Securities and Markets Stakeholder Group

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ADVICE TO THE ESAS

SMSG advice to the ESA's Joint Consultation Paper on Taxonomy-related sustainability disclosures (draft regulatory technical standards with regard to the content and presentation pursuant to Article 8(4), Article 9(6), Article 11(5) of Regulation (EU) 2019/2088.

I. Executive summary

The SMSG refers to its earlier advice on ESG Disclosures (ESMA 22-106-2858). "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 aligned with one another."

By introducing the Taxonomy Regulation's Environmentally Sustainable Activities into the Sustainable Finance Disclosure Regulation, another piece of the puzzle is completed. Although the SMSG welcomes this, it remains worried by the complexity that results from the piecemeal introduction of different pieces of legislation and the use of concepts that are close to one another although not identical to one another. While the SMSG is aware that the draft RTS are confined by the Level 1 legislation, it has added some suggestions for simplification.

With regard to the different questions, the SMSG supports the ESA's proposal to amend the existing draft RTS, rather than draft a new set of RTS.

The SMSG believes that derivatives can serve many purposes, including ESG purposes. In such contexts, the KPI can be extended to include derivatives, provided that it is adequately disclosed how they serve ESG purposes.

On the issue of the KPI indicator, the SMSG is worried that the KPI tells only part of the story. Some instruments cannot be included (example sovereign bonds); social objectives are not yet included. Also, it is concerned that in the perception of the investor, the KPI gets undue prominence ("one indicator tells it all"). For this reason, the SMSG supports an approach where the denominator excludes instruments that are not in scope of the Taxonomy Regulation. However, this should be complemented by another indicator which indicates the *potential* coverage of the Taxonomy Regulation.

The SMSG believes that assessment by a third party would be useful. However, due to data problems and methodological challenges, it is reasonable to assume that in the beginning, financial companies will be on a learning curve. As such, such assessment should be of an advisory, rather than a compliance nature at first. The SMSG also believes that the responsibility of the data on the investee companies rests with the

investee companies themselves. This is something that should be provided for in the Corporate Sustainability Reporting Directive.

It is likely that not only companies, but also National Competent Authorities will be on a learning curve. For this reason, the SMSG proposes that the implementation of this legislation should be a prime focus of regulatory convergence. Also it suggests that questions by financial institutions are primarily answered through ESMA Q&A, rather than bilaterally with national competent authorities.

As already described above, the SMSG remains worried about the complexity of the proposals, to a large extent resulting from piecemeal implementation of different sets of level 1 legislation. To reduce, within the confines of level 1 legislation, the SMSG suggests (i) some subtle wording changes; (ii) to avoid duplication in questions; (iii) clarifications with regard to the indicators.

The SMSG supports the preferred options proposed by the ESAs in their impact analysis be it with some side remarks.

I. Question 1: do you have any views regarding the ESA's proposed approach to amend the existing SFDR RTS instead of drafting a new set of draft RTS

1. The SMSG agrees with the proposed approach. It is much easier to have one set of RTS rather than two parallel RTS. However, this also raises the question of the implementation date of requirements provided by this new RTS. The implementation date should consider the timeline of green asset ratio reporting under article 8 of the taxonomy regulation (which is planned in Q1 2022), as it would allow market participants to use reliable data from issuers. This will help ensure that clients will benefit from correct and consistent information.

II. Question 2: do you have any views on the KPI for the disclosure of the extent to which investments are aligned with the taxonomy, which is based on the share of the taxonomy-aligned turnover, capital expenditure or operational expenditure of all underlying non-financial investee companies? Do you agree with that the same approach should apply to all investments made by a given financial product?

III. Question 3: do you have any views on the benefits and drawbacks of including specifically operational expenditure of underlying non-financial investee companies as one of the possible ways to calculate the KPI referred to in question 2?

2. Turnover, capital expenditure and operational expenditure have potentially different merits. Turnover could be an indicator of the degree of sustainable activities at present. Capital expenditure looks more to the future while operational expenditure is the indicator for a company which could have the most direct impact on in its daily working. At the same time, the relevance of the indicator may vary from company to company. Investment products like funds invest into different companies. For some companies, a turnover indicator would be most relevant; for others, capital expenditure would. The relevance of operational expenditure is more questionable. Hence, applying one and the same approach for all issuers in an investment product would not serve its relevance.

3. On the other hand, using different approaches for the different investments made by a given financial product would increase complexity, not only for the investor, but also for the manufacturer (data storage). Nevertheless, for the sake of relevance, the SMSG believes that the possibility to use different approaches should be allowed, provided that background information on the approach is available. However, taking into account that this is highly technical and that the proposed templates for precontractual disclosure and periodic reports are already highly complex and lengthy, this explanation should not be included in the proposed templates but merely available on demand.

IV. Question 4: the proposed KPI includes equity and debt instrument issued by financial and non-financial undertakings and real estate assets, do you agree that this should also be extended to derivatives such as contracts for differences

4. Securities like bonds, stocks and commercial paper can serve as financing instruments to channel funds for environmentally sustainable economic activities. While not disregarding the relevance of derivatives to real economic activities, this might seem less direct as for instance bond and stocks, especially in terms of their relevance as tools to finance ESG activities. Even if one would find technical ways to assess to what degree derivatives are linked to the Taxonomy, the interpretation and meaningfulness of such a KPI might seem less straightforward.

5. While the interpretation could seem less straightforward, the SMSG recognizes that there are strategies that use ESG derivatives to attain their investment objective and at the same time are useful for ESG

purposes. In these cases, disclosure is paramount to fully explain to investors how derivatives are used to contribute to ESG purposes.

6. Derivatives can serve many purposes. In some cases, they can be used to hedge risks (such as exchange risks; interest rate risk). While this may be of use to the investor, in this context they are financial instruments of a general nature and not directly related to ESG purposes. However, in other cases, they may serve a specific ESG purpose. Carbon Contracts for Differences, for example, may be useful to finance carbon-free technology by providing certainty on the value of the emissions reduced. Other examples include, for example, instruments that set a premium to be paid if certain ESG criteria are not met. As markets for ESG investments develop, investors will need to benchmark their investment strategies with the relevant sectoral indices. This inevitably implies a need for forward prices of these assets and their related indices. Derivatives markets are a key component of mature secondary markets which help deliver this crucial benchmark and pricing function. It will therefore be increasingly necessary over time that ESG derivatives and ESG financial instruments that embed derivatives – and not just contracts for difference – are accounted for. The SMSG acknowledges that these strategies may be beneficial for sustainability purposes. However, at the same time it is worried that it may become increasingly difficult to convey to investors how such strategies contribute to sustainability. For this reason, it reiterates the necessity of adequate disclosure.

7. Some investors may require data on their ESG investments for reporting purposes. In these cases, it is important that derivatives are included provided that their contribution to ESG objectives can be substantiated. To avoid greenwashing risk, this should require, where relevant, netting long positions of short ones.

8. For these reasons, the SMSG believes that the KPI could be extended to derivatives, provided that it is adequately disclosed how the use of those derivatives helps attain the sustainability objectives.

9. The SMSG warns that while this is relevant for disclosure at the level of a financial product, aggregating the figures thus reported over all financial products could entail double counting. As such, the methodology of any such aggregation should be carefully considered so as to eliminate any double counting and to arrive at a realistic estimate of the overall level of ESG finance. As this is outside the scope of this consultation, the SMSG merely mentions this issue without further elaborating on it.

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V. Question 5: is the use of “equities” and “debt instruments” sufficiently clear to capture relevant instruments issued by investee companies? If not, how could that be clarified? Are any specific valuation criteria necessary to ensure that the disclosures are comparable?

10. The SMSG suggests some minor clarifications. With regard to equity, it should be clarified that this refers to shares only. This implied that for example. depository receipts are not considered as equity. With regard to debt instrument, the SMSG suggests to clarify that convertible bonds are considered to be debt instruments till their conversion.

VI. Question 6: do you have any views about including all investments, including sovereign bonds and other assets that cannot be assessed for taxonomy-alignment, of the financial product in the denominator for the KPI.

11. In answering this question, the SMSG is aware of article 5 of the Taxonomy Regulation, “the description shall specify the proportion of investments in environmentally sustainable activities… as a percentage of <u>all</u> investments selected for the financial product”.

12. The SMSG has as particular concern that the reference to the EU Taxonomy KPI could result in a situation where in the perception of the investor that indicator gets undue prominence. As an illustration of this concern, imagine a hypothetical (institutional) mixed fund: the equity assets consists exclusively of shares in companies that have signed ILO recognized Global Framework Agreements (=potential social objective), while at the same time upholding high standards on gender diversity in the board (=social principal adverse impact indicator); the fixed income part consists of Social Bonds issued by issuers such as the African Development Bank (=potential social objective). Unfortunately, none of these features qualifies the investments as EU Taxonomy Aligned. Hence, the KPI would signal 0%, which could deter investors. While for the sake of the argument, this is a very clear example, other examples can be given as well (example an Emerging Markets Bond fund).

13. While sovereign bonds are a prime example of instruments that cannot be assessed under the Taxonomy Regulation, there are other instruments for which this is not straightforward. For example, it is not sure under which circumstances derivatives can be included (see Q4). Also, as a taxonomy for social objectives is not yet in place, neither can instruments which incorporate social objectives at present be assessed for the KPI. To avoid a wrong perception among investors, the SMSG believes that it is potentially useful information for the investor to know the proportion of instruments that are potentially in scope of the Taxonomy Regulation.

14. As a possible compromise, the SMSG suggests that the denominator of the KPI should exclude instruments that are not in scope of the Taxonomy Regulation. However, this should be complemented by another indicator which indicates the *potential* coverage of the Taxonomy Regulation.

    a. This could be done, for example, by a sentence: “This investment products envisages 50% instruments that are covered by the EU Taxonomy Regulation. Of these, the minimum proportion of Taxonomy aligned products is 75%.

    b. Alternatively, a similar objective could be reached by including in the graph “what was the share of investment aligned with the EU Taxonomy” in the category ‘other investments’ a subdivision ‘instruments within scope of the Taxonomy Regulation’.

Both alternatives enable the investor to assess the proportion of investments aligned with the Taxonomy Regulation and hence comply with article 5 of the Taxonomy Regulation. However, the additional information helps to avoid the problem of perception that could otherwise arise because of a low KPI.

VII. Question 7: do you have any views on the statement of taxonomy compliance of the activities the financial product invests in and whether those statements should be subject to assessment by external or third parties

15. Due to methodological challenges and data issues, most financial institutions will be on a learning curve in the beginning years. While the SMSG believes in the usefulness of external assessment, this should initially be of an advisory rather than a compliance nature. It could be useful in validating methodological issues, like for example the indicators chosen (see Q2-3) to calculate the KPI.

16. Notwithstanding the external assessment on taxonomy compliance, the prime responsibility for the accuracy at the level of data on investee companies rests with the investee companies. This responsibility should not be transferred to the manager of the financial investment product. Here, the SMSG repeats its earlier advice with regard to the relation with the Corporate Sustainability Reporting Directive.

17. For the same reasons, it is likely that not only financial institutions, but also national supervisory authorities are on a learning curve. For this reason, the SMSG proposes that the implementation of this legislation should be a prime focus of regulatory convergence regulation exchange. Also it suggests that questions by financial institutions are primarily answered through ESMA Q&A, rather than bilaterally with national competent authorities.

VIII. Question 8: do you have any views on the proposed periodic disclosures which mirror the proposals for pre-contractual amendments?

IX. Question 9: do you have any views on the amended pre-contractual and periodic templates?

X. Question 10: The draft RTS propose unified pre-contractual and periodic templates applicable to all Article 8 and 9 SFDR products (including Article 5 and 6 TR products which are a sub-set of Article 8 and 9 SFDR products). Do you believe it would be preferable to have separate pre-contractual and periodic templates for Article 5-6 TR products, instead of using the same template for all Article 8-9 SFDR products?

18. The SMSG is aware of the confines set by the Level 1 legislation. Nevertheless, it is extremely worried by the complexity that results from the piecemeal introduction of different pieces of legislation and the use of concepts that are close to one another although not identical to one another. The draft RTS recognize Environmentally Sustainable Activities (Taxonomy Regulation) as a subset of the SFDR article 8 and 9 products. Although this an almost inevitable consequence of the present status of the level 1 legislation, it will have as unfortunate consequence to increase the complexity to the end investor.

    a. the SFDR refers to (environmental and social) “characteristics” (art 8), alongside “objectives” (art 9). The Taxonomy Regulation refers to “environmentally sustainable activities”. For an activity to be environmentally sustainable, it should contribute substantially to one or more of the environmental “objectives” of the Taxonomy Regulation. Investments into environmentally sustainable activities can be a subset of both art 8 and 9 products. However, at the same the draft RTS require that the precontractual information for art 8 products should state (see article 13 of the draft RTS): “the financial product promotes environmental or social characteristics, but does not have as its objective a sustainable investment”. These subtilities transform sustainable investing into intellectual high-tech. Unless the investor fully understands the different concepts, it will be very difficult to understand why a product which indicates a minimum share of environmentally sustainable activities at the same time carries a warning: “this product does not have as it objective a sustainable investment.”

    b. Also, at present, the focus of the Taxonomy Regulation is on Environmental objectives. On the other hand, the Sustainable Finance Disclosure Regulation (2019/2088) includes, alongside environmental objectives, also social objectives and governance requirements. To understand all this, the investor should not only understand the difference between ESG-characteristics (art 8) and ESG objectives (art 9), but also the subtle differences between environmental objectives in terms of the Taxonomy Regulation, environmental objectives other than those mentioned in the Taxonomy Regulation and ESG-objectives in general.

    c. SFDR uses the concept of “principal adverse impact”. The Taxonomy Regulation uses the notion of “minimum safeguards” and “does not significantly harm”. The notion of “minimum safeguards” in the Taxonomy Regulation, is smaller than the notion of “principal adverse impact” of the SFDR. For example, board gender diversity, which is a principal adverse impact indicator, is not a minimum safeguard for Taxonomy Alignment. Also, its application is limited to environmentally sustainable activities as defined by the Taxonomy Regulation. The “does not significantly harm” principle of the Taxonomy Regulation focuses on the six environmental objectives recognized by the Taxonomy Regulation. The “principal adverse impact indicators” of the SFDR have a broader scope, ranging from environmental indicators to social and employee, respect for human rights, anti-corruption, and anti-bribery matters.

    d. The subheading “what is the minimum share of sustainable investments that are not aligned with the EU Taxonomy” is confusing. It is doubtful that fund managers will commit

themselves to a minimum share of sustainable investments that are <u>not</u> aligned with the EU Taxonomy.

19. The SMSG also repeats its concern that in the perception of the investor to reduce complexity, one indicator tells it all (the EU Taxonomy KPI) (see also point 10). This could not only overshadow other environmental or social characteristics/objectives, but also principal adverse impact indicators. If "one indicator tells it all", then why still pay attention to all other information? In this case, a particular concern is that this could distance the EU sustainability legislation from standards elsewhere. For example: in the USA, diversity is a top-of-mind indicator. In this SFDR, this is covered as principal adverse indicator but not as part of the EU Taxonomy KPI.

20. The SMSG notes that "gender diversity within the board of investee companies" is an Annex 1 principal adverse impact indicator and as such should be monitored for investee companies. The focus of the Sustainable Finance Disclosure Regulation is on disclosure with regard to investee companies and not on the investment companies themselves. Nevertheless, the SMSG believes that the credibility of the asset management industry would be enhanced if indicators monitored for investee companies would also be applied within the industry itself.

21. The SMSG considered the possibility to give more prominence to principal adverse indicators by detailing in the template relevant questions such as: (i) which principal indicators were used and why? (ii) are the principal adverse impact indicators used for all investee companies within a financial product or only for those investments with environmental and social objectives? (iii) how are the indicators used to assess adverse impact? However, while fully recognizing the relevance of these questions, the SMSG feared that additional detailing would increase the complexity of an already complex template.

22. While the draft RTS cannot amend the level 1 legislation, the SMSG believes that subtle changes in wording can reduce complexity and the risk of misunderstandings. Examples how to do so, are:

    a. Rather than use, in the proposed template, the wording "EU Taxonomy", use the wording "EU Environmental Taxonomy". In this way, the scope of the Taxonomy becomes more visible;

    b. Rather than use, in the context of art 8 products, the wording "the financial product promotes environmental or social characteristics, but does not have as its objective a sustainable investment", use "…but does not have as its **<u>core</u>** objective a sustainable investment;

    c. Rather than use the 'negative' wording "in activities not aligned with the EU Taxonomy", use a positive wording: "in investments with environmental objectives other than the EU Environmental Taxonomy"; "in investments with social objectives";

    d. To avoid confusion between the concepts "significant harm", used in the Taxonomy Regulation, and "principal adverse impact" used in the SFDR, clarify the question in the template "to which objectives do the sustainable investments contribute and how do they not cause significant harm" as "… and how do they not cause significant harm *to other environmental objectives";*

    e. The question "why does the product invest in activities that are not environmentally sustainable" could shed a needlessly negative shadow over a financial investment product. Would this refer to sovereign bonds? Investments into instruments promoting social, rather than environmental objectives?

23. Some minor changes could reduce the length of the template. For example:

    a. The heading "what investment strategy does this product follow?" can be omitted. Details on general investment strategy can usually be found elsewhere in precontractual

information. ESG specific information relating to the investment strategy fit under the heading above "what environmental/social characteristics are promoted by this financial product"

b. The question "how is that strategy implemented in the investment process on a continuous basis" has little added value, given the question above: "what are the binding elements of the investment strategy to attain each of the environmental or social characteristics"

c. The question "where can I find more details on the investment strategy" can be omitted, as there is at the end of the template a general question "can I find more product-specific information online".

24. Separate templates for products incorporating article 5 and 6 Taxonomy Regulation products would be particularly useful for precontractual information. The additional information required for the Taxonomy Regulation adds significantly to the complexity. The questions that are exclusively required for the Taxonomy Regulation are numerous (in particular subheadings: "what is the minimum share of investments aligned with the EU Taxonomy"; "what is the minimum share of investments not aligned with the EU Taxonomy") and they introduce concepts that could be confusing (for example 'do not significant harm' as compared to principal adverse impact'). Consequently, omitting these questions when they are not needed would reduce complexity.

25. To increase user-friendliness, the SMSG is of the opinion that templates should be consumer-tested

XI. Question 11: the draft RTS propose in the amended templates to identify whether products making sustainable investments do so according to the EU taxonomy. While this is done to clearly indicate whether Article 5 and 6 TR products (that make sustainable investments with environmental objectives) use the taxonomy, arguably this would have the effect of requiring Article 8 and 9 SFDR products making sustainable investments with social objectives to indicate that too. Do you agree with this proposal?

26. The aim 'to clearly indicate whether sustainable investments with environmental objectives" is irrelevant in the case of social objectives, as there is not yet a Taxonomy on social objectives. In its answers on Question 9, the SMSG already indicated the problems that arise because the Taxonomy Regulation's scope is exclusively on Environmental objectives, whereas the SFDR has a broader scope. Hence, the SMSG agrees with the proposal. Once and if social objectives are the defined in the Taxonomy Regulation, the complexity could be partially remedied. In the meantime, the SMSG repeats its suggestions made above:

a. Rather than use the wording EU Taxonomy, use the word "EU Environmental Taxonomy". In this way, the limited scope of the Taxonomy becomes more visible;

b. Rather than use the 'negative' wording "in activities not aligned with the EU Taxonomy", use a positive wording: "in investments with environmental activities not aligned with the EU Environmental Taxonomy"; "in investments with social objectives"

XII. Question 12: Do you have any views regarding the preliminary impact assessments? Can you provide more granular examples of costs associated with the policy options?

27. Generally speaking, the SMSG supports the preferred options proposed by the ESA's, be it with some side-remarks:

a. On the proposal of a binding template vs (i) no template or (ii) a non-binding template. The SMSG supports the preferred option of a binding template but reiterates its call for possible simplification;

b. On KPI based on weighted average share of turnover/capex/opex – based KPI of investee companies vs alternatives of (i) revenue derived from investments or (ii) more granular

calculation of each activity. The SMSG supports the preferred option but warns that any choice will depend on data availability and implicit simplifying assumptions and will require years to mature;

c. On the preferred option of a binding statement within a standardized framework with optional verification by a third party vs alternatives (i) non-binding statements or (ii) full granular disclosure of each activity. The SMSG refers to its answer on question 7, in particular "While the SMSG believes in the usefulness of external assessment, this should initially be of an advisory rather than a compliance nature", and believes this comes close to the ESA's preferred option.

XIII. Other issues

28. On 21st April, the Commission published a draft Delegated Act with technical screening criteria for two of the six environmental objectives in the Taxonomy Regulation. That means that for the time being there are no technical screening criteria for four out of six environmental objectives. Timely delivery of technical screening criteria would be needed to ensure adequate data from investee companies.

29. Major infrastructure projects, often related to the Green Deal, are often executed through SPV's or Public Private Partnerships. These SPV's may have various characteristics, both with operational content (such as assigning work to contractors for, maintenance) and as investment vehicles, often very big in size and of high relevance to institutional investors. Would such SPV's qualify as non-financial investee company or as a financial company. The SMSG would welcome clarification on this.

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

Adopted on 14 May 2021

[signed]	[signed]
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