could be logical that this is also the case for the TSC. Yet, until a “Social Taxonomy” or a “Social standard” gets developed, the EU Taxonomy DNSH only covers environmental DNSH and miss to tackle both objectives. Also, the implementation of even the environmental Taxonomy and its TSC’s may require much time. Although the co-existence of two parallel concepts of sustainability may not be ideal, it is likely to be the situation for a long time to come.

38. The SMSG refers once again to the Commission Notice 2023/C 211/01, on the “interpretation and implementation of certain legal provisions of the EU Taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation”. However, this would only be relevant for a niche of companies, i.e. companies that have 100% taxonomy-aligned activities. For not taxonomy-aligned activities, the SFDR provision regarding DNSH remain relevant.

39. The TSC defined under the Taxonomy Regulation, is often activity-specific. To the contrary, the assessment of DNSH under SFDR today in most cases rests on generic criteria. Hence, a switch to TSC would mean a major shift in methodologies. At the same time, the TSC are still incomplete. Hence, the SMSG believes it is premature to say that “if two concepts of sustainability are retained, then the TSC should form the basis of DNSH assessment”.

**XXI. Question 21: Are there other options for the SFDR Delegated Regulation DNSH disclosures to reduce the risk of greenwashing and increase comparability?**

40. In the context of DNSH, disclosure of the quantitative thresholds that are used is a necessary but not sufficient condition. The relevance of PAI indicators for DNSH purposes

f may vary across financial products. There should be transparency on the selection and prioritisation of PAI indicators. Hence the relevance of article 7 of Commission Delegated Regulation 2022/1288 on “Description of policies to identify and prioritise principal adverse impacts on investments decisions on sustainability factor”.

41. Disclosure of quantitative thresholds is of little use if it is not known what these thresholds are used for. Which action will follow if a threshold is breached? Will it be exclusion? Focused engagement? A warning signal....? Assume a particular investment fund has set as threshold for PAI indicator 13 (management and supervisory board gender diversity) that the minimum ratio of female members in the management board is 20%. What action will be taken towards investee companies that fall below this threshold?

42. The SMSG also repeats its view, expressed in its advice of 14 September 2020 (ESMA22-106-2858), that disclosure is most relevant at the product level, not the entity level. Already then, the SMSG referred to consistency with MiFID. In the meantime, MiFID has been reviewed to incorporate sustainability preferences. This includes as one of the possible options, PAI preferences. However, this is at the product level, not the entity level.

43. As long as the regulatory framework is not finalised and stabilised and the new requirements not fully understood by both entities subject to these requirements and regulators in charge of their enforcement, risks of non-compliance can arise from diverging interpretations and practices which could be seen as greenwashing by certain stakeholders. Only a robust, clear, comprehensible and stabilised framework can eventually prevent diverging interpretations or practices. Such a framework is also necessary to ensure that companies are not discouraged from setting sustainability-related targets and reporting on sustainability-related actions or products for fear of being accused of greenwashing.

**XXII. Question 22: Do you agree that the proposed disclosures strike the right balance between the need for clear, reliable, decision-useful information for investors and the need to keep requirements feasible and proportional for FMPs? Please explain your answers.**

44. Overall, yes. Specific remarks will be formulated under the questions below. There are ways in which the information could be improved to make it more decision-useful for investors, because many of the required narrative explanations are relatively vague and leave too much discretion to the product providers. However, this vagueness is largely the result of the level 1 text.

**XXIII. Question 23: Do you agree with the proposed approach of providing a hyperlink to the benchmark disclosures for products having GHG emissions reduction as their investment objective under Article 9(3) SFDR or would you prefer specific**

**disclosures for such financial products? Do you believe the introduction of GHG emissions reduction target disclosures could lead to confusion between Article 9(3) and other Article 9 and 8 financial products? Please explain your answer**

45. The hyperlink can be useful to avoid lengthy disclosures on technicalities of the benchmark. However, it is not sufficient on its own without some basic information in the precontractual information itself. The EU Paris-aligned and Climate transition benchmarks differ with regard to their goals and levels of ambition. The Paris-aligned benchmark is basically the stricter one, and retail investors should be informed about this in pre-contractual disclosures through a short and understandable paragraph. This should be followed by the hyperlink for more information.
46. The ESAs' proposal does not appear to address products that have an emissions reduction target, but do not designate an EU Climate Transition Benchmark or EU Paris-Aligned Benchmark. In principle they should be treated exactly the same, i.e. they should provide a link to the non-EU-regulated benchmark used and a short explanation of what that benchmark does and what its ambition level is with regard to decarbonisation and/or Paris-alignment. If no benchmark at all is used, there should be an explanation that fulfils the requirement in Article 9(3) subparagraph 2 of the SFDR.
47. For the reasons mentioned above, the SMSG believes that that the precontractual information needs to provide, alongside the hyperlink, some general information about the benchmark, with focus on why a specific benchmark is chosen. However, assuming adequate disclosure which clearly spells out the focus on GHG emission reduction, confusion can be avoided.

**XXIV. Question 24: The ESAs have introduced a distinction between a product-level commitment to achieve a reduction in financed emissions (through a strategy that possibly relies only on divestments and reallocations) and a commitment to achieve a reduction in investees' emissions (through investment in companies that has adopted and duly executes a convincing transition plan or through active ownership). Do you find this distinction useful for investors and actionable for FMPs? Please explain your answer.**

48. The distinction is useful, because the investor has the right to know how the product intends to achieve the GHG reduction it aims for. Two additional remarks:
- a) Whether is in all circumstances actionable depends on the type of product. A product-level commitment may not be useful when part of the underlying assets do not allow to include GHG emission data – especially not when the relative proportions of the asset type vary. Imagine a mixed fund, invested into both sovereign bonds and equity. GHG emission figures of sovereigns and of companies refer to different realities. In case of



govies, they could refer, for example, to total GHG emission per inhabitant, or per unit of GDP, on the territory of the sovereign. Or alternatively, to the GHG emissions by governmental infrastructure. In case of equity, they may refer to GHG emission by the corporate (be it scope 1, 2 or 3). In no case does aggregating GHG emissions over both asset types makes sense.

- b) In case of a commitment through reduction targets in investees' emission, the ESA's consultation paper, suggests that (i) investing in companies that are expected to deliver a reduction in GHG emission; (ii) engagement is an either-or matter and it should be clearly disclosed what the product commits to. However, the SMSG believes that these options are not mutually exclusive. Ideally, engagement should be aligned with the reduction targets.

**XXV. Question 25: Do you find it useful to have a disclosure on the degree of Paris-Alignment of the Article 9 product's target(s)? Do you think that existing methodologies can provide sufficiently robust assessments of that aspect? If yes, please specify which methodology (or methodologies) would be relevant for that purpose and what are their most critical features? Please explain your answer.**

49. For art 9 products that focus on GHG reduction, it is useful to disclose the (degree of) Paris-alignment in pre-contractual information because it helps retail investors understand how meaningful or ambitious the product's reduction target is. The Paris agreement is the obvious reference here because it is the globally agreed yardstick against which reduction targets must be measured.

50. It should be made clear that this reduction comes from effective GHG reductions, and not from carbon credits.

51. A particular challenge could arise for individual companies or companies dependent on a same national grid when the electricity production of that grid becomes more GHG dependent (for example due to a nuclear exit when there is insufficient capacity of renewable energy). In that case, the GHG emission of companies could increase even if their internal processes become more energy-efficient.

52. A statistical challenge could occur when accounting standards are changed. In a previous advice, the SMSG (ESMA 22-106-4325, 02/12/2022) pointed at one potential issue: methane leakages are not yet incorporated into the GHG emission of electricity production out of natural gas, although the concern for methane leakages was referred to in the Global Methane Pledge (Copenhagen COP) and the European Council agreed in principle to reduce and measure more accurately methane emissions (December 2022).

**XXVI. Question 26: Do you agree with the proposed approach to require that the target is**

**calculated on the basis of all investments of the financial product? Please explain your answer.**

53. If a target is calculated on the basis of all investments, that would have the advantage of clarity and simplicity for the investor. However, for some asset types like cash and derivatives it is difficult to determine GHG emissions. Also, we refer here to question 24: aggregating over asset types like government bonds and equity has little relevance. In such a situation, determining targets at product level is of little relevance. As an alternative, targets could be determined at issuer level, in line with the ESA's proposal to focus investments on companies that have committed to and execute a transition plan. While under the current proposals, this issuer-focused approach is also geared toward corporates (either corporate bonds or equity), it could be broadened with appropriate KPI's to include for example Green Bonds, or more general sovereign bonds.

**XXVII. Question 27: Do you agree with the proposed approach to require that, at product level, Financed GHG emissions reduction targets be set and disclosed based on the GHG accounting and reporting standard to be referenced in the forthcoming Delegated Act (DA) of the CSRD? Should the Global GHG Accounting and Reporting Standard for the Financial Industry developed by PCAF be required as the only standard to be used for the disclosures, or should any other standard be considered? Please justify your answer and provide the name of alternative standards you would suggest, if any.**

54. The Greenhouse Gas Protocol's Global GHG Accounting and Reporting Standard for the Financial Industry are the most popular. For consistency reasons, cross-references in legislation indicating a unique methodology should be preferred. This would also have advantages of simplicity and comparability. That could be possible between legal texts in the EU. Although the GHG Protocol's standards are the most popular globally, it could be difficult to impose a unique standard also for issuers outside the EU. Taking into account that many investment products have a global scope, the SMSG believes that alternative standards should not be forbidden. An example is the ISO 14064-1:2018 standard. In any case, disclosure about which standard is used and why, is important.

**XXVIII. Question 28: Do you agree with the approach taken to removals and the use of carbon credits and the alignment the ESAs have sought to achieve with the EFRAG Draft ERS E1? Please explain your answer.**

55. The SMSG believes that the investor has the right to know how effectively an issuer is in reducing greenhouse emissions, irrespective of the carbon credits. For this reason, the SMSG is not in favour of netting GHG emissions and carbon credits to set reduction targets, and favours disclosing them separately.

**XXIX. Question 29: Do you find it useful to ask for disclosures regarding the consistency between the product targets and the financial market participants entity-level targets and transition plan for climate change mitigation? What could be the benefits of and challenges to making such disclosures available? Please explain your answer**

56. Retail investors buy products, not entities, and they are primarily interested in the sustainability performance of the former, not the latter. There is a clear difference here between the financial and the non-financial sector. When buying physical products, consumers are very interested in company-level targets because the main emissions typically lie in the production or transport of goods and the value chain. In the investment industry, on the other hand, the emissions that count are the financed emissions and those are connected to the investment products. The information at entity-level may not be completely irrelevant, but it is not very important. Second, there is a concern about the quality of this kind of information, professed at entity-level. To the extent that entity-level decarbonisation pledges, such as those that are made in the context of the various 'Net Zero' alliances, are not very serious, this could be a loophole for greenwashing. Also, targets defined at entity level and those defined at product-level can diverge. For these reasons, one should be careful in requiring or permitting explanations about the connection or alleged consistency between product targets and entity targets.

57. However, something that could be useful in the future is to include information about the consistency between product level targets and the entity's transition plan for climate change mitigation as reported under disclosure requirement ESRS E1-1. Websites and periodic reports could contain this information in a specific section, while pre-contractual product-level disclosures should only contain a link to the website section and a neutral-sounding sentence (e.g. 'More information about the connection between the GHG emissions reduction target of this product and our company's climate transition plan can be found online here: ...').

**XXX. Question 30: What are your views on the inclusion of a dashboard at the top of Annexes II-V of the SFDR Delegated Regulation as summary of the key information to complement the more detailed information in the pre-contractual and periodic disclosures? Does it serve the purpose of helping consumers and less experienced retail investors understand the essential information in a simpler and more visual way?**

**XXXI. Question 31: Do you agree that the current version of the templates capture all the information needed for retail investors to understand the characteristics of the products? Do you have views on how to further simplify the language in the dashboard, or other sections of the templates, to make it more understandable to retail investors?**

**XXXII. Question 32: Do you have any suggestion on how to further simplify or enhance the legibility of the current templates?**

58. The proposed Dashboard is an improvement. It is concise. It has the merit of being aligned with the three options of MiFID sustainability preferences as well as with greenhouse reduction targets. An element where there is still scope of improvement could be to better explain what is meant by environmental and social “characteristics”, because the difference between characteristics and objectives is far from obvious for an investor. Although the SMSG considers the dashboard as an improvement, it suggests that these and other changes are consumer-tested.

59. The SMSG has at this stage no further suggestions to simplify or enhance the legibility of the current templates. The level 1 legislation itself is complex and as a result it is quite challenging to summarise the information in appropriate templates.

**XXXIII. Question 33: Is the investment tree in the asset allocation section necessary if the dashboard shows the proportion of sustainable and taxonomy-aligned investments?**

60. With hindsight, the investment tree had several shortcomings. First of all, it suggests that “sustainable” is composed of three categories: taxonomy-aligned; other environmental; social. In reality, these are different concepts that cannot simply be aggregated. Taxonomy is activity-based; SFDR (environmental or social) is investee company-based. Secondly, it distinguishes “aligned with E/S characteristics.” However, one could wonder whether this category should be distinguished separately in summary information for the investor as it is not part of MiFID sustainability preferences. Thirdly, it is difficult to use this investment-tree without adding the (minimum) percentages of taxonomy-aligned, other environmental or social. As such, the SMSG believes that it can be replaced by the dashboard. However, here too, consumer-testing should be performed.

**XXXIV. Question 34: Do you agree with this approach of ensuring consistency in the use of colours in Annex II to V in the templates?**

61. Consistency in the use of colours enhances the legibility across FMP’s. For this reason, the SMSG is in favour of ensuring consistency in the use of colours.

62. However, the SMSG warns against potential misunderstandings that can result by using colouring to attract attention. For example, a green colour, without percentage to denote taxonomy-alignment does not differentiate between 1% and 99%.

**XXXV. Question 35: Do you agree with the approach to allow to display the pre-contractual and periodic disclosures in an extendable manner electronically?**

63. Conditional on consumer-testing, the SMSG agrees with this approach. It suggests a two-steps approach where the most relevant information is visible at first glance and additional information can be obtained by clicking.

**XXXVI. Question 36: Do you have any feedback with regard to the potential criteria for estimates?**

**XXXVII. Question 37: Do you perceive the need for a more specific definition of the concept of “key environmental metrics” to prevent greenwashing? If so, how could those metrics be defined?**

64. The SMSG is afraid that estimates could be used to navigate around the Taxonomy Regulation. Verification of taxonomy-alignment is a demanding process. One cannot imagine that it can be done outside the investee company. As such, the SMSG is afraid that allowing estimates to define percentage taxonomy alignment goes beyond the capabilities of FMP’s and could evolve in a light version of the Taxonomy Regulation. As such, the SMSG would argue against the use of estimates.

65. Question 37 is asked in the context of equivalent information and as such the answer is related to question 36. As the SMSG argues against the use of estimates, question 37 is without object.

66. Totally outside the context of equivalent information and estimates, the SMSG wants to use question 37 to point at the relevance of a particular observation formulated in ESMA’s Progress Report on Greenwashing, point 54, which is particularly relevant in the context of Greenhouse Gas Reduction: *“Lack of fair and meaningful comparisons, thresholds and underlying assumptions poses greenwashing risk in particular in relation to ESG metrics like GHG emissions, carbon footprint or other SFDR Principal Adverse Impacts (PAIs) or benchmark ESG factors. Greenwashing occurs when the actual claims about an ESG metric, for instance, are true, but the comparisons/thresholds or underlying assumptions are selected in bad faith to overstate the sustainability performance of the entity or product.”*

**XXXVIII. Question 38: Do you see the need to set out specific rules on the calculation of the proportion of sustainable investments of financial products? Please elaborate**

67. Given time-constraints, the SMSG was not able to elaborate on this.

**XXXIX. Question 39: Do you agree that cross-referencing in periodic disclosures of financial products with investment options would be beneficial to address information overload?**

68. The SMSG understands the need to address information overload and to avoid duplication

of information. However, this is subject to the following conditions: (i) the cross-references should be identifiable in a straightforward way; (ii) there must be a minimum degree of available information. Situations where investors are cross-referred to another document and then need to extensively through the document to find the required information must be avoided.

**XL. Question 40: Do you agree with the proposed website disclosures for financial products with investment options?**

**XLI. Question 41: What are your views on the proposal to require that any investment option with sustainability-related features that qualifies the financial product with investment options as a financial product that promotes environmental and/or social characteristics or as a financial product that has sustainable investment as its objective, should disclose the financial product templates, with the exception of those investment options that are financial instruments according to Annex I of Directive 2014/65/EU and are not units in collective investment undertakings? Should those investment options be covered in some other way?**

**XLII. Question 42: What are the criteria the ESAs should consider when defining which information should be disclosed in a machine-readable format? Do you have any views at this stage as to which machine-readable format should be used? What challenges do you anticipate preparing and/or consuming such information in a machine-readable format?**

69. Given time-constraints, the SMSG was not able to elaborate on this.

**XLIII. Question 43: Do you have any views on the preliminary impact assessments? Can you provide estimates of costs associated with each of the policy options?**

70. Back to 1494? 1494 was the year when the first publication advocating the double-entry accounting system appeared. Over the next centuries the method was improved step by step only to take off fully during the Industrial Revolution. Today, a major paradigm shift is occurring again by complementing financial reporting with non-financial reporting, through CSRD at European level or through global initiatives such as the Global Reporting Initiative Standards. However, what took centuries to develop is now to be implemented in a couple of years. This raises both practical and conceptual challenges.

71. In this context, the financial sector is not the producer but the user of primary data. The dependence on primary data exposes the financial sector to a trade-off between relevance for the investor on the one hand and practical challenges on the other.

72. For this reason, the draft Delegated Act on ESRS raises concerns of a decoupling of

disclosure requirements under SFDR and disclosure requirements for investee companies.

73. For investee companies, this raises the concern that additional costs will need to be done for parallel reporting. The parallel reporting could result from:

- a) Indicators defined differently under CSRD and SFDR, although referring to a similar KPI;
- b) New indicators being added while the ESRS is not yet fully implemented or stabilised;
- c) Indicators that are part of SFDR PAI but not part of ESRS;
- d) Enquiries from financial institutions to investee companies to provide data for SFDR although they are considered not-material from the perspective of the draft delegated act on ESRS.

74. For financial market participants, a major concern is the cost of data through data providers. A particular concern is that there will be a need to obtain estimates in order to provide aggregated data. Apart from the cost of these estimates, there is the concern that estimates are just a proxy. However, the need for estimates has been made more compelling by the draft Delegated Act on ESRS as the data points required for PAI indicators under SFDR have been subjected to the materiality principle under the ESRS.

75. At a time where ESG proof is asked more and more for all market participants, it is of utmost importance that CSRD application is fully in line with the Commission's transparency ambition (including the SFDR PAIs). Accuracy and confidence on certified/audited issuer raw data (together with access to it via the ESAP) should be a priority to be considered also with regards to the transparency requirements of SFDR.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

Veerle Colaert  
Chair  
Securities and Markets Stakeholder Group

[signed]

Chris Vervliet  
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