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Implementation of the Sustainable Finance Disclosure Regulation (SFDR)

Annex to the targeted consultation

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ANNEX: ADDITIONAL INPUT TO THE PUBLIC CONSULTATION ON THE SFDR 'LEVEL 1'

In the context of the public consultation on the "Level 2" of the SFDR, meaning the "Disclosure Delegated Regulation", Climate & Company had already published two policy briefs summarizing our main messages and recommendations on two dimensions: (1) biodiversity-related indicators and the coverage of the value chain (link) ; (2) greenhouse gases (GHG) emissions reduction targets and carbon credits (link).

ALIGNMENT OF DEFINITIONS AND INDICATORS ON DEFORESTATION AND BIODIVERSITY WITH OTHER FILES

While this present consultation is on the "Level 1" SFDR itself, a few points brought during the previous consultation are worth considering here. Particularly with regard to question 1.8.1 which asks whether the current list of mandatory PAI indicators is "the right ones to be considered as always material". While we agree that at least those should be considered material, we also would extent this to Table 2 on Annex 1 of the SFDR, as well as recommend changes to the indicators themselves, to increase the usefulness and clarity of those indicators and thus the effectiveness of the SFDR. Particularly, on biodiversity-related indicators:

The **definition of an "activity negatively affecting biodiversity-sensitive areas**" (Annex 1 (8)) refers to three Directives and their equivalent at national or international level, for which none of the conclusions, mitigation measures, or impact assessments adopted have been implemented. Our concerns and recommendations regarding this definition include:

- The first issue with this definition is the threshold for "*no action*", which indicates that the implementation of insignificant or small-scale mitigation measures or other types of action is sufficient to consider an activity as not adversely affecting biodiversity-sensitive areas. Biodiversity impacts should be reported regardless of whether actions have been taken to mitigate the damage caused. Mitigation actions would be reported on an annual basis in column 6 ("Actions taken, and actions planned and targets set for the next reference period") and should hopefully lead to results to be reported in column 3 ("Impact [year n]")
- An improvement to this definition would be to include a **reference to the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct**[1], which were very recently updated. The SFDR already refers to the OECD Guidelines in its due diligence requirements[2], so the updated version should now be referenced instead. Furthermore, the updated Guidelines include clearer expectations for companies to carry out risk-based due diligence to assess and address adverse environmental impacts, particularly pointing at biodiversity loss, degradation of land and deforestation, among others. The draft ESRS 1 from the European Financial Reporting Advisory Group (EFRAG) also refer to the OECD Guidelines for their due diligence process.[3]
- Furthermore, the definition does not make reference to the **upcoming Corporate Sustainability Due Diligence Directive (CSDDD)**, where financial and non-financial corporates would (not yet adopted) be required to take actions to mitigate impact on biological resources (as part of one of the violations of the Annex I part II of the CSDDD[4]). Lack of measures to mitigate negative impacts on the use of biological resources will be made transparent under the CSDDD and should therefore be used by investors. Adding the CSDDD as a Directive under this definition would improve policy coherence.

[1] OECD (2023), OECD Guidelines for Multinational Enterprises on Responsible Business Conduct, updated 8th June 2023, link.
[2] Recital (18) of the SFDR and Article 22 (a)(ii), Article 26 (2)(b) of the Disclosure Delegated Regulation.
[3] EFRAG (November 2022), Draft ESRS 1 General Requirements, link.
[4] European Commission (2022), Annex to the proposal for a Directive on Corporate Sustainability due Diligence, link.

- The **ESRS E4 on Biodiversity**, although proposed in the EU Commission's draft Delegated Act (of June 2023) as a voluntary standard subject to a materiality assessment, would be a highly relevant reference framework for disclosure of biodiversity-related metrics. In particularly, the biodiversity transition plans included in ESRS E4 could inform FMPs about the specific actions that companies will take to transition to more sustainable activities. However, the EU Commission has decided in its draft Delegated Act to make biodiversity transition plans voluntary. This would allow for greenwashing, disincentivize investor from considering impacts, and threaten data quality and comparability. It is therefore crucial that the EU Commission takes EFRAG's technical advice into account in this context, particularly in light of the reliance of FMPs on sustainability information from their investee companies.

Regarding other biodiversity-relevant definitions, we support the **reference to the ESRS E4** for the definitions of "**land degradation**" and "**desertification**", which is a helpful approach to increasing coherence between the SFDR and CSRD/ESRS.

The **definition of 'deforestation'** for both ESRS and SFDR (outlined in Annex 1 of the consultation document) are aligned to mean '*temporary or permanent human-induced conversion of forested land to non-forested land'* reflecting the UN's Food and Agriculture Organisation's definition. However, no reference is made to the definition of deforestation in the **EU Deforestation-free Products Regulation (EUDR),** the most stringent piece of EU legislation on deforestation where considerable thoughts have gone into deciding the definition of deforestation". This is a missed opportunity to increase policy coherence and to allow for more comparability of information. The EUDR covers the most important forest-risk commodities. Furthermore, the EUDR will be subject to various reviews to potentially extent the scope of lands, ecosystems and commodities covered by the requirements of the Regulation. So, an explicit reference to this evolving Regulation will hopefully enable a **broader scope of ecosystems** to be covered by the disclosure requirements of the SFDR. The disclosure requirements ESRS E4 already address ecosystem conversion in a broader sense (beyond deforestation). The concept of ecosystem conversion is not covered in the SFDR yet. In the interest of further alignment between EU disclosure policies, we recommend the ESAs to add this concept in the scope of PAI of the SFDR.

Lastly, the **indicator on deforestation** *("Share of investments in companies without a policy to address deforestation", Annex 1, Table 2, indicator 15*) **is not informative**. An indication of whether a company has a deforestation policy in place or not, does not provide useful and accurate information about the quality and impact of those policies.

- Therefore, we recommend including the **EUDR as an explicit reference** in the indicator on deforestation as follows: "*Share of investments in investee companies **trading commodities subject to the EUDR fulfilling all compliance requirements AND share of investments in investee companies that voluntary disclose on all (material) disclosure requirements of ESRS E4***".
  - All disclosure requirements of the ESRS E4 are not only about deforestation but related to it. We recommend the SFDR to provide several incentives through different indicators to require biodiversity disclosures through the ESRS E4 for the purpose of **reinforcing the "Do No Significant Harm" (DNSH) assessment** (see below under "Error! Reference source not found.") and **the use of the voluntary ESRS E4**.
- This recommendation is aligned with other established international metrics, such as the indicator recommended by the Accountability Framework Initiative (AFi) Coalition for all companies: "proportion of deforestation- and conversion-free (DCF) commodity volumes in the supply chains".[5]

[5] Accountability Framework Initiative (2023), The AFi Coalition calls on companies to disclose progress towards deforestation-and conversion-free supply chains, link.

Reliance on readily available information disclosed within the CSRD means that the EU Commission cannot delay and weaken the ESRS.

The ESAs' suggested to include precisions on the use of value chain data when available[6]. We are worried that focusing only on **readily available** information could cause two main blind spots:

First, the CSRD is intended to serve as the data foundation for FMPs' reporting under the SFDR. So, reliance on readily available information increases the risk that **(expected) delays and dilutions of the ESRS spill over into the SFDR**. The European Commission's latest draft Delegated Act[7] has subjected the mandatory reporting requirements on the topical standards (including biodiversity) to a materiality assessment, with questions about the assurance that this assessment is well-executed. There is a danger that this change (from mandatory to voluntary assessment) leads to huge data gaps for the obligatory reporting of the PAI under the SFDR. Additionally, there are still concerns that the European Commission might pursue a climate-first approach with this Delegated Act, in which case the non-climate topical standards (including biodiversity) will not be included, and their finalisation will be significantly postponed until late after the elections. Both risks have been introduced after the ESAs provided their amendments to the SFDR, therefore increasing the importance of their consideration.

Second, the **impact of sectors that are dominated by SMEs still fall outside the scope of the CSRD**, and therefore their information is unlikely to be readily available. The ESAs suggest using information that is readily available, "*for example by third party data providers*" (Recital (3)). This is not enough to ensure the value chain is sufficiently covered. Agriculture is a good example of a sector dominated by SMEs outside of the scope of the CSRD, and it is unlikely their value chains' information is readily available.

The European Commission's draft Delegated Act for the cross-cutting and topical ESRS provides more guidance and direction to what can be done if the undertaking cannot collect value chain information, making an estimation "using all reasonable and supportable information that is available to the undertaking at the reporting date without undue cost or effort" (ESRS E1 AR 17 (p. 27)). This would not yet solve the issues above, but aligning with this would be a potential intermediate solution (in terms of policy coherence).

Policy coherence needs to be improved by linking the "Do No Significant Harm" (DNSH) principle of the Taxonomy Regulation and the SFDR

DISCLOSURE OF QUANTITATIVE THRESHOLDS

We strongly support the ESA's recommendation to make mandatory disclosure on the quantitative thresholds FMPs use. Mandatory disclosures on quantitative thresholds ensure a higher degree of comparability, and when communicated transparently, can increase the level of ambition in setting the thresholds. Leaving the definition/threshold of DNSH up to FMPs' discretion raises significant concerns regarding the generation of comparable and accurate data across investments and may lead to greenwashing. While comparability may be limited by the fact that many PAI approaches differ in terms of sectors, company size, and other factors, we encourage efforts to increase transparency.

REQUIREMENT TO BASE DNSH ASSESSMENT ON DISCLOSURES FROM THE CSRD

The CSRD and its ESRS are crucial sources of information for the assessment of whether financial products "do no significant harm". While some of the PAI indicators already refer to definitions used in the ESRS (see above), we recommend requiring FMPs to base their DNSH assessment under the SFDR on information reported in the topical standards of the ESRS. This requirement would reinforce the DNSH assessment and ensure that it is based on information reported under concrete guidelines, as well as boost the disclosures of non-financial

[6] "*FMPs shall include information on the value chains of other investee companies where that information is readily available*"

[7] European Commission (2023), draft Delegated Act for cross-cutting standards and standards for the disclosure of environmental, social and governance information, link.

companies under the different topical standards. Creating an incentivize for non-financial companies to disclose information according to the ESRS will address substantial challenges that a voluntary approach to disclosure standards will pose on FMPs. It is imperative that the Commission recognizes the importance of maintaining consistency within the reporting framework and upholds the CSRD provisions to ensure that sustainability standards encompass the information essential for compliance with SFDR.

- For example, for the DNSH criteria of the biodiversity-related PAI indicators (in both Table 1 and 2 of Annex II) to be fulfilled, FMPs should base their assessment on data disclosed in ESRS E4 on Biodiversity.

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