Principles for Responsible Investment

PRI RESPONSE

EUROPEAN SUPERVISORY AUTHORITIES: JOINT CONSULTATION PAPER, ESG DISCLOSURES

Draft regulatory technical standards with regard to the content, methodologies and presentation of disclosures 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

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UNEP FINANCE INITIATIVE
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

SUMMARY OF RESPONSE

In recent years, PRI has recognised greater attention to real economy outcomes amongst investors. We are working with our Signatories to understand, monitor and manage the outcomes of investments including through our Reporting and Assessment Framework, which is reported on annually by over 2,000 investors globally. In June 2020, the PRI released Investing with SDG outcomes[1] which sets out guidance to investors seeking to contribute to real-world outcomes aligned with the Sustainable Development Goals.

The PRI strongly supports the aims and objectives of the Regulation on Sustainability-Related Disclosures in the Financial Sector (Regulation (EU) 2019/2088 (hereinafter Sustainable Finance Disclosure Regulation "SFDR"). We understand the aims to include helping end-investors to understand the sustainability impact of products and encouraging management of adverse impacts by investors.

However, we are concerned that the proposed RTS framework approach to entity level principal adverse impact indicators is not fit for purpose. Indicators at the investor/entity level typically focus on decisions made at the highest level: policy, governance and due diligence. This can be supplemented by quantified impact measures, but the aggregation must be done carefully and respecting the processes surrounding management of individual funds. Many of the indicators in Annexes I, II and III could be suitable for assessing the performance of an individual issuer but become unhelpful or misleading when aggregated to the entity level. They also present substantial methodological and data collection challenges, leading to a substantial reporting burden for limited additional value.

We are also concerned that the RTS framework for entity and fund level disclosures appears to be developed independently of the EU Taxonomy, a framework which seeks to address many of the same concepts and has many of the same investors and funds in scope. This presents a fragmented and potentially confusing framework for investors and end-users of the disclosures.

RECOMMENDATIONS

1. **The EU institutions should develop and publish a clear overview of how SFDR, the Taxonomy and current and future RTSs, as well as the revision of the Non-Financial Reporting Directive, will work together as a coherent framework for disclosure of sustainability risk and impact by investors and companies**.

2. **The approach set out in Chapter II, Annex I, II and III should be reconsidered.** In the short term, we recommend the RTS focus on indicators which evidence the quality of an investor's due diligence processes on environmental and social issues, consistent with Regulation and the key elements of due diligence laid out in the OECD Guidelines on Responsible Business Conduct for Institutional Investors, on which the Regulation is based. Over time, the EU should work towards

[1] https://www.unpri.org/sdgs/investing-with-sdg-outcomes-a-five-part-framework/5895.article

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greater integration of the "adverse impacts" concept with the "do no significant harm" and minimum safeguard expectations of the EU Taxonomy.

Below, we set out an example of how this could be done. This approach has the following key characteristics:

a) Investors should be able to identify the most significant issues[2] in their overall portfolio, should demonstrate the steps taken to understand the full range of potential issues, and provide justification when issues are not considered principal adverse impacts. However, we recognise that certain issues are systemic and likely to be significant for every investor. We therefore recommend that all investors should always be required to disclose on their response to **climate change** and respect for **human rights** (although as below, we have some reservations on the proposed indicators relating to both themes).
b) The template should focus on indicators which map to the key elements of the OECD guidelines.
c) Quantitative indicators should be used to support and substantiate this due diligence-based reporting, but investors should select these where appropriate to their overall strategy.
    a. For climate change, we recommend that the "principal adverse impacts" indicators reference the "do no significant harm" elements of the EU Taxonomy, subject to review once these have been finalised. We note that practical implementation will be very challenging as the data evolves, and investors and companies become more familiar with the Framework. Investors could therefore disclose indictors such as:
        i. Number of funds/individual holdings assessed for significant harm in a given year;
        ii. Number of funds in which instances of harm were identified;
        iii. Number of individual holdings in which significant harm was identified;
        iv. Proportion of the portfolio that exceeds the "do no significant harm" criteria of the EU Taxonomy;

    Investors should also have the option to include additional impact indicators to help them communicate their approach, for example:
        v. Implied warming of the portfolio, expressed in degrees.
    b. On quantitative indicators relating to social and employee matters and human rights, we recognise the need for greater clarity on measurement, but are concerned that the existing indicators require substantial further development. We encourage the ESAs to undertake more development in consultation with industry and human rights experts and to align this with the potential development of an EU Social Taxonomy.

[2] An example of one approach to seeking to identify important negative outcomes can be found within the UN Guiding Principles on Business and Human Rights (UNGPs), which uses the term salience to define something that is so prominent or important, that it stands out conspicuously. For example, a company's salient human rights issues are those human rights that stand out because they are at risk of the most severe negative impact through the company's activities or business relationships. The concept of salience uses the lens of negative outcomes to people, not the business (see https://www.ungpreporting.org/resources/salient-human-rights-issues/).

Below, we give an example of this approach in practice (this should be subject to further testing):

Principal Adverse Impacts: Due Diligence and Outcomes Indicators	
1. Embedding responsible business conduct into policies and management systems	
1a.	Statement(s) regarding the FMP's response to specific international agreements, such as the SDG goals and targets, the Paris Agreement, the UN Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises – including guidance on Responsible Business Conduct for Institutional Investors.
1b.	Policies relating to the implementation of these agreements, if relevant, with dates of approval and individual(s) or groups responsible for approval.
1c.	Individuals and business units with responsibility for implementation, and specific responsibilities.
2. Identifying and assessing adverse impacts in the firms in which it invests	
2a.	Which sustainability issues have been considered, including at least those in scope for the EU Taxonomy (climate change mitigation, climate change adaptation, circular economy, water, pollution and protection and restoration of healthy ecosystems) and NFRD (social responsibility and treatment of employees, respect for human rights, anticorruption and bribery, Board Diversity).
2b.	Which issues have been identified as Principal Adverse Impacts of the investor (including climate and human rights), and justification for issues not identified as PAIs.
2c.	How the process considers geographical, economic, social and other factors.
2d.	How the process considers the probability of occurrence, severity and irremediable character of impacts.
2e.	Limitations of the methodologies including limits of accessible data.
3. Ceasing, preventing or mitigating adverse impacts	
3a.	For each issue identified as a Principal Adverse Impact, a description of the actions taken during the reference period, and planned for the next reference period.
3b.	Targets set in relation to these issues, at what level they are set and how they derive from global goals such as those listed in 1a.
4. Tracking implementation and results	
4a.	Taxonomy-aligned indicators (could include): • Number of funds/individual holdings assessed for significant harm in a given year; • Number of funds in which instances of harm were identified; • Number of individual holdings in which significant harm was identified; • Proportion of the portfolio that exceeds the "do no significant harm" criteria of the EU Taxonomy; . (Current scope is environmental issues, with possible extension to include future social Taxonomy).
4b.	Optional additional indicators: • Implied warming of the portfolio, expressed in degrees.
5. Communicating how impacts are addressed	
5a.	How the investor communicates externally about its impacts, excluding the RTS disclosure requirements.
6. Providing for, or cooperating in, remediation where appropriate	
6a.	Statement of policy regarding remedy for the adverse impacts on individuals, workers and communities that it has caused, contributed to or been linked to.
6b.	Examples from the current reference period.
6c.	Planned actions for the next reference period.

3. The following issues should be considered in developing the Articles:

- The proposed disclaimer for Article 8 funds – “this product does not have sustainable investment as its objective” – should be removed or amended to avoid misleading consumers.
- The definition of “fossil fuels” should at minimum be aligned to the IPCC definitions, but ideally replaced with a more sophisticated concept of environmental harm.
- The disclosure requirements around ESG and climate benchmarks should revised to reflect the fact that firms may have valid reasons for not choosing an ESG benchmark, and should not be penalised for doing so.

DETAILED COMMENTS

Below, we provide a summary of our key concerns, divided into two sections:

1. Principal Adverse Impact disclosures, covering:
    a. Impact metrics
    b. Alignment with EU Taxonomy
    c. Reference to international standards
    d. Obtaining data

2. Article 8 & 9 fund disclosures, covering:
    a. Distinction between Article 8 and 9 funds
    b. Disclaimer for Article 8 funds
    c. Taxonomy alignment
    d. Definition of fossil fuels
    e. Treatment of benchmarks

1. Principal Adverse Impact disclosures

a. Impact metrics

As noted above, PRI has recognised greater attention to real economy outcomes amongst investors. In June 2020, the PRI released Investing with SDG outcomes[3] which sets out guidance to investors seeking to contribute to real-world outcomes aligned with the Sustainable Development Goals.

We are concerned that the proposed RTS framework approach to entity level indicators is not fit for purpose. Typical indicators at the investor/entity level are those relating to policy, governance and due diligence.

There are other indicators which may be suitable for assessing the performance of an individual issuer but which are misleading or unhelpful when aggregated to the entity level. This is the case for many of the indicators proposed in Annexes I, II and III. As drafted, we are concerned that they would provide an inaccurate account of investor impacts and incentivise investor behaviours that are not aligned with the aims of the Regulation. They also present substantial methodological and data collection challenges.

All investments have outcomes, which can be positive or negative, intentional or unintentional. It is important to distinguish between the different roles that investors can have in relation to outcomes.[4] The Sustainability Disclosures Regulation refers to the OECD guidelines on Responsible Business Conduct for Institutional Investors. This is also the framework the PRI uses for conceptualising investor impact. This framework differentiates between outcomes that an investor:

[3] https://www.unpri.org/sdgs/investing-with-sdg-outcomes-a-five-part-framework/5895.article
[4] See https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf and https://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf

1. has caused – through its own business activities (e.g. through decisions around its own employees);
2. has contributed to – through a business relationship or investment activity (actions or omissions) that induces or facilitates an outcome from an investee company or project;
3. is directly linked to – through the activities, products or services of an investee company or project.

While the investee company or project causing the outcome has responsibility, the investor – through its investments, and acting alone or in collaboration with others where appropriate – is in a position to use its leverage to influence the entity, with the aim of decreasing negative and increasing positive outcomes.

There are three principal ways in which investors can contribute to a change in outcomes, or impact: [5]

1. Capital allocation;
2. Stewardship;
3. Dialogue with policymakers.

Depending on the characteristics of the investment, one of these may be more powerful than another. For example, many ESG funds in Europe are listed equity funds. Capital allocation may have a small influence on price, and therefore a weak and indirect influence on the company. However, investors can have a significant and direct impact through company engagement and exercise of ownership rights, as demonstrated by recent net-zero commitments by European oil majors as a direct result of investor pressure.[6] Allocating capital to high carbon companies is integral to this strategy, as it confers ownership rights. The proposed PAI indicators would suggest that these firms are causing the most substantial harm, when they may be amongst leading investors on climate and using their leverage. As currently presented, these indicators would provide a misleading and inaccurate understanding of the impact of a firm or portfolio.

In addition, the impact metrics are provided in isolation. To provide a meaningful assessment of impact, they should be contextualised by explaining their relationship with key EU commitments, such as net-zero by 2050.

When considering alternative metrics, any future metrics should;

1. Build from metrics in use in the investment industry;
2. Reflect the SFDR / OECD framework for understanding investor impact (cause, contribute, be linked to); and
3. Contextualise the impact in relation to Union goals.

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[5] The PRI understands impact to mean a change in an outcome or outcomes.

[6] For example:

- https://www.shell.com/energy-and-innovation/the-energy-future/shells-ambition-to-be-a-net-zero-emissions-energy-business.html
- https://www.bp.com/en/global/corporate/news-and-insights/press-releases/bernard-looney-announces-new-ambition-for-bp.html

b. Taxonomy alignment

The indicators proposed are not coherent with the broader package of EU disclosure requirements. The concept of “principal adverse impacts” is closely linked to the concept of “significant harm” and “minimum safeguards” embedded in the Taxonomy Regulation.

The forthcoming Taxonomy delegated acts will provide harmonised metrics and screening criteria for establishing whether an activity is causing significant harm. By contrast, the proposed PAI indicators focus on quantifying the impact, but not putting that impact into context with respect to the EU’s environmental or social objectives. Creating two distinct sets of indicators for measuring these related concepts is confusing and unhelpful.

c. Reference to international standards

Article 10 requires disclosure of adherence to international standards, including disclosure of the degree of alignment with The Paris Agreement based on a forward-looking scenario. However, no guidance is given on appropriate metrics for demonstrating this alignment. While methodologies on how this could be done are still evolving, one approach that TCFD is considering the implied temperature warming of portfolio[7], which is one example of a potential impact metric that could support the disclosure obligations of this Regulation. There is, however, need to ensure that industry practice has time to sufficiently develop around how to demonstrate entity level alignment with The Paris Agreement. PRI would also recommend considering if, and how the disclosure obligations could be broadened to encompass the elements of board oversight, resilience of investment and lending strategy, monitoring, metrics and group-wide targets of TCFD to ensure this metric is provided in the appropriate context.

d. Obtaining data

RTS Article 7 sets out disclosure requirements where information is not readily available. It requires investors to disclose either their best efforts used to obtain the information directly from companies, or if that isn’t available, description of assumptions, research, use of third-party data providers or other external experts.

This suggests that investors should only resort to using data providers if their best efforts to get data directly from the company have failed. In practice, data providers have an important role here and should not be treated as a secondary approach to data collection. In the absence of systematic corporate disclosures aligned to the investor reporting obligations, modelled data and assumptions will be an integral part of investor reporting.

2. Article 8 & 9 funds

[7] For further elaboration of this metric, see: https://www.unepfi.org/publications/investment-publications/changing-course-a-comprehensive-investor-guide-to-scenario-based-methods-for-climate-risk-assessment-in-response-to-the-tcfd/

Concerns relate to:

a. Distinction between Article 8 and 9 funds
b. Disclaimer for Article 8 funds
c. Taxonomy alignment
d. Definition of fossil fuels
e. Treatment of benchmarks

a. *Distinction between Article 8 and 9 funds*

Conceptually, the SFDR understands two types of fund:

1. "Article 8" funds which promote the environmental and social characteristics of the underlying investments, alone or in combination with other characteristics. This is implicitly understood to be a lower impact ("light green") category of fund, and to include strategies such as stewardship.
2. "Article 9" funds which target "sustainable investments", as defined by the regulation, including a sub-set of funds targeting a reduction in carbon emissions (Article 9.3). This is implicitly understood to be a higher impact type of fund ("dark green").

In practice, we do not recognise that Article 9 funds will always create more positive impact than Article 8 funds (see above for commentary on stewardship). The framework is designed to assess the underlying investments in a fund, but as described above (*a – Impact metrics*), the characteristics of the underlying investment are not always a good measure of the impact of the investor's strategy. For that reason, the differential disclosure requirements for these fund types may not be based on clear differences in impact.

The framework for Article 8 and 9 funds cannot be changed in the RTS. However, we recommend that the disclosure expectations for both be the same. This would allow end investors to make a judgement based on clear performance indicators, rather than on the distinction created in the SFDR.

The proposed disclosure requirement for Article 8 funds add to the confusion. In RTS Article 15, these funds would be required to disclose the proportion of the fund that is "sustainable investments" as per the Article 9 definition. This implies that investors offering Article 8 funds must evaluate whether all of the underlying investments meet the Article 9 definition even if they are not the target of the investment strategy. This is in addition to completing Taxonomy disclosures where the fund promotes environmental characteristics.

b. *Disclaimer for Article 8 funds*

Under the proposed RTS Article 16 (No sustainable investment objective), Article 8 funds must carry a disclaimer that states "**this product does not have sustainable investment as its objective**".

Article 8 funds will include a large number of existing ESG and SRI products on the market. As above, these funds may have very significant positive impacts on the environment and society, even if they do not meet the Article 9 definition.

The term "sustainable investment" will be understood in a much wider way than the narrowly defined regulatory definition. In particular, most consumers would read this to mean that the fund is not in any way sustainable. We are concerned that this disclaimer would be misleading.

c. Taxonomy alignment

The Taxonomy will provide a single Union-wide definition of "environmentally sustainable economic activities". Funds covered under Article 8 and Article 9 SFRD will be required to disclose against the EU Taxonomy, where environmental issues are a theme of their fund, and may be required to disclose against a future Social Taxonomy subject to the outcome of a future review by the European Commission.

Under the proposed regime, an individual Article 8 fund with an environmental focus would be required to comply with two distinct sets of disclosure requirements which address the same fundamental concepts in two different ways:

SFDR RTS proposal	Taxonomy obligation
Article 15 RTS: ■ A graph presenting: 1. How much of the product is "**sustainable investments**" according to SFDR broken down by environmental and social; 2. The total investments, excluding the above, that contribute to E&S characteristics, broken down by E&S; 3. Everything else ■ Narrative to include description of the purpose of the remainder of the investments and the investment in different sectors, including solid fossil fuels (labelled as fossil fuels). **Article 18 RTS:** ■ A list of sustainability indicators.	■ Narrative explaining the extent to which the EU Taxonomy was used in determining the sustainability of the investments; ■ Proportion of the fund that is "**environmentally sustainable investments**" in accordance with the EU Taxonomy; ■ Environmental objectives to which the fund contributes; ■ Proportion of "enabling" and "transition" investments within the fund. ■ [TEG recommendation: proportion of the fund that is potentially aligned but for which full validation cannot be completed]

(Article 9 disclosure requirements differ in that there is no obligation to disclose the total investments promoting E&S characteristics, and they must indicate how significant harm is avoided including how they make use of the principal adverse impacts indicators and any exclusions).

These disclosures must be made in the same documents. End investors seeking to understand the impact of the products will therefore be presented with two different frameworks for understanding the impact of the fund.

The proposed SFDR RTS seeks to address the same basic concepts as the EU Taxonomy but provides a less robust framework for doing so. For example, the inclusion of mandatory disclosure of fossil fuels appears designed to identify the extent to which a product is invested in high-carbon activities, a source of substantial environmental harm. While this is true, fossil fuel sectors are not the only source of substantial harm and may not have a substantial negative impact on other environmental issues. The Taxonomy, by contrast, establishes technology-neutral thresholds by which an economic activity, such as energy generation, can demonstrate that it is avoiding substantial harm across all environmental goals.[8]

The Taxonomy also focusses on the environmental performance of the underlying activity, giving flexibility to the discloser around the investment approach used to improve the underlying performance. The TEG has also recommended different financial metrics to calculate Taxonomy portfolio or fund alignment which can support different narratives around the strategy.

The Taxonomy provides a robust and credible framework for assessing the environmental sustainability of investments. It is a tool that many EU companies and investors will already be required to use.

d. Definition of fossil fuels

The draft RTS proposes to define the term "fossil fuel sectors" to only include solid fossil fuels. This is misleading. The term "fossil fuels" is already widely understood to refer to all hydrocarbon-based fuel sources including oil and natural gas, as referenced under the definitions promoted by the Intergovernmental Panel on Climate Change.[9]

Unless the end investor is familiar with the regulatory definition, they are likely to assume that this refers to all fossil fuels. There is a substantial risk that they will be misled as to where their money is invested. This is entirely contradictory to the purposes of this regulation.

e. Benchmarks

PRI supports the development of low carbon benchmarks and greater ESG disclosure by benchmark administrators. However, have concerns about the treatment of low-carbon and ESG benchmarks in this regulation, which appears to indicate that;

1. All Article 8 funds should have an ESG benchmark aligned with the objectives of the fund;
2. All Article 9 funds must have an ESG benchmark

[8] This is in addition to the threshold for demonstrating a substantial contribution.
[9] https://www.ipcc-data.org/guidelines/pages/glossary/glossary_fg.html).

3. All Article 9(3) funds (targeting a reduction in carbon emissions) must use a low carbon benchmark if one is available.
4. Irrespective of whether an ESG benchmark is used, the investor must disclose how the index differs from the broad market index including its sustainability performance measured by both the indicators that the investor considers relevant AND the indicators disclosed in the Benchmarks statement; and how the sustainability performance of the product compares to both the selected benchmark and a broad market index.[10]

ESG and low carbon benchmarks are tools which should help investors to demonstrate and communicate their financial, environmental and social performance. However, it is unreasonable to expect that all sustainable funds find a benchmark which matches their objectives, and there are valid reasons why an investor would choose to use a non-ESG benchmark to benchmark performance of an ESG fund.

With the exception of low carbon benchmarks, there are no minimum standards for marketing an ESG benchmark. Requiring investors to disclose the sustainability performance of their fund in relation to an ESG benchmark effectively introduces an addition sustainability disclosure regime for these funds, on top of the existing requirements set out above.

[10] Articles 40 and 47 of the RTS contain the same disclosure requirements but apply in different situations. Article 40 appears to apply in cases where the index designated as a reference benchmark for an Article 8 fund is NOT aligned with an environmental or social characteristic promoted by the fund. Article 47 applies to Article 9 funds which do not appear to have the option to select an index not aligned to the objectives of the fund.