



13 April 2023

Consultations published under the SFDR and the Taxonomy Regulation

The past week has been a busy one for developments in the EU sustainable finance sphere, with the ESAs publishing a consultation on proposed amendments to the SFDR Level 2 Measures¹ and the European Commission publishing a consultation on the extension of the EU Taxonomy framework.

ESA Consultation on Proposed Amendments to SFDR Level 2 Measures

On 12 April 2023, the ESAs published a [consultation paper](#) which outlines a suite of proposals to amend the SFDR Level 2 Measures (**ESA Consultation Paper**) which may have significant implications for certain financial market participants if implemented as proposed. While the proposals put forward by the ESAs relating to PAI indicators and disclosure on GHG emissions targets are in response to a mandate issued to them by the European Commission in April 2022, the ESAs have also taken the opportunity to propose other additional changes to the SFDR Level 2 Measures.

PAI Indicators

The ESAs have proposed the extension of the mandatory indicators to incorporate additional “social indicators” including impacts arising from earnings in non-cooperative tax jurisdictions, the cultivation and production of tobacco and employees earning less than an adequate wage. Other additional “opt-in” social indicators have also been proposed by the ESAs.

The ESAs have also proposed targeted changes to some of the existing PAI indicators contained in the SFDR Level 2 Measures, including the introduction of new formulae for PAI indicators that did not already have them and the presentation of the share of information derived directly from investee companies, sovereigns, supranationals or real estate assets.

¹ Commission Delegated Regulation (EU) 2022/1288 as amended by Commission Delegated Regulation (EU) 2023/363

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GHG Emissions Reduction Targets

Additional pre-contractual, periodic report and website disclosure obligations on any financial product which set a greenhouse gas emissions reduction (or “decarbonisation”) target, including providing information on intermediary targets and milestones and actions pursued to meet such targets have also been proposed by the ESAs. For those financial products which do not set such targets, no additional disclosure obligations are proposed save for being required to confirm that no such targets have been set for that product.

One point worth noting is that the ESAs have indicated that they believe that all such targets should be disclosed as a measure of “financed GHG emissions” in order to ensure the comparability of different financial products.

“Do No Significant Harm” Disclosures

Under current rules, financial market participants are required to disclose how they “take into account” the PAI indicators when assessing whether a proposed investment meets the “DNSH” test which must be satisfied in order to classify an investment as a “sustainable investment” within the meaning of Article 2(17) of the SFDR. However, because “take into account” remains undefined, they currently have discretion about the criteria which they will use when conducting the assessment, resulting in a lack of comparability between financial products.

The ESAs have proposed that financial market participants investing in sustainable investments should be required to disclose on their websites the quantitative thresholds relating to PAI indicators used to determine that the sustainable investments do not significantly harm any environmental or social objectives. However the ESAs have not proposed that any specific methodology should be used to assess same.

Treatment of derivatives

The ESA Consultation Paper addresses the treatment of derivatives (i) in the calculation of PAI indicators and (ii) in the calculation of the proportion of investments which are “sustainable investments” or “taxonomy aligned investments”.

As regards the treatment of derivatives in the calculation of PAI indicators, the ESAs have proposed that any derivative with an equivalent long net exposure would be included in the numerator of the PAI indicator unless it could be demonstrated that the derivative did not ultimately result in a physical investment in the underlying security by the counterparty or any other intermediary in the investment chain.

For the purposes of calculating the proportion of investments which are “sustainable investments”, the ESAs have suggested that for long net exposures on a given issuer, the numerator should take into account short positions achieved through derivatives. Net short exposure on a given issuer cannot be taken into account and therefore the proportion of sustainable investments can never be negative at the level of the individual issuer. They have also asked whether the netting rules (which set out the method to be used to calculate net short positions) applicable to calculating Taxonomy-alignment ratios should be applied to sustainable investment calculations.

The ESAs provide that when calculating the proportion of investments of a financial product which are taxonomy-aligned, net long positions achieved only through derivatives should not be taken into account while short positions achieved through derivatives to reduce the long net exposure to a given issuer should be taken into account. Again, they have proposed that net short exposure on a given issuer cannot be taken into account and therefore the proportion of Taxonomy-aligned investments can never be negative at the level of the individual issuer. They have also asked for feedback on whether the scope of the existing netting provisions for Taxonomy-aligned investments (which set out the method to be used to calculate net short positions) should be extended to asset classes other than equity and sovereign debt exposures.

Other proposed changes to the SFDR Level 2 Measures

The ESAs have also sought feedback on a number of other proposed changes to the SFDR Level 2 Measures which include the following:

- (i) Simplification of the pre-contractual and periodic report annexes and the inclusion of a dedicated “dashboard” of key information;
- (ii) Clarifying the test to be met in order to use “equivalent information” (or estimates) provided by investee companies or third-party providers where the taxonomy-alignment of investments is not available from public disclosures of investee companies; and
- (iii) Whether or not the ESAs should set out specific rules on the calculation of the proportion of sustainable investments held by a financial product.

Next steps

Feedback to the ESA Consultation Paper must be submitted to the ESAs using the required [response form](#) no later than 4 July 2023. The ESAs are expected to issue their final advices containing revisions to the SFDR Level 2 Measures by the end of October 2023. These proposals will then need to be considered by the European Commission and will also be subject to scrutiny by the European Parliament and the Council before being published in the Official Journal.

European Commission Consultation on EU Taxonomy Framework

Background

Under the EU Taxonomy framework, in order for an economic activity to be considered environmentally sustainable (or taxonomy-aligned), that economic activity must meet the four following criteria:

- (i) It must contribute substantially to one of six environmental objectives identified in the Taxonomy Regulation;
- (ii) It cannot significantly harm any of those environmental objectives;
- (iii) It must be carried out in accordance with minimum safeguards set down in the Taxonomy Regulation; and

- (iv) It must comply with technical screening criteria set down by the European Commission in delegated acts for that economic activity in order to be considered to meet conditions (i) and (ii) above.

To date, only the technical screening criteria for the first two environmental objectives of climate change mitigation and climate change adaptation have been identified by the European Commission in Commission Delegated Regulation (EU) 2021/2139 as amended² (**Taxonomy Climate Delegated Act**). This has meant that that it has not been possible for financial market participants to determine whether or not an investment contributes substantially to one of the "remaining four" environmental objectives set down in the Taxonomy Regulation, namely (i) sustainable use and protection of water and marine resources, (ii) transition to a circular economy, (iii) pollution prevention and control or (iv) protection and restoration of biodiversity and ecosystems (**Four Remaining Environmental Objectives**).

Publication of European Commission Consultation on Extension of EU Taxonomy Framework

On 5 April 2023, the European Commission published a [consultation](#) in which it seeks feedback from stakeholders on the following:

- (i) Technical screening criteria to be used to determine whether an economic activity contributes to one of the Four Remaining Environmental Objectives;
- (ii) Proposed changes to the Taxonomy Climate Delegated Act to add technical screening criteria for economic activities not yet covered by the EU Taxonomy framework or complement existing technical screening criteria for climate change mitigation and climate change adaptation; and
- (iii) Proposed changes to the Taxonomy Disclosures Delegated Act³ to ensure, in particular that newly added economic activities contributing to the Four Remaining Environmental Objectives are appropriately reported by both non-financial and financial undertakings that are required to report on the eligibility and alignment of their activities with the EU Taxonomy.

Interested stakeholders have until 3 May 2023 to provide their feedback on the proposals put forward by the European Commission in its consultation.

If you have any questions relating to this briefing, please get in touch with your usual contact in our Asset Management and Investment Funds team.

Dillon Eustace LLP
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² The Taxonomy Climate Delegated Act was amended by Commission Delegated Regulation to extend the EU taxonomy framework to allow certain activities on energy generation from nuclear energy and natural gas to be considered

³ Commission Delegated Regulation (EU) 2021/2178

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