Climate Change and the EU Regulatory Response:

SFDR Art. 9 - “Sustainability Scam, Sphinx or Superstar” ?

Andreas G. F. Hoepner

- Head of Data Science Hub, EU Platform for Sustainable Finance -

Notes: The underlying EU TEG work is based on the excellent and tireless efforts of Claudia Bolli, Manuel Coeslier, Theodor Cojoianu, Delphine Dirat, Steffen Hoerter, Nadia Humphreys, Patrik Karlsson, Sebastien Lieblich, Sara Lovisolo, Astrid Matthey, Veronique Menou, Jean-Christophe Nicaise Chateau, Elena Philipova, Antoine Picot, Cesare Posti, Fabiola Schneider, Chantal Sourlas, Helena Vines Fiestas and Jean-Yves Wilmotte. Andreas also gratefully acknowledges scientific support on the EU TEG / PSF work from Matthew McQuade, Ifigeneia Paliampelou, Saphira Rekker, Joeri Rogelj, Theresa Spandel and Gabija Zdanceviciute.

Preamble:

Is ESG a “scam”, occasionally?

Are current real world outcomes sustainable?

Sell-Side ESG: Tesla out? Exxon top???


Elon Musk
@elonmusk

Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list!

ESG is a scam. It has been weaponized by phony social justice warriors.

2:44 PM • May 18, 2022

Dilbert’s View on ESG …

EU TECHNICAL EXPERT GROUP ON SUSTAINABLE FINANCE

Real Impact Outcome: Male Execs 99% vs. Female Execs 1%

washingtonpost.com/business/economy/nearly-75-percent-of-nursing-homes-at-risk-of-closures/2022/06/06/cf03cc12-e59d-11ec-b037-e344f38e0a4f_story.html

ections

The Washington Post
Democracy Dies in Darkness

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Male execs control 99% of share values

Women account for about a quarter of the top executives at S&P 500 companies and they only control about 1 percent of the value of shares held among their fellow corporate leaders, new research shows.

The disparity means male executives held about $770 billion worth of shares in S&P 500 companies in 2020, compared with about $9 billion for female executives, said Andreas Hoepner, a professor of operational risk, banking and finance at the Smurfit Graduate School of Business at the University of Dublin.

He said the study, conducted with Swedish gender data company ExecuShe, found the ratio was skewed even after removing company founders and outliers like Tesla chief executive Elon Musk.

As more women get promoted to c-suite jobs, a larger share of their overall compensation comes from equity or stock options, and the disparity with male peers grows. In 2020, women in the top ranks of S&P 500 leadership earned only 75 percent of the compensation of male executives, the widest gap in nine years, mostly because of the imbalance in stock ownership, according to analysts at Morningstar. The

1 World Bank warns global economy may suffer 1970s-style stagflation

2 The Colorado River is in crisis, and it's getting worse every day

3 Crypto industry scores a big win under long anticipated Senate bill

4 Raytheon will move headquarters to Arlington

5 'We're all afraid': Massive rent increases hit mobile homes

UN: Cut emissions by > 7%, every year!

unfccc.int/news/cut-global-emissions-by-76-percent-every-year-for-next-decade-to-meet-15degc-paris-target-un-report

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News ··· Cut Global Emissions by 7.6 Percent Every Ye...

Cut Global Emissions by 7.6 Percent Every Year for Next Decade to Meet 1.5°C Paris Target - UN Report

26 NOV, 2019
EXTERNAL PRESS RELEASE

Geneva, 26 November 2019 – On the eve of a year in which nations are due to strengthen their Paris climate pledges, a new UN Environment Programme (UNEP) report warns that unless global greenhouse gas emissions

ESG Ratings vs. Real Impact Outcomes (RIOs)

ESG Ratings:

- Mostly developed in 2000s
- Based predominantly on Inputs (e.g. Policies, Objectives) given data and technology availability at the time
- Weighting various KPIs into one overall rating that does not uniquely identify one outcome (i.e. “Gaming ESG ratings is easy”)

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Real Impact Outcomes (**RIOs**):

- Emerged strongly around 2020 with, in particular, the ~7% number
- Purely Measures Outcomes in commonly known units (e.g. CO2e emissions, Women among Top Execs)
- Avoid Artificial Ratings Scale (ARS)

SFDR simplified by EU FISMA “SFDR” (i.e. C4) Unit Head

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"#Article9 claims to be walking the walk,

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#Article6 you have to do it whether or not you are talking or walking"

Alain Deckers (Head of Asset Management Unit, EU FISMA) on LinkedIn (May 13th '22) in response to my simplification below

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Alain Deckers UA • 1st
Head of unit, Asset management
2d

Um, no.

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#Article6 you have to do it whether or not you are talking or walking

Celebrate · 26 | Reply · 6 Replies

Dag A.D. Messelt, CEFA, CESGA® • 1st
Certified ESG Analyst and Senior Sustainability Consultant at su...
2d

Alain Deckers UA But is it not really:
#Article9 requires specific pre contractual elements and periodic reporting if you claim the product to be walking the walk
#Article8 requires specific pre contractual elements and periodic reporting if you claim the product to be talking the walk
#Article6 you have to inform about whether you integrate ESG risks in investment decisions and explain (how or why not) whether or not you are talking or walking or none of them

It is all about disclosure and not classification!

Like | Reply

Alain Deckers UA • 1st
Head of unit, Asset management
2d

If you go back through my social media channels you'll see that I make this point over and over again. "Claims" in my comment refers to disclosures.

Like · 1 | Reply

SFDR simplified by EU FISMA "SFDR" (i.e. C4) Unit Head

"#Article9 claims to be walking the walk,

#Article8 claims to be talking the walk, *[Marketing Restrictions!]*

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SFDR Article 9

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Transparency of sustainable investments in pre-contractual disclosures

1. Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following:

(a) information on how the designated index is aligned with that objective;

(b) an explanation as to why and how the designated index aligned with that objective differs from a broad market index.

2. Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall include an explanation on how that objective is to be attained.

3. Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council ([20]) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

4. Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the indices referred to in paragraph 1 of this Article and the benchmarks referred to in the second subparagraph of paragraph 3 of this Article are to be found.

5. The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.

SFDR Article 9 (3)

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SFDR Article 9 (1)(a)

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SFDR Article 2 (17)

(17) ‘sustainable investment’ means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance;

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SFDR 2(17) simplified:

(a) You can include any investment with at least one underlying activity contributing [somewhat or substantial] to one of the sustainability objectives chosen for your fund

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(a) You can include any investment with at least one underlying activity contributing [somewhat or substantial] to one of the sustainability objectives chosen for your fund

(b) Provided that, you exclude (i) any investment with at least one underlying activity doing significant harm on any social or environmental PAI and (ii) any corporation with less than good management structures, employee relations, employee renumeration and tax structures

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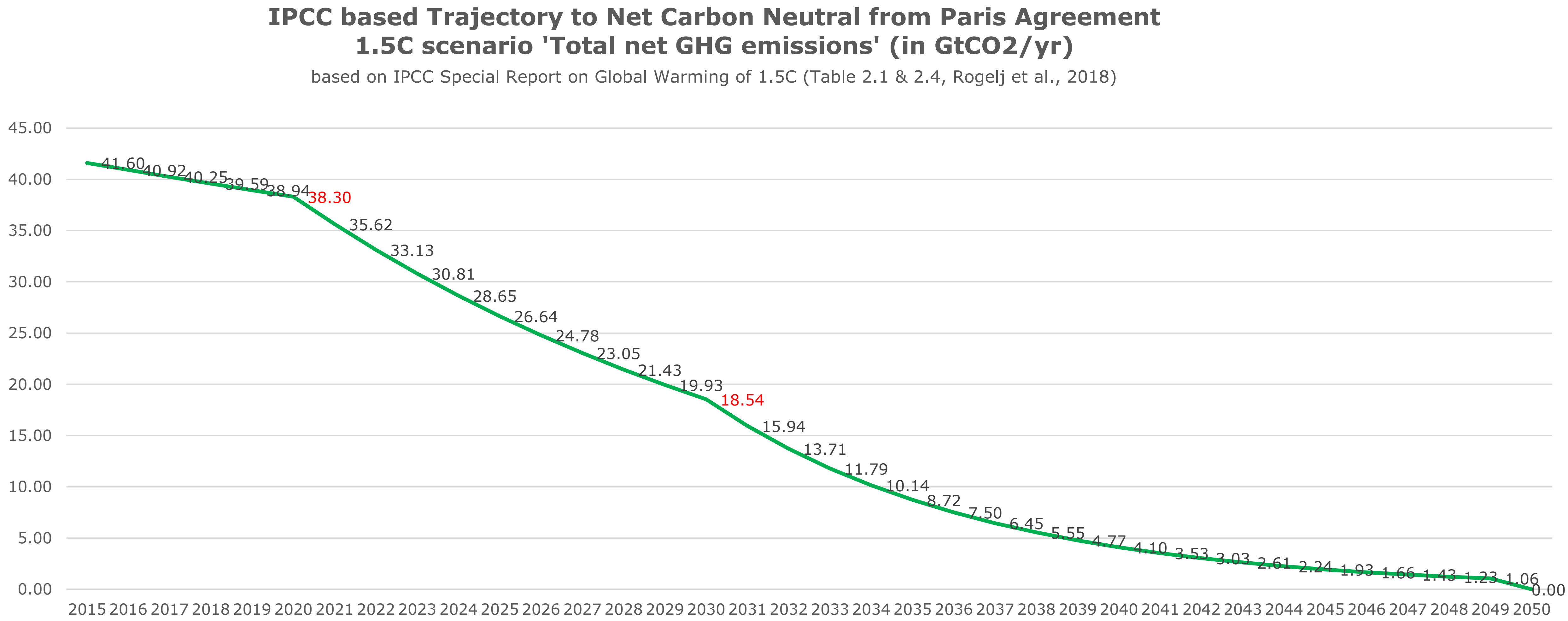
Key to understanding 2(17) is to recognise that (a) and (b)(i) represent an assessment of activities NOT the corporation itself, which is only assessed in (b)(ii). In other words, two corporations with an identical portfolio of activities but very different public reputation should be classified equivalently under (a) and (b)(i), which is crucial to insulate 2(17) from PR based Greenwashing.

Where is Greenwashing Risk located?

Contribution of Economic Activity to Objective	Company sustainability performance re Objective assessed as	
	strong	**weak**
Contribution evident	Sustainable Investment Objective met	Sustainable Investment Objective met but issuer engagement required
Contribution not evident	Concern of Potential Greenwashing on Objective	Sustainable Investment Objective not met

Figure 2: Comparison of SFDR Economic Activity Contribution test (vertical axis) with conventional company sustainability assessments

SFDR 9(3): Paris-Aligned Benchmarks
A trajectory to Net Zero by 2050



Absolutely Sustainable Investing =

1. ***Reduce GHG emissions vs. Market Benchmark*** *in a given year (Relatively more sustainable investing as practiced in 2019)*

+

2. ***Reduce GHG emissions year on year*** *by at least 7% p.a..*

+

3. *Reach* ***Net Zero GHG emissions by 2050****.*

+

4. *Integrate* ***Scope 3 GHG emissions.***

+

5. *Use the* ***Precautionary Principle*** *in GHG data estimations****.***

Precautionary Principle based Estimation

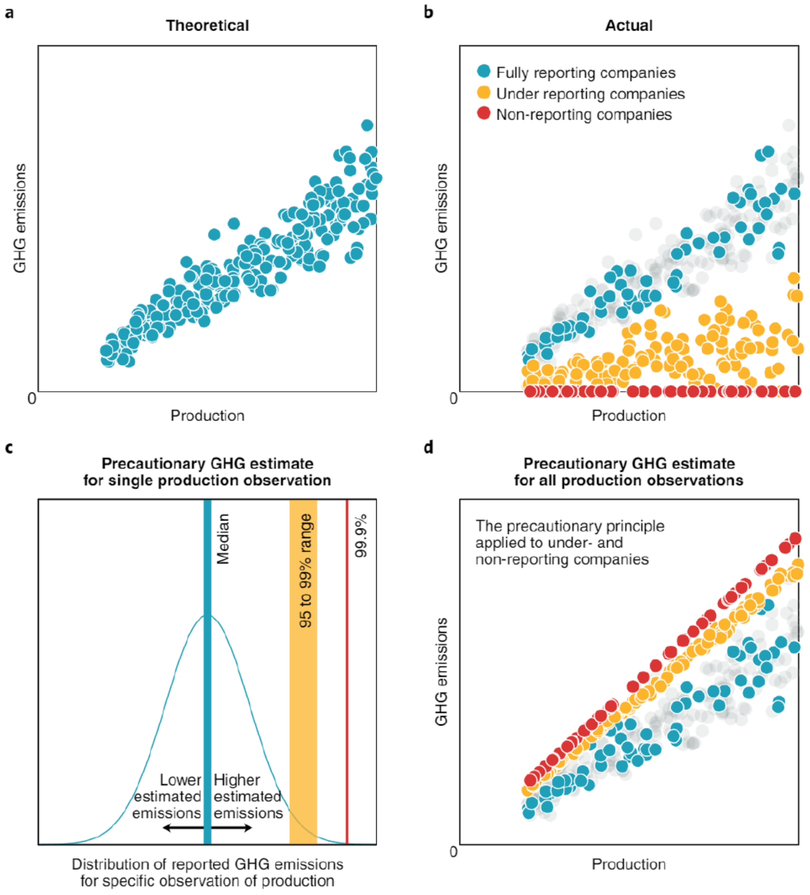


Fig. 1 | Application of the precautionary principle to estimation of under- and non-reporting companies. **a**, Theoretical distribution of company GHG emissions as a function of production. **b**, Illustrative actual distribution of company GHG emissions under full (blue), underreporting (yellow) and non-reporting (red) scenarios. **c**, Proposed application of the precautionary principle to estimate the GHG emissions for an under- or non-reporting company with a specific production level. **d**, Outcome of the application of the precautionary principle to estimating under- and non-reporting emissions, providing incentives for improvement.

Climate Transition (i.e. Paris-Aligned) Investing: absolutely sustainable.

“Thank you for your attention.
I would love to learn from your questions and comments.”

Andreas G. F. Hoepner

April 2023, Key Insights

1) **#InvestorEngagement** matters to SFDR, a lot actually! Investors are required to not only describr **#AdverseImpacts** but also disclose "the procedures put in place to mitigate those impacts." Since this refers to securities already selected, engagement across all (!) asset classes will be key for convincing SFDR disclosures and even other adverse impact risk mitigation practices maybe developed. (see Q6 of 8)

2) **#ParisAlignedBenchmarks** pass the **#Contribution2Objective** test of Article 2(17), period.
"financial market participants do not
have to provide a detailed explanation of how the continued effort of
attaining the objective of reducing carbon emissions is ensured in view of
achieving the long-term global warming objectives of the Paris Agreement,
as these products are deemed to have sustainable investments as defined
in Article 2, point (17) SFDR as their objective." (Q5 of 8)

This is not a complete **#SafeHarbour** for **#PABs** as they still need to pass **#GoodGovernance** and applicable **#PAI** thresholds (i.e. no investments in tax havens) but it very much reinforces **#PABs** as the blueprint for the **#WalkingTheWalk** ambition of Article 9 funds.

3) In a second or three nods to **#PABs** as blueprint, Article8 funds are explicitly warned to be very careful in their marketing and avoid any implication that their objective is to align with the **#ParisAgreement**.

"Article 13 SFDR requires that marketing communications do not contradict the
content of disclosures made pursuant to the SFDR: this implies that marketing documents should not lead investors into believing that the product pursues sustainable investment, where the promotion of carbon emissions reductions is only a mere characteristic of the product's investment strategy" (Q4 of 6)

4) In the third nod to the **#PABblueprint**, it is clarified that Article 9(3) and hence **#ParisAlignedBenchmarks** apply to both, passive and active products.
"The first subparagraph of Article 9, paragraph (3), is neutral in terms of
product design. Financial products that have an objective of reduction in
carbon emissions can therefore fall within the scope of Article 9(3) SFDR
whether they use a passive or active investment strategy." (Q3 of 8)

5) Question 2 of 8 highlights that commonly used Fund Marketing plays or reliance on corporate lipservice are in themselves not sufficient for Article 2(17), thereby nicely reassuring that **#SFDR** is truly based on scientific evidence rather than nonevidence promises. On climate, for instance, the emission reduction track record matters, not the promised transition plan.
"referring to a transition plan aiming to
achieve that the whole investment does not significantly harm any
environmental and social objectives in the future could for instance not be
considered as sufficient."