Proskauer

ESAs Report on Principal Adverse Impact Disclosures

October 3, 2023

The annual report of the European Supervisory Authorities (the "**ESAs**") on the extent of voluntary disclosure of principal adverse impacts ("**PAIs**") under the Sustainable Finance Disclosure Regulation ("**SFDR**") was published on 28 September. The report follows the survey from the ESAs to the National Competent Authorities (the "**NCAs**") with eleven questions on various aspects of the PAIs under SFDR. The report is a useful guide for good and bad practice and broad regulatory expectations for complying with the requirements for disclosures on PAIs.

What are principal adverse impacts "PAIs"?

To recap, PAIs are those impacts of investment decisions and advice that result in negative effects on sustainability factors. "Sustainability factors" are defined as meaning environmental, social and employee matters; respect for human rights; and anti-corruption and anti-bribery matters.

SFDR sets out that when adverse sustainability impacts are considered, financial market participants should publish and maintain a statement on due diligence policies relating to the impacts (covering all investments made across all financial products). This should take into account the size, nature and scale of their activities and the types of financial products they make available, and should cover:

- information about the financial market participant's policies on the identification of PAIs and indicators;
- a description of the PAIs and any actions taken or planned;
- brief summaries of engagement policies, where applicable; and
- a reference to adherence to responsible business conduct codes and internationally recognized standards for due diligence and reporting, and, where relevant the degree of their alignment with the objectives of the Paris Alignment.

There is a standard template to make such annual disclosures and it is mandatory to do so for financial market participants with 500 employees or more.

For financial market participants with less than 500 employees the disclosures must be made on a "comply or explain" basis and where adverse sustainability impacts are not considered there needs to be a disclosure on the clear reasons as to why not, including information as to whether and when they intend to cover such adverse impacts.

Financial advisers also have to publish and maintain information about whether or not they consider in their investment (or insurance advice) the PAI on sustainability factors.

In European Commission guidance published in May 2022 there was a clarification that even when a financial market participant does not commit to considering PAIs at entity-level for all investments there is the possibility for PAIs to be considered in specific financial products. This has proven a welcome flexibility with a greater number of strategies having some consideration to PAIs without the requirement to comply with the entity level reporting requirements.

Key findings in the report

We set out here some of the key findings in the report that may be of useful reference when making PAIs disclosures at entity level:

- **Easily available on websites:** the ESAs noted that disclosures were easier and more straight forward to find in comparison to the previous year;
- **Disclosures of non-consideration of PAIs need to improve:** the ESAs set out that generally the explanations of why an entity does not consider PAIs were not fully complete or satisfactory in many cases. They commented on finding short and vague references to issues with data availability and comparability, or insufficient clarity, from a legal perspective in these disclosures, which are commonly found in the market. In the ESA's opinion, there has also been some misinterpretation of the "spirit of the article" with disclosures setting out the rationale for not considering PAIs being that they employed fewer than 500 people, with no further explanation. The ESAs consider this to fail to meet the requirement to "explain" why PAIs are not considered and that there should be a further explanation of reasons and ideally a target date of when that financial market participant does intend to commit to consider PAIs.
- **PAIs and alignment to the Paris Agreement is vague**: there is only a requirement to disclose on the degree of alignment of investments with the Paris Agreement "where relevant" under SFDR. However, the ESAs noted that there is often no reference to the PAI indicators and the decarbonization path of investments with comparison to the Paris Agreement.

- **Supervisory action for non-compliance:**the ESAs reminded the NCAs that where non-compliance was found that supervisory and enforcement action should be considered as appropriate.

Recommendations to the European Commission include increasing disclosure requirements on PAIs

There are also recommendations to the European Commission for consideration on PAIs set out in the report. The European Commission is requested to consider such recommendations in the context of their comprehensive consultations on SFDR that are currently underway (which we reported on here):

- **Alternative to 500-employee threshold:** the ESAs have queried whether there may be a more meaningful way to measure the extent to which investments may have PAIs on sustainability factors than the 500-employee threshold. The alternative example provided is whether to establish a threshold for requirements to report on PAIs based on the size of the financial market participant's assets under management ("**AUM**") (although no specific threshold is proposed by the ESAs). There are similar questions posed by the European Commission itself in their current SFDR consultations on widening the scope of PAI reporting. Benching the requirements to report on PAIs against AUM would be similar to the approach taken under the UK's TCFD reporting for asset managers (and asset owners) where reporting requirements apply to UK asset managers/advisers with more than £5 billion of AUM.
- **Comply or explain at product level for PAIs:** at present the product-level SFDR template has a question on whether the financial product will consider PAIs on sustainability factors and an option is to respond with "No" with no further explanation. The ESAs suggest that the product-level PAIs disclosures could align with those at entity-level and require an "explain or comply" approach which would increase the disclosure requirements on this area in the SFDR pre-contractual disclosures.
- **ESAs report to be made every 2-3 years, rather than annually:** the ESAs set out that if they had a longer time to report then they could have more meaningful analysis about longer term trends.

Overall, the report contains analysis and recommendation that are non-binding. However, financial market participants may find the findings and examples of good and poor practice useful for ensuring that disclosures meet regulatory expectations, particularly with the reminder from the ESAs to the NCAs to consider supervisory action in cases of non-compliance. The report, including the ESAs recommendations on PAIs, is also interesting in terms of the overall direction of travel as SFDR as it seems we are heading towards SFDR 2.0.

For further information, please reach out to UKRegulatory@proskauer.com

Related Professionals

- **John Verwey**
  Partner
- **Rachel E. Lowe**
  Partner
- **Michael Singh**
  Associate
- **Sulaiman I. Malik**
  Associate