



ADVICE TO THE ESAS

SMSG advice to the ESA's Joint Consultation Paper on ESG Disclosures (draft regulatory technical standards with regard to the content, methodologies and presentation pursuant to Article 2a, Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation EU 2019/2088.

I. Executive summary

The SMSG believes that the synergy between different pieces of legislation (in particular the Non-Financial Reporting Directive (NFRD), the Taxonomy Regulation, and the Sustainable Finance Disclosure Regulation (SFDR), but also adjacent legislation such as the Shareholders Rights Directive II and the scheduled reviews of MiFID and UCITS/AIFMD) can contribute significantly to enhancing sustainability in the economy. However, neither the timings nor the concepts of these different pieces of legislation are fully synchronized or aligned with one another. The SMSG believes in the usefulness of setting a significant step forward now, while enabling the possibility of an iterative process resulting from the interaction between the different pieces of legislation.

To optimally exploit this synergy, enhance effectiveness of the different pieces of legislation and maintain simplicity, the SMSG believes in the usefulness of an iterative process between these different pieces of legislation, probably for at least two-three years. This could be organized to culminate with the scheduled review of the SFDR end 2022. However, to allow sufficient degrees of freedom for the iterative process, the SMSG suggests a phased approach with regard to the draft RTS. This is particularly relevant for the proposed set of mandatory reference indicators to describe adverse impact. It is feared that introducing these indicators in a 'Big Bang' would set path dependency, which makes it difficult to finetune them at a later stage.

The SMSG believes it is important to set a first step forward. In this respect, it notes that the draft RTS entail many aspects such as the use of a format, the description of policies, engagement etc. Among all these is also the use of descriptive indicators. It is on the latter that the discussion is focused. The SMSG contests the use of an extended set of indicators for the following reasons:

- There will be a problem of data availability for a substantial period to come
- The proposed set requires fine-tuning, which could possibly come by as a result of the iterative process described above. However, there is a risk that introducing these indicators in a one-off Big Bang seals the possibility for later adjustments.

An alternative could for example be to start with a much smaller core set of reference indicators to be used whenever relevant following a comply or explain mode, while maintaining the policy indicators. Over time, this set could possibly expand.

While it is useful, as a common toolbox for cross-sector non-financial analysis and as input to the review of the NFRD, to suggest, already at this stage, a set of potential reference indicators, the SMSG believes in the need to finetune them. This toolbox should also be viewed as a common language between investors/analysts on one side and issuers on the other. The dialogue with issuers is paramount to reach meaningful transparency and the establishment of indicators should not pre-empt the review of the NFRD.

The present proposals reflect the status of the current political decision making in the EU. As such, the Social indicators (for which the ESA mandate provides a later deadline) are underdeveloped as compared to the Environmental indicators. While the SMSG values that the ESA's try to insert indicators for Governance into the draft RTS, through for example the indicators for 'social and employee matters', it regrets that Level 1 legislation has not given them an explicit mandate to develop Governance indicators.

One of the reasons for development of the SFDR was the need for comparability of information disclosed to investors. Regarding this, the SMSG would like to point ESA's attention to the issue of precise definitions of particular indicators. The definitions of particular indicators provided in the draft RTS may have precise names, but they need to be accompanied by detailed instructions as to what data need to be used to calculate these indicators. Without these instructions companies may provide financial institutions with data as seems appropriate to the companies and that would result in incomparability of data from different Member States.

On a conceptual level, the SMSG questions the usefulness of an extended set of descriptive indicators at entity level, as the most relevant level for the investor is the product level. Also, the SMSG believes that the relevance of individual indicators may vary depending on the type of product. However, if one allows a degree of flexibility, one should also demand transparency and disclosure regarding this flexibility. For this reason, the SMSG suggests that:

- the field "description of policies to identify and prioritise principal adverse sustainability impacts" (template under article 4), should disclose (i) which criteria are used to select and prioritize indicators for adverse impact at product level and (ii) the process (governance) through which this done.
- Specifically for art. 8 and 9 products, the templates (still to be developed) should disclose why particular indicators are used and why others are not.

The SMSG asks the ESA's and the Commission to take their responsibility and provide more clarity on what exactly is meant by article 8 and 9 products. Given the wide range of products that could possibly fit under article 8, transparency about the degree of sustainability is important. Hence a graphic representation illustrating the degree of sustainability is useful, combined with a narrative which is simple and straightforward. In this respect, it is also important that there is consistency between marketing communication and website information /precontractual disclosure. The SMSG points at the possibility (article 13, draft RTS) for the ESA's to ensure this consistency through draft RTS. For reasons of simplicity, the SMSG proposes to integrate the warning referred to in draft article 16(1) in the narrative accompanying the graph and reformulate it accordingly, with reference to the graph (for example: "only the part indicated in the graph ... promotes environmental or social characteristics"). Also, the SMSG suggests to reinforce the link between the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation with regard to sustainable investment.

With regard to the use of adverse impact indicators at product level, the SMSG notes that many of the concerns at entity level, are also relevant at product level: timing problems with regard to the availability of data, problems of materiality (relevance of indicators differs across products) and proportionality, the need to allow an iterative process rather than seal the indicators through a "Big Bang" at too early a stage, the need to consider qualitative considerations in the assessment of adverse impact, rather than merely quantitative ones (example: thresholds). The SMSG calls on the ESA's to consider alternative approaches, keeping these considerations in mind.

I. Bridging the gap between theory and practice

1. The SMSG is aware of the context in which it writes its advice: daunting economic and social challenges on a global scale resulting from the COVID-19 crisis; unprecedented environmental threats, in particular climate change. Against this background, enhancing the Environmental, Social and Governance (ESG) inclination of the economy has a valuable role to play. Also, it can increase the appeal of entrepreneurship and investing as being part of the solution.
2. Financial legislation alone cannot adequately deal with these challenges. Nevertheless, disclosure has its role to play. As such, the SMSG is aware of the unique opportunity arising at this point in time, in particular by the potential synergy between the Sustainable Finance Disclosure Regulation (SFDR) and the Non-Financial Reporting Directive (NFRD).
3. To fully exploit this potential, the gap between theory and practice should be bridged. In this respect, well-balanced regulatory technical standards guiding the implementation are of utmost importance.
 - a. “Go forward, but mind the steps”. The SMSG’s principal worry is the timing, which is considered to be unrealistic for several reasons:
 - i. There will be a time lag between the review of the Non-Financial Reporting Directive and the implementation of the Sustainable Finance Disclosure Regulation. However, the former is a prerequisite for the latter, as its review is needed to facilitate data availability. Reliable data are important to enhance the credibility of the SFDR. The SMSG cautions not to jeopardize the potential of this legislation by timings that do not take into account data constraints. Inasmuch as a primary purpose of the NFRD review will be to identify which indicators should be standardized on cross-sector basis (taking into account principle of materiality), the proposed set of indicators should not pre-empt this complex analysis.
 - ii. The implementation of SFDR will require additional costs and resources for data collecting and reporting from issuer-companies. This will be particularly so for SME’s, who are at this stage less acquainted with ESG reporting. However, the Sustainable Finance Disclosure Regulation was approved in pre-COVID-19 times. Today, many companies, including SME’s are struggling for survival. As such, the timing imposed by the SFDR requires a ‘new-reality’ check.
 - iii. The indicators put forward by the ESAs are addressed to investors (financial market participants) to allow them to assess the principal adverse impacts of their investment decisions (or financial advice). These indicators will directly impact reporting of non-financial information by issuers and when the data will not be available, financial market participants will turn to investee companies to collect all necessary information. All reporting requirements should be dealt with in the context of the review of the Non-Financial Reporting Directive (NFRD) and ensure consistency of the reporting framework for issuers with the Taxonomy Regulation.
 - iv. Article 7(2) of the draft RTS implies that the principal source of information relevant to the disclosures should be gathered through direct engagement with investee companies. Where “best efforts” have been insufficient to gather the necessary information from the investee company, an asset manager may resort to “third-party data providers”, conduct additional research or make “reasonable assumptions”. As the data required to calculate adverse impacts according to the indicators is, at this early stage, in most cases unattainable directly from investee companies, entities subject to the disclosure requirements risk developing a dependence on third-party data providers that claim to have access to the necessary information. Hence, there are legitimate concerns that pursuing the Big Bang approach

represented by these draft RTS will trigger a “race to the bottom” among third-party data providers as they scramble to offer data that purport to cater to the needs of asset managers arising from the disclosure requirements. For their part, asset managers harbour serious concerns regarding the reliability, accuracy and robustness of the data offered by third-party providers that relates to indicators for which data is not available or readily attainable from investee companies.

- v. the 32 core indicators put forward by the ESAs will add up to the indicators laid down in the Taxonomy Regulation (sustainable proportion of turnover, capital expenditure and operating expenditure) and to the KPIs that will come out of the review of the NFRD
4. Notwithstanding these remarks, the SMSG believes it is important to move forward, but rather than a Big Bang approach, it suggests a phased approach (see below).
 5. There is scope for crossfertilisation between different pieces of legislation, in particular the SFDR, the NFRD and the Taxonomy Regulation. As such, the SMSG’s plea for a phased approach should allow for an iterative interaction between different sets of legislation.
 6. Investors require comparability, simplicity and reliability. Each of these concerns will be kept in mind throughout this advice. The consultation acknowledges the need for disclosure that is easy to use and refers amongst others to the use of templates. While not all templates were ready at the time of the consultation, the SMSG points at the importance of them being consumer tested. Particular challenges are:
 - a. How to cope with the difference in precontractual disclosure between UCITS and occupational pensions, resulting from Level 1 legislation;
 - b. How to device the template so that aside of the quantitative indicators, attention is also drawn to how financial institutions/products go along with these realities (for example: engagement through (proxy) voting);
 7. “In der Beschränkung zeigt sich der Meister”. A major concern is data overload for both the investor who needs to understand and the financial advisor who needs to explain. This is particularly so for the high number of data to screen against the proposed adverse impact indicators. This also invokes the question: at which level are data most relevant: at an overall level encompassing all products or at product level, taking into account the specificities of the product (for example: SME vs large cap funds; sectoral differences...).
 8. Materiality and proportionality. Taking into account on the one hand the risk of data overload, on the other hand the challenges of data availability, the SMSG suggests to look more deeply into the matter of materiality and proportionality.
 - a. Materiality: the SMSG doubts the relevance of 32 mandatory indicators to assess principal adverse impact. In particular, the SMSG wants to discuss the relevance of aggregating these indicators over all relevant products of a financial institution (see below). Moreover, an extended set of mandatory indicators may not necessarily increase the relevance. The longer the list of mandatory indicators, the less scope there is for adding optional indicators, without increasing the data overload. However, these optional indicators may be relevant for specific products. This then raises the issue of the appropriate level of using indicators and related to that, the relation between SFDR art 4, 7, 8, 9 (see below).
 - b. Proportionality: the extended set does not allow for proportionality between data delivered by SME’s and large caps. This risks to put a strain on the resources of SME’s.

9. More clarity is needed on the requirements for precontractual disclosure. In particular, the following issues should be addressed.
 - a. A clear demarcation of which products fall under SFDR art 8 and art 9 respectively;
 - b. The relation between the information to be provided at the level of the financial institution and at the level of products.

10. The 32 mandatory indicators reflect to a large extent the status of the political decision making in Europe, with a focus on the E(nvironmental), where the Taxonomy Regulation reflects a political consensus. This results in a choice of 16 mandatory Environmental indicators. G(overnance) on the other hand has no 'own' indicators, neither mandatory, nor optional. Instead, the indicators relevant for Governance are inserted into the indicators for "Social and Employee Matters", leaving less potential indicators for the latter. Unfortunately, the ESA's are constrained here by the level 1 legislation, which does not give them a mandate to elaborate separate draft regulatory standards on G(overnance). The focus on the E reflects the European context while other countries/regions may focus more on S(ocial)¹ and G(overnance). The focus on the E should not obscure the importance of the S and G. This is all the more important as the indicators that are distinguished by the SFDR will probably guide the review of the NFRD.

II. The timing: putting the pieces of the puzzles together...

Alignment with other legislation

11. The draft RTS and the SFDR in its entirety cannot be seen in isolation but are part of a puzzle, the pieces of which will gradually be assembled over the next two-three years.

12. Of direct relevance to this draft RTS are:
 - a. MiFID II Commission Delegated Regulation: the draft text aligns the reporting on principal adverse impact with the timing for precontractual disclosure in SFDR, i.e. 30 December 2022². When it comes to retail clients the alignment with regard to MiFID II (and PRIIPs) is highly desirable. The scope of the financial products defined in article 2(12) SFDR however is not consistent with the scope defined by the draft text of MiFID II (Art. 1 Delegated Directive 2017/593) and Art. 2 (Delegated Regulation 2017/565). This may cause problems when it comes to financial instruments others than those defined in the SFDR which are designed to respond to investors sustainability preferences and where the issuer is required to comply with MiFID II product governance requirements. Therefor we recommend that the ESAs should already take into account the necessity of making the scopes consistent.

 - b. Taxonomy Regulation³: the Taxonomy Regulation contains several links to SFDR.
 - i. Art 18: linking 'minimum safeguards' and 'do not significantly harm': unfortunately, due to the difference in timing between the approval of the Taxonomy Regulation and the draft RTS, not all of the 'minimum safeguards' provided for in art 18 of the Taxonomy Regulation are in Annex 1 of the draft RTS⁴

¹ For example, the focus on diversity in the American context.

² ...as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in article 7(1), point (a), of that Regulation.

³ Regulation 2019/2088, in full: Regulation on the establishment of a framework to facilitate sustainable investment and amending Regulation 2019/2088. It is popularly known as 'Taxonomy Regulation'.

⁴ The OECD Principles for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights are not in Annex 1 of the draft RTS, neither as mandatory nor as opt-in indicators.

- ii. follow-up tasks for the ESA's to provide draft RTS on environmental objectives, with as deadlines (depending on the kind of objective) 1 June 2021 and 1 June 2022;
- iii. More granular timings, at least as far as it touches upon environmental objectives.

For all of the above, the Taxonomy Regulation incorporates amendments to the SFDR. Apart from these, the Taxonomy Regulation also provides a timetable for its own extension. By 31 December 2021 the Commission shall publish a report to extend the scope of the Taxonomy Regulation to cover other sustainability objectives, such as social objectives (Taxonomy Regulation, art. 26 (2)).

The SMSG suggests to reinforce the link between the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation in particular regarding the definitions of sustainable investment.

- c. Non-Financial Reporting Directive: a review of the NFRD is scheduled. The Commission proposal is scheduled in Q1 2021. The relevance of the NFRD is discussed below.
- d. the review of UCITS and AIFMD. This refers to elements such as the organization of the firm and the assessment of sustainability risk, that are outside the scope of the draft RTS. The SMSG understands that the draft RTS are constrained by Level 1 legislation. Nevertheless, we suggest that the templates are developed as part of the existing funds' documentation, rather than as new documents. However, the provisions should be practically thought-through and well-aligned with other key client disclosures, such as the UCITS KIID and its space constraints. More generally, for information requested in templates for pre-contractual disclosures, more guidance would be useful with respect to whether and to what extent references (links) to websites containing the required information will be accepted.

Stepwise approach for SFDR itself

13. The SFDR itself provides for a phased implementation:

- a. By 30 December 2020, the ESA's shall develop draft RTS in relation to the adverse impact on the climate and the environment and on precontractual disclosure requirements for art 8 and 9 products. By 30 December 2021, they shall develop draft RTS in relation to adverse impacts in the fields of social and employee matters, respect for human rights, anti-corruption and anti-bribery.
- b. The first full period for the reporting (website) at the level of the entity (=financial institution) is 31 Dec 2021 – 31 December 2022.
- c. By 30 December 2022, precontractual disclosure at product level should be ready.
- d. By 30 December 2022, the Commission shall evaluate the SFDR, considering in particular proportionality and data availability.

Timing constraints for the draft RTS

14. In referring to policy options for the Do Not Significantly Harm principle, the ESA's themselves indicate that they were "not able to consider all policy options' possible detailed impacts due to the general lack of time to develop the proposals" (draft RTS, page 91). The SMSG is aware of the timings set by the Level 1 legislation. However, taking into account on the one hand the importance of this legislation, on the other hand the timing constraints under which the draft RTS need to be developed, it prefers a stepwise approach, that allows for gradual improvement, over a Big Bang at an early stage.

Towards an iterative process

15. From the overview above, the SMSG concludes that there will be a complex interaction between different pieces of legislation for at least two years to come. The amendment of the SFDR by the Taxonomy Regulation is a first proof of this. Taking into account the iterative interaction between different pieces of legislation that will follow in the next two years, the SMSG contests the usefulness of a Big Bang with regard to data provision at an early stage.
16. Apart from the considerations above, there is a particular legal concern. The draft RTS to be provided by the ESA's are input for the Commission to supplement the Regulation. Taking into account the time allowed to the Commission to endorse the draft RTS proposed by the ESA's and the time allowed to Parliament and the Council to object to the RTS, it is theoretically impossible to have the RTS endorsed by the start date of the SFDR, i.e. 10 March 2020.
17. The SMSG recognizes the virtues of different points of view with regard to the start of the SFDR and in particular the draft RTS. On the one hand, it is important to move forward. On the other hand, the problems with regard to data availability cannot be disregarded.
18. The draft RTS are multifaceted. They include elements such as the use of templates for comparability and simplicity, the description of policy principles, engagement policies and, also, as one element amongst other, the use of 32 mandatory reference indicators and a series of optional indicators.
19. It is on these reference indicators that much of the discussion is focused. The prime merit of suggesting indicators at this early stage is that they provide input for review of the NFRD (see below, discussion on the Non-Financial Reporting Directive). On the other hand, the obligation to describe 32 indicators and a series of optional indicators creates, for the entity, a problem of data availability and or the end investor a problem of information overload. Also, these indicators refer primarily to the entity level, less at product level. For this reason, the SMSG is fearful of a Big Bang, which puts much of the challenge for data provision at an early stage and at level which is less relevant (entity level).

III. The Non-Financial Reporting Directive

20. Although NFRD is not the topic of this consultation, there are good reasons to discuss the relation to NFRD.
21. On the one hand, the NFRD can facilitate the availability of data. However, realistically speaking there will be a substantial time gap between the implementation of the SFDR and the review of the NFRD. The Commission proposal for the NFRD is not expected before Q1 2021. At that time, the trilateral interaction between Parliament, the Commission and the Council still has to start. In the absence of the reviewed NFRD, the dependence on a limited number of data providers increases.
22. On the other hand, by suggesting indicators, irrespective of whether they are optional or mandatory, the SFDR and its technical guidelines, provide input for the review of the NFRD. This means that the choice of indicators should be carefully balanced:
 - a. the longer the list of mandatory indicators, the less scope there will be for the NFRD to differentiate for example between companies > 500 employees and SME. A degree of proportionality in the NFRD would be useful to avoid too high a reporting burden for SME's and to avoid perverse side-effects like encouraging a shift to private equity, away from listed entities.
 - b. the present lack of standards for data delivery often results in additional work for issuers as they have to fill in different questionnaires by different interested parties. In this respect, bringing more standardization through a reviewed NFRD could be beneficial. However, to the extent that there is a relative underweight of S and G in the indicators proposed by the SFDR, there is a risk that this is mirrored in the NFRD as well. Apart from the ethical and

social considerations, this could negatively impact the relevance of the NFRD and its potential to become an alternative for the multiple questionnaires.

23. For all these reasons, the SMSG believes that an iterative process of cross-fertilisation between the SFDR and the NFRD is useful. The draft regulatory standards can facilitate this by allowing a phased approach.

24. One of the concerns of the SMSG is reliability of data. However, the end result (i.e. the disclosure pursuant to the SFDR) depends on the reliability of the input. For this reason, the SMSG calls on legislators to provide sufficient safeguards that the data provided through the NFRD are reliable.

25. Possible remedies in the remits of the ESAs mandate (especially relevant to product disclosures) are the following:

- a. Ensure flexibility (and legal certainty) by allowing the use of qualitative information, narrative descriptions and estimates. However, some members are concerned that narrative descriptions and estimates may be used to deprive readers from the relevant information or may be misleading. Also, estimates are impractical for several indicators (for example gender diversity at the board). An alternative suggestion, with pros and cons, is to make the reporting on a specific part of the investment universe on a best effort base rather than using estimates;
- b. Carefully balance information to be provided in pre-contractual disclosures vs website disclosures. Website disclosures are better suited to disclose information characterized by uncertainty and frequent updates. Those could be more easily updated, subject to availability of data.

IV. 32 mandatory indicators + optional indicators for adverse impact

Article 4: an intro for dummies

26. The ESA's have a mandate, under article 4(6) and 4(7) of the SFDR to develop draft regulatory technical standards in relation to adverse impact:

- a. climate and other environmental-related adverse impacts; (art 4.6, by 30 December 2020);
- b. social and employee matters, respect for human rights, anti-corruption and anti-bribery matters (art 4.7, by 30 December 2021).

27. The SMSG notes and regrets that this does not specifically include governance indicators.

28. It is important to keep in mind that article 4 refers to transparency on adverse impacts at entity level (i.e. at the level of the financial institution, not at product level).

29. To do so, the draft RTS propose a format (template) that includes:

- a. a summary;
- b. a description of principal adverse impacts;
- c. description of policies to identify and prioritise principal adverse sustainability impacts;
- d. description of actions to address principal adverse sustainability impacts;
- e. engagement policies;

- f. references to international standards.

30. The SMSG acknowledges the usefulness, for reasons of simplicity and comparability, of a format to disclose policies, actions and engagement.

31. However, the approach chosen for the description of adverse impact is strongly contested.

Adverse impact indicators: what the fuss is all about

32. The ESA's propose 32 mandatory indicators (Annex 1), to be complemented by some optional indicators. Of the 32 mandatory indicators, 16 refer to E(nvironmental) indicators, that are to a large extent mapped on the Taxonomy Regulation. Theoretically, the aggregation of all these reference indicators at entity level could reflect some kind of name and shame approach, with as aim identifying financial institutions that offer products with proportionally higher adverse impacts. Although this would probably present data overload for the average retail investor, it may be relevant for other parties (for example: journalists; stakeholder representatives; organized shareholders). Nevertheless, this approach runs into a variety of practical problems:

- a. Certainly in the first years, there will be data problems: ("bad data drive out the good ones"). At a product level, some products will at an earlier stage have reliable quantified data while others may lag (for example large cap funds vs SME funds). However, aggregation over all products would mean that reliable data are lumped with incomplete data;
- b. A complete class of products is outside the scope of the draft RTS anyway: government bond funds. Annex 1 of the draft Regulatory Technical Standards does not include a single indicator relevant to government bond funds. Aggregating over products is not relevant if a major class of products is excluded.
- c. the set of potential indicators, either mandatory or potential, may not yet be optimally balanced nor complete. Progressive insight or the iteration between SFDR, the NFRD and the Taxonomy Regulation or other pieces of regulation could result in additional finetuning. However, the present proposal of 32 mandatory indicators risks of setting in motion a huge investment into data provision, so that there is little scope for finetuning afterwards. A Big Bang risks to introduce path dependency which excludes finetuning at a later stage. Some examples where finetuning could be useful:
 - i. item 6 (annex 1): "breakdown of energy consumption by type of non-renewable source or energy". Proposed indicators should be aligned as much as possible with requirements by other reporting standards. However, the proposed indicators require more detailed information than what is currently disclosed by the CDP;
 - ii. "Excessive CEO pay ratio" could possibly be better aligned with the disclosure obligation required under the Shareholders Rights Directive II, which does not require a ratio per se but a comparison between the evolution of the performance of the company, the evolution of the remuneration of directors and of those of the employees of the company (see art 9b (1b) in addition to a narrative to be provided under article 9a (6) how pay and employment conditions were taken into account in the remuneration policy.
 - iii. item 26 and 27, annex 1: 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. On the other hand, 'supplier code of conduct', which would be relevant in this case,

is just an optional indicator (table 3, item 3). More in general, it would be useful to have a closer look at potential Global Value Chain indicators;

- iv. not all of the minimum safeguards of Article 18 of the Taxonomy Regulation are in Annex 1 of the draft RTS.
- v. Several of the indicators proposed in Annex 1 require instructions on how to calculate them. Example: gender pay gap (proposed indicator 18). One can use different definitions of employee (only persons with work employment contract; persons employed on civil-law contracts; temporary workers; insourced employees; etc.). Also, one may calculate base salary (gross or net), base salary+bonuses etc. Clarification is needed to allow comparability. Alignment with the Shareholder Rights Directive should be investigated.

33. The quantitative data on itself only tell part of the story and it must be avoided that they start leading a life on their own. For example, engagement/(proxy) voting is very relevant and could be used as a lever to encourage change, for example if one has a high exposure to fossil fuel companies.

34. The choice to describe adverse impact through a combination of mandatory and optional reference indicators is primarily a choice made by the ESA's to ensure comparability and discussed with pro's and con's in the draft RTS (see p 72 – 73), rather than a formal legal obligation resulting from the level 1 text.

35. Article 4 refers to disclosure at entity level. The SMSG is of the opinion that the product level is the most relevant for the following reasons:

- a. The investors buys a product (an investment fund; a pension fund...), not the managing asset manager.
- b. Consistency with other pieces of legislation, in particular MiFID. MiFID will be reviewed to incorporate sustainability preference in suitability assessment and in product governance. However, this is at product level.
- c. Alignment with the responsibility of the financial advisor. The draft RTS, article 12, describes the responsibility of the financial advisor with regard to adverse impact. This too refers to the product level: "The statement shall contain details on the process to select the financial products they advise on, including the following: (a) how the information published by financial market participants in accordance with this Regulation is used; (b) whether the financial adviser ranks and selects financial products based on the principal adverse impacts referred to in Table 1 of Annex I and, if so, a description of the ranking and selection methodology used; and (c) any criteria or thresholds used to select financial products and advise on them based on those impacts."

From entity level to product level

36. While all of the above contests (i) the mandatory aggregation of reference indicators at entity level, (ii) the high number of these mandatory indicators, it does not contest the usefulness of indicators as such. However, the usefulness stems from other reasons:

- a. As a common toolbox for cross-sector non-financial analysis. This toolbox should also be viewed a common language between investors/analysts on one side and issuers on the other. The dialogue with issuers is paramount to reach meaningful transparency.
- b. As input for the review of the NFRD

- c. As input for the disclosure at product level, to ensure, that where reference indicators are used, these follow common methodologies. Although article 4 refers to disclosure at entity level, there is also a link to information at product level.
 - i. Article 7, referring to transparency of adverse sustainability impacts in precontractual information at product level: “Where information in Article 11(2) includes quantifications of principal adverse impacts on sustainability factors, that information may rely on the provisions of the regulatory technical standards adopted pursuant to Article 4(6) and (7)”.
 - ii. Draft RTS, article 16, referring to precontractual information for products promoting amongst others environmental of social characteristics (i.e. art 8 products): “Where a financial product invests in a sustainable investment, the section shall also contain an explanation of how the sustainable investment does not significantly harm the sustainable investment objectives, including: (a) how the indicators for adverse impacts in Annex I are taken into account; and....
 - iii. Draft RTS, article 25, referring to precontractual information for products having sustainable investment as their goal (i.e. art 9 products): promoting amongst others environmental of social characteristics (i.e. art 8 products): “The section referred to (...)shall contain an explanation of how the investments of the financial product do not significantly harm the sustainable investment objectives, including: (a) how the indicators for adverse impacts in Annex I are taken into account; and...
 - iv. Draft RTS, article 34, referring to website product information for article 8 products: “...Where a financial product invests in a sustainable investment, the section shall also contain an explanation of how the sustainable investment does not significantly harm the sustainable investment objectives, including: (a) how the indicators for adverse impacts in Annex I are taken into account; and...”. A similar reference to Annex 1 is made for periodic reports of article 8 products (draft RTS, article 38)
 - v. Draft RTS, article 35, referring to website product information for article 9 products: “The section.... shall contain an explanation of how the investments of the financial product do not significantly harm the sustainable investment objectives, including: (a) how the indicators for adverse impacts in Annex I are taken into account; and...”. A similar reference to Annex 1 is made for periodic reports of article 9 products (draft RTS, article 39).

37. The references to Annex 1 show the importance of Annex 1 as a framework containing standardized reference indicators. On the other hand, it is not clear to what the wording “may rely on” (art 7); “shall contain an explanation how the indicators referred to are taken into account” (art 8 and 9 products) exactly implies. While the SMSG is aware that the ESA’s do not have a mandate on article 7, they do have a mandate to elaborate RTS for article 8 and 9 products.

38. For all these reasons, the SMSG believes that is extremely important to carefully balance the information to be presented at product level:

- a. Clarity is to be given on the relation between reference indicators at entity level and those at product level.
- b. A degree of flexibility should be safeguarded to finetune the choice of reference indicators to the nature of the product, without increasing the information overload. The relevance of reference indicators depends partly on the nature of the product. For example: a reference to the OECD guidelines for MNC’s may be useful for a large cap equity fund, but much less

for a SME fund. However, an extended set of mandatory indicators plus opt-in indicators, leaves little possibility to add optional indicators without increasing the data overload.

- c. Notwithstanding this degree of flexibility, circumvention should be avoided. To avoid circumvention, it is important that it is disclosed why particular indicators are used and why others are not. Also, where reference indicators are used, they should be standardized.

39. As a possible way out within the confines of the level 1, the SMSG would suggest:

- a. rather than 32 mandatory indicators and additional opt-in indicators (entity level), a strongly reduced core-set of indicators to be used whenever relevant following a strict comply or explain mode⁵, that could possibly expand over time, as data availability improves. While the SMSG acknowledged the difficulties arising at this point in time, some insisted that the goal should remain for these indicators to become mandatory after a given period in time, with the scheduled review of the SFDR by 30/12/2022 as possible target date. Starting with a limited core set of indicators would have the advantage of reducing the workload at a time when there are still many uncertainties; reducing the risk of path dependence; not confining the information to be given at product level. Although the SMSG advances the principle of a core set of indicators, it was not able, due to timing constraints to evaluate examples of such core sets. In any case, they should aim to be cross-sectoral, have high propensity to standardization and data availability. In this case, a high degree of compliance can be expected.
- b. Use the field “description of policies to identify and prioritize principal adverse sustainability impacts” in the template to be developed under article 4, to disclose which criteria are used to select and prioritize indicators for adverse impact at product level and the process (governance) through which this done.
- c. Use the templates (still to be developed) for art 8 and 9 products, on which the ESA’s have a mandate, to disclose why particular indicators were used and why others were not.

V. Disclosure at the level of products

40. The ESA’s have a mandate to develop draft RTS for disclosure at product level for article 8 and article 9 products. This refers to precontractual information (SFDR article 8-9); website information (SFDR article 10) and periodic reports (art 11).

Art 8 and 9: what are we speaking about?

41. A particular concern of the SMSG is that there is still much confusion about what exactly is meant by article 8 and article 9 products. The SMSG calls on the ESA’s (together with the Commission) to provide further clarification to that extent. That should preferably be done through the draft RTS, to the extent that the ESA’s have a mandate to do so through the draft RTS; if not so, through, for example, Q&A

42. While art 8 in particular invokes uncertainty and confusion, there are also uncertainties surrounding article 9 products. The Level 1 legislation (SFDR, article 9), refers to article 9 as: “where a financial product has sustainable investment as objective”. The draft RTS refers to “sustainable investment objective of the product”, and also to “the” sustainable investment objective. We would suggest to align the wording with the level 1 text (i.e. sustainable investment as objective).

⁵ While a majority of the working group members agreed with the wording, there was no *full* consensus on the reference to a comply or explain mode. The intention was to avoid, by using the word ‘mandatory’ a wording that leaves no room to exceptions and operational real-life challenges. Against this concern stood the fear that comply or explain should not result in dilution.

Art 8: how to make sure that the investor knows what he is buying

43. The SMSG is concerned that, given the wide range of products that could possibly fit under article 8, it is important that there is sufficient disclosure on the degree of sustainability within an article 8 product. For this reason, a graphic representation, as provided for in the draft RTS (article 15), is potentially helpful, although it requires a taxonomy on social objectives to be fully effective. In addition, the accompanying narrative needs to be sufficiently simple and straightforward. Also it is important that there is consistency between marketing communication and website information/ precontractual disclosure describing the degree of sustainability of article 8 products, which the ESA's can safeguard in terms of SFDR article 13.

44. Related to this, The SMSG discussed the warning to be provided in precontractual disclosure for article 8 products (draft RTS, article 16, 1: 'this product does not have as its objective sustainable investment'). In considering this warning, the SMSG took into account the following considerations:

- a. it is important to distinguish article 8 from article 9 products, the latter having sustainable investment as objective (while article 8 products promote, amongst others, environmental or social characteristics);
- b. the wording of this warning is such that it could result in investors disregarding this product from a sustainability point of view;
- c. this warning comes on top of a warning to be provided because of the Taxonomy Regulation⁶ and on top of a narrative accompanying a graph that illustrates the degree of sustainability, making disclosure extremely complex to understand.

45. As an alternative to the warning proposed in draft RTS art 16-1, the SMSG proposes to use the narrative accompanying the graph, for example through wording like: "only the part indicated in the graph ... promotes environmental or social characteristics".

Adverse impact at the product level

46. Finally, the SMSG discussed the disclosure requirements for adverse impact at product level (art 8 and 9). Neither the level 1 text, nor the draft RTS explicitly contains the provision that the indicators in Annex 1 are to be described or quantified at product level. The draft RTS requires: "Where a financial product invests in a sustainable investment, the section shall also contain an explanation of how the sustainable investment does not significantly harm the sustainable investment objectives, including: (a) how the indicators for adverse impacts in Annex I are taken into account." However, this wording does not constitute an obligation to describe in full these indicators.

47. With regard to product level, the SMSG confirmed the relevance of different issues mentioned before.

- a. A timing problem: it will take substantial time before it will be possible to quantify these indicators, due to lack of data. Nevertheless, the SMSG also recognized that the indication that certain indicators will need to be used, can trigger the provision of these data, be it with a delay;
- b. The relevance of indicators differs depending on the product;

⁶ Taxonomy Regulation art 6: 'The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.'

- c. There is a need for finetuning of indicators as well as for an iterative process between different pieces of legislation rather than a Big Bang which seals the indicators that are to be used.
- d. The complexity of the data to be disclosed is a cause of concern:
 - i. for the investor. In addition to the risk of information overload, the definitions of article 8 and 9 products; concepts such as adverse impact, the relation with the Taxonomy Regulation, It all adds up to an increasingly complex puzzle. Consumer testing of templates and the provided information would be useful, but apart from that draft RTS should avoid needless complexity through information overload. Yet on the other hand, the SMSG is aware that for specific stakeholders (consumer representatives; NGO's; journalists...) this information, although complex, is potentially relevant;
 - ii. for asset managers. A specific concern is that the data requirements could be so demanding that they become barriers to entry for smaller financial entities. In such a case, that could have as adverse side-effect that less, not more investment is channelled to sustainable finance.
- e. It must be avoided that these quantitative indicators start living a life on their own.

48. With this in mind, the SMSG considered an approach, derived from the draft RTS, where for each product, all of the 50 Annex 1 impact indicators should be assessed. This approach would be the most comprehensive one and is related⁷ to option 1.3 in the draft RTS on Do Not Significantly Harm (page 89). The most comprehensive approach was considered to avoid that at product level, the indicators were confined to the selection of opt-in indicators selected at entity level. Note that on itself, this would not require financial market participants to publish details of the product's impact against the indicators, but only to disclose how it has taken into account the indicators. Under the ESA's favoured option (see option 1.2, page 90), assessment would require that it is assessed whether the investments made by the product *do not significantly breach certain thresholds*, defined by the financial market participant, for any of the indicators.

49. However, the SMSG concluded that this was not in line with its concerns. First of all and foremost, it will be impossible for a substantial time to implement it. Secondly, it does not distinguish between indicators that are relevant for a specific product and those that are not. Thirdly, the use of thresholds sets quantitative exclusion criteria and in doing so does not allow for qualitative considerations to be taken into account. Finally, it would require a heavy exercise, while the SMSG preferred a gradual process whereby through an iterative process the methodology is improved over time.

50. The SMSG also touched upon two subsequent alternatives.

51. The first one is 'out of the box', as compared to the paradigm of the draft RTS (i.e. use of extended set of adverse impact indicators). It consists in considering a limited and evolving list of indicators (Environment, Social, and Governance) used like a common toolbox for investors/analysts. These indicators should be of potential, but varying relevance in different sectors. Whenever relevant, these indicators should be used to evidence the fund's Principal Adverse Impact. These indicators should also be contributed/approved by the issuers to ensure meaningfulness as well as cross-sector data availability. Another advantage would be that it results in a limited number of indicators, tailored to the product.

52. For the other alternative, the starting point would be the complete set of Annex 1 indicators. However, not assessing indicators would be possible on a "comply or explain" basis for three possible reasons: (i) the indicator is not relevant for the particular product; (ii) due to lack of data, the indicator cannot yet be

⁷ Not identical, because option 1.3 also captures the Taxonomy Regulation's Environmental objectives.

used; (iii) the financial market participant has another indicator for the same issue⁸. Possibly, this “comply or explain” approach could be integrated in the template (still to be developed) for reporting on art 8 or 9 products, in the field that allows to explain why and how certain indicators are prioritised. Certainly, in the beginning, with a scarcity of data, “comply or explain” should be allowed to be the rule rather than the exception. Once a reduced number of indicators is selected, it should be indicated how investments are assessed against these indicators. 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 recognized Global Framework Agreements, suppliers Codes of Conduct or else. Or exposure to fossil fuel companies could be mitigated by engagement policies (voting). Rather than referring to thresholds as only alternative, the draft RTS could refer to different possible alternatives. Compared to the first alternative (the ‘toolbox’), this second alternative would alleviate some of the problems associated with the use of the Annex 1 indicators. However, the starting point, *with pros and cons*, would still be the extended set of indicators.

53. Due to time constraints, the SMSG could not discuss the proposals at length, nor achieve consensus. They are mentioned as illustration of possible alternatives, with a call to the ESA’s to investigate these and other possible alternatives before coming to a final proposal, keeping in mind the concerns raised by the SMSG.

VI. Financial impact of the proposals

54. The draft RTS attempt to quantify the financial impact of the proposal (see page 74). In doing so it refers to the impact assessment done by the Commission, where the focus is on the cost to buy external data, doing internal research, engagement policies...). The overall conclusion is that this cost is marginal.

55. The SMSG is concerned that this impact analysis focuses only at one cost element: the purchase of data and the use of it by the financial entity. In addition, the SMSG believes that two more cost elements need to be taken into account.

56. At the level of distributor, there is the additional costs of financial advice – at least in a context where advice is given person-to-person. Assuming a gross wage cost of a financial advisor equivalent to 1 euro/minute (proxy) and assuming that explaining these indicators would require an additional 10 – 15 minutes, the additional wage cost of advice would be equivalent to 10 – 15 euro. On an investment amount of 5000 euro, this would be equivalent to a one-off cost of 0.2 to 0.3%. Simplicity and avoidance of data overload could be useful here. Data overload would not only be more time consuming for the advisor, but would neither be desirable from the investor’s point of view.

57. Secondly, there is the cost of data delivery, i.e. costs for issuers. These costs may be proportionally higher for SME’s. Also, in comparison to large corporations, they often do not yet have processes in places to provide such data. However, there also possibilities to lessen this cost. At present, issuers are asked by different agencies to provide sustainability data. To the extent that standardization could result in less data varieties to be provided and less different formats to be filled in, it would contribute to lowering the costs of data provision. However, to achieve this goal, a well-balanced iterative process between at least three crucial pieces of legislation is needed: the Taxonomy Regulation; the Non-Reporting Directive and the Sustainable Finance Disclosure Regulation. However, the SMSG believes that at present, the situation is still premature. Hence, it is important that the draft RTS does not constrain the iterative process.

VII. Other issues

⁸ This third option could reduce comparability among products and financial market participants. On the other hand, it is in line with the concern to allow an iterative process of improving the indicators, as it could allow learning by doing by suggesting alternative and possibly better indicators for the same issue.

58. For financial products that are “portfolios” ESAs note in the consultation paper (see page 12) that the requirements on product-by-product disclosures on websites will entail GDPR considerations. The SMSG notes that in addition thereto, it should be considered whether a requirement to disclose information linked to individual clients could in fact be in contravention with bank and contractual secrecy legislation and which regulatory measures could be taken to remedy this problem.
59. The SMSG also suggests to consider the specific situation of green bonds (or rather a fund investing into green bonds), where the issuer has possibly set in place due diligence to separate the funding for the project from general corporate funding. To what extent are the present disclosure requirements and in particular the descriptive indicators meaningful for these products?
60. While templates could be useful for retail investors, the SMSG suggest to look at other ways of disclosure for institutional investors. Institutional investors may face very specific disclosure requirements, that could probably not be met through standardized templates.
61. It is possible that financial market participants or products consider other adverse impact than the one mentioned in Annex 1. Examples: exclusion criteria for adult entertainment, tobacco... To avoid later discussions with regulators, it would be good that the draft RTS explicitly allows financial market participants and products to include additional adverse impact indicators.
62. the public utility of having the Commission to organize a consolidated database where issuers report and different stakeholders access quality ESG data should be assessed.

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

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[signed]

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