CLARITY AI

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SUSTAINABLE INVESTMENT

SFDR: JUST HOW SUSTAINABLE ARE ARTICLE 9 FUNDS?

Sustainability regulations are on the rise, all in an effort to manage capital flows towards sustainable investments, but the question remains, are these regulations succeeding?

Clarity AI examined the effects of Sustainable Finance Disclosure Regulation (SFDR) and looked under the hood to understand how successful regulation has been in reducing greenwashing. To do this, we reviewed the relevant regulations to understand what a "sustainable investment" is. Our analysis shows that there are still questions on the sustainability-alignment of some of the funds marketed as Article 9 (i.e., financial products with sustainable investing as their primary objective).

THE EU REGULATORY LANDSCAPE FOR SUSTAINABLE FINANCE

European regulatory authorities are leading the global transition to a more sustainable economy through multiple linked regulatory initiatives. These include:

- The Non-Financial Reporting Directive (NFRD, soon to be the Corporate Sustainability Reporting Directive [CSRD])
- The establishment of an EU Taxonomy
- Recent changes to integrate sustainability preferences into the suitability requirements under the Markets in Financial Instruments Directive (MiFID II)
- The Sustainable Finance Disclosure Regulation (SFDR)

The regulations differ in their application and scope but share a common goal of facilitating efficient capital flows to sustainable investments. This is managed through shared sub-goals including improvement in the quality and level of sustainability disclosures of financial instruments and reducing greenwashing.

Tackling greenwashing is one of three priorities set out by ESMA in its Sustainable Finance Roadmap 2022-2024. In August 2022, the European Commission requested that the European Supervisory Authorities (ESAs)[1] provide input on multiple issues related to greenwashing, including developing a common definition for the term.[2]

For the purposes of this paper, we will rely on ESMA's description in its roadmap:

> ***"The term greenwashing may be defined in a number of ways, but it intuitively refers to market practices, both intentional and unintentional, whereby the publicly disclosed sustainability profile of an issuer and the characteristics and / or objectives of a financial instrument or a financial product either by action or omission do not properly reflect the underlying sustainability risks and impacts associated to that issuer, financial instrument or financial product."***

1. The ESAs include the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).
2. https://www.esma.europa.eu/sites/default/files/library/request_to_esas_on_greenwashing_monitoring_and_supervision.pdf

One area highlighted by the European Commission as a potential space for greenwashing is the sale or marketing of financial products under SFDR. As shown in Figure 1, the SFDR Regulatory Technical Standards (RTS) will apply from 1 January 2023, though many funds are already reporting under the SFDR level 1 requirements.

While European authorities have stressed that Article 8 and Article 9 should not be treated as labels, there is a debate in some member jurisdictions as to whether to "goldplate"[3] or not the European regulation and include nationally determined minimum thresholds of sustainable investments as part of the SFDR.

Other jurisdictions have been monitoring the European regulations closely as they consider their own regimes and whether to include minimum thresholds. For example, the UK is consulting on including labels as part of its Sustainable Disclosure Requirements (SDR).

SFDR: FUND CLASSIFICATION

Under SFDR, funds must make key mandatory disclosures and can choose to make further disclosures depending on their level of sustainable ambition. In short:

Article 6 funds

Have no sustainability related objectives but must still make disclosures including how they incorporate sustainability related risks into their investment decision making.

Article 8 funds

Make investments to promote sustainability related characteristics.

Article 9 funds

Have sustainability related investments as their primary objective.

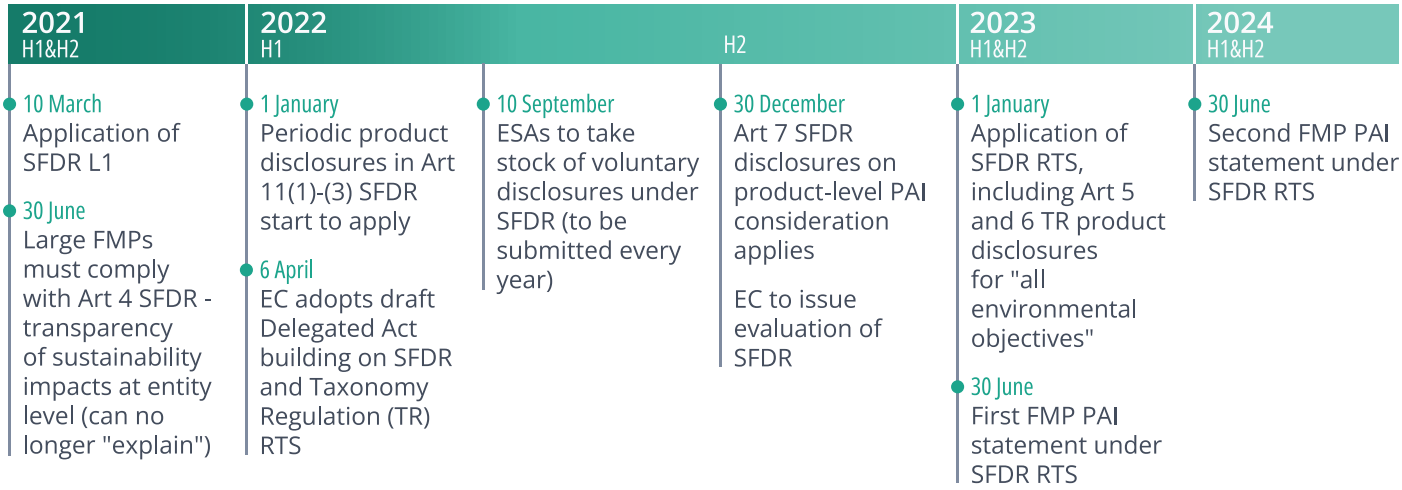

Figure 1. Implementation timeline for SFDR (Source: ESMA)

3. Goldplating refers to the practice of European member jurisdictions implementing European level directives and including their own criteria that go above and beyond the European directive. See for example: https://www.responsible-investor.com/title-national-regulators-esg-fund-requirements-trigger-sfdr-fragmentation-fears/

WHAT ARE ARTICLE 9 FUNDS?

In this paper we focus on Article 9 funds in an attempt to critically review whether they are delivering on their promise of investing sustainably. It should be noted that the amount of sustainable investment to be made under Article 9 still remains open to interpretation.

In June 2022, the ESAs referenced European Commission comments from July 2021 and offered guidance on the so-called Article 9 funds noting that such funds should only make sustainable investments. However, given the need for funds to invest in instruments for other purposes, such as cash management and hedging, they stopped short of setting a minimum threshold.[4]

ESAs' comments suggest that the amount of sustainable investment made by an Article 9 fund should be close to 100%. An exact figure, however, has not been codified.

THE AMOUNT OF SUSTAINABLE INVESTMENT TO BE MADE UNDER ARTICLE 9 IS STILL OPEN TO INTERPRETATION, BUT THE EXPECTATION IS THAT IT SHOULD BE CLOSE TO 100%

Extract from the "Clarifications on the ESAs draft RTS under SFDR" published in June 2022

> ***For the avoidance of doubt, as stated by the European Commission in its SFDR Q&A from July 2021, financial products that have sustainable investment as an objective should only make sustainable investments. However, disclosures are still required on the amount and purpose of any remaining assets to demonstrate how those do not prevent the financial product from attaining its sustainable investment objective.[5]***

4, 5. https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf

Article 2(17) of SFDR

"'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".

WHAT IS A SUSTAINABLE INVESTMENT?

Having established the context of the sustainability regulatory landscape, we must also understand the main elements in defining a sustainable investment, as referenced in the SFDR regulation.

1. It must contribute to an environmental or social objective;
2. It must not significantly harm other environmental or social objectives (DNSH); and
3. The investee company must follow good governance processes (GG).

To classify an investment as sustainable, it must fulfill all three of the above criteria. On the first criterion – contribution to a sustainable objective – there has been little guidance from European authorities on how to define a sustainable investment. Therefore, the market is taking a range of different approaches to classifying the sustainability of companies they invest in.

Clarity AI has been supporting its clients in interpreting the meaning of sustainable investment as defined under Article 2(17). Doing so requires a degree of flexibility, which is embedded within the drafting of the regulation.[6]

6. Clarity AI notes the upcoming clarification on SFDR due in the coming weeks through ESAs Q&A and the upcoming 2023 changes to the PAI framework which may amend the mandatory PAIs. We are also closely monitoring developments in other jurisdictions to understand how funds active in other countries and regions may be impacted. It is our strong view however that key aspects of SFDR will remain open to interpretation and market participants will need to be vigilant to navigate the regulatory environment. We are here to help in that regard.

Clarity AI's suggested approach to measuring a contribution to sustainable investment draws on three main lenses:

1. Performance on mandatory principal adverse impact (PAI) indicators mentioned within the SFDR regulation;
2. Alignment with the EU Taxonomy (also mentioned in the regulation); and
3. Assessment across UN Sustainable Development Goals (not mentioned in the regulation but important for covering a range of possible strategies that include social outcomes such as health and education).[7]

On the second criterion, DNSH, there has been more guidance. Recently, the ESAs stated: "*The use of principal adverse impact (PAI) indicators is mandatory to demonstrate that an investment qualifies as a sustainable investment.*"[8]

This provides a more objective way to compare the performance of Article 9 funds using data from PAI indicators to measure DNSH.

For the third criterion – good governance – Clarity AI employs its controversies module which uses Natural Language Processing (NLP) to exclude companies with high or very high severity controversies around Management Structures (Shareholder Rights & Insider Dealing), Employee Relations (Working Conditions & Diversity), Remuneration of Staff (Employee Wages & Management Compensation) and Tax Compliance, covering all topics in the regulation. Clarity AI's NLP advanced technology processes more than 100,000 news articles per day from more than 33,000 trusted new sources.

HIGH LEVEL OVERVIEW OF CLARITY AI'S 3-STEP METHODOLOGY TO ASSESS SUSTAINABLE INVESTMENTS

1 Contribution to a Sustainable Objective

- Measure contribution through **PAIs** per ESAs' guidance:* Top performing companies on PAIs applicable to their industries.
- Target climate change with the **EU Taxonomy:** EU Taxonomy aligned companies that also pass the Taxonomy's specific DNSH and Social Safeguard tests.
- Cover more objectives with **UN SDG** alignment: Companies with a significant positive impact on an SDG through Products and Services.

2 Do No Significant Harm

Ensure investee companies have:

- No negative exposure or controversy PAI**
- No other mandatory PAIs in bottom 5th percentile***

3 Good Governance

Exclude companies with high/very high severity controversies in all topics covered by the regulation.

* The June 2022 Clarifications on the ESAs' draft RTS (point 6) under SFDR indicate that PAI indicators can be used to measure sustainable investments.

** PAIs considered are all mandatory PAI indicators in Table I Annex I of the SFDR regulation. Exposure PAIs refer to PAI 4 (Exposure to fossil fuels) and PAI 14 (Exposure to controversial weapons). Controversy PAIs include PAI 7 (Activities negatively affecting biodiversity sensitive areas), PAI 10 (Violations of UNCG and OECD-MNE), PAI 11 (Lack of Mechanisms for conformance to UNGC and OECD-MNE) and PAI 16 (Sovereigns Social Violations).

*** This threshold is based on analysis of the performance of investments in Article 9 funds. Clarity AI uses industry applicability for PAI contribution calculations. Non exposure PAIs are evaluated against Clarity AI's whole universe within the applicable industries.

7. The first two approaches mirror closely the SFDR regulation. The third is included to broaden the scope of possible sustainable investments, in particular where the taxonomy or the PAIs do not cover social objectives such as health or education.
8. See table under point (7) https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf

CLARITY AI'S APPROACH TO USING PRINCIPAL ADVERSE IMPACTS TO DETERMINE DNSH

PAI indicators are mandatory disclosures for asset managers with more than 500 employees. All of them need to report on 18 PAIs, which are mandatory, and choose at least two from a set of 46 additional PAIs.[9] Within these indicators are a mixture of quantitative measures (e.g., GHG emissions), exposures (e.g., exposure to companies active in the fossil fuel sector) and code violations (e.g., Violations of UN Global Compact [UNGC] principles and Organization for Economic Cooperation and Development [OECD] Guidelines for Multinational Enterprises). Clarity AI has closely reviewed statements from European regulators on how to apply the DNSH principle. It has also liaised with consultants, regulatory and industry professionals to ensure its methodology is as closely aligned to the intention of the regulation as possible. Our approach takes account of the mandatory PAIs ensuring that investee companies have:

- no exposure to **companies active in the fossil fuel sector**;
- no exposure to **controversial weapons**;
- no violations of **UNGC principles and OECD Guidelines for Multinational Enterprises**;
- no activity negatively **affecting biodiversity-sensitive areas**; and
- that they are not among **the worst performers for any of the remaining mandatory PAIs** (e.g., GHG emissions).

In developing our approach, we considered using a subsection of mandatory PAI indicators to be able to target specific outcomes that should be avoided for an investment to be considered as sustainable. We also considered broadening the scope by including metrics that were not included in the PAIs.

However, we disregarded both approaches to fully align with the ESAs' clarifications from June 2022,[10] which were clear that the use of PAI indicators for DNSH is *"…mandatory to demonstrate that an investment qualifies as a sustainable investment"* and the ones that should be used are at least the mandatory PAIs listed in Table 1 of Annex 1 in the SFDR regulation.

CLARITY AI HAS LIAISED WITH CONSULTANTS, REGULATORY AND INDUSTRY PROFESSIONALS TO ENSURE ITS METHODOLOGY IS AS CLOSELY ALIGNED TO THE INTENTION OF THE REGULATION AS POSSIBLE

9. Download the full list of mandatory and additional PAIs in Annex 1 here: https://ec.europa.eu/transparency/documents-register/api/files/C(2022)1931_1/090166e5eaa87772?rendition=false
10. Table under point (7) https://www.esma.europa.eu/sites/default/files/library/jc_2022_23_-_clarifications_on_the_esas_draft_rts_under_sfdr.pdf

ARE ARTICLE 9 FUNDS INVESTING SUSTAINABLY?

Despite the lack of a hard threshold within the regulation, it is accepted that an Article 9 fund should make only sustainable investments, with the exception of hedging and cash management purposes. For the non-sustainable investments in Article 9 funds, it would be reasonable to expect that:

1. The magnitude of non-sustainable investments would be very small in comparison to the sustainable investments;
2. The fund would be able to explain the purpose of any non-sustainable investment (by, for example, reference to its role as a hedging or cash management instrument); and
3. That, while not contributing to an environmental or social objective, even the non-sustainable investments would still respect the DNSH and GG principles.

Clarity AI assessed 15,000 funds with information about their SFDR classification and for which there is sufficient information on over 80% of their holdings. We focused our analysis on the ~750 Article 9 funds that are part of this universe. Clarity AI's research has shown that many Article 9 funds fall short in terms of their sustainability characteristics when considering DNSH.

While a small share of investments in companies that cause principal adverse impacts is expected Clarity AI found that nearly **20% of the Article 9 funds have more than 10% of their investments in companies with violations of the UNGC principles or the OECD Guidelines for multinational enterprises** - and 40% have more than 5% exposure.

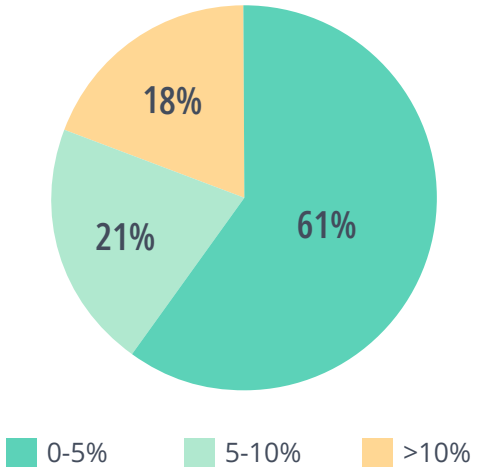

Figure 2. Distribution of Article 9 funds based on share of investments in companies with violations of the UN Global Compact principles or the OECD Guidelines for Multinational Enterprises (PAI 10)

The Article 9 funds analyzed invest in 166 different companies that violate the UNGC or OECD principles. These violations include bribery and corruption convictions (e.g., a financial services company pleading guilty in a bribery case), anticompetitive practices (e.g., a payments company, which was fined by the United Kingdom for collusion on prepaid cards), and environmental impacts (e.g., a tourism-based company admitted to dumping fuel and food waste along with thousands of gallons of sewage into the ocean).

These violations, which might be escaping the fund managers' attention, are captured by Clarity AI's controversy model. There is a similar pattern when looking at investments in companies with exposure to fossil fuels. In the context of the energy transition, and with exposure to fossil fuels recognized by the SFDR as a principal adverse impact, **nearly 10% of Article 9 funds have more than 10% exposure to fossil fuels.** While funds might be pursuing strategies that involve active ownership, investors need to be aware of what they are financing and what the fund's strategy is to achieve impact.

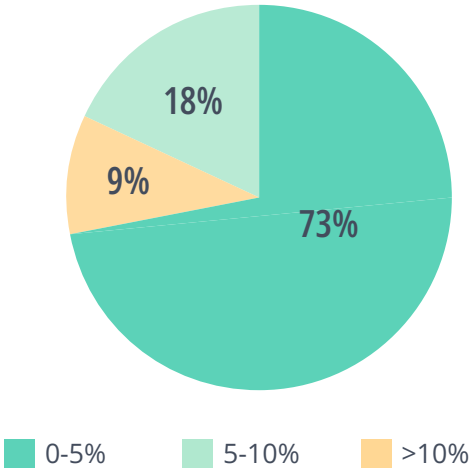

Figure 3. Distribution of Article 9 funds based on share of investments in companies exposed to fossil fuels (PAI 4)

In total, the Article 9 funds analyzed are investing in over 1,250 companies that produce or participate in the distribution of fossil fuels. While some of these companies have a small share of their revenues coming from activities related to fossil fuels, more than 500 companies earn the majority of their revenues from these activities.

Looking more broadly at the mandatory PAIs that do not reflect exposures and violations the picture is also far from ideal. **38% of Article 9 funds have more than 10% of assets invested in companies with very poor performance in mandatory quantitative PAIs**. While they claim to be sustainable, these funds are investing in companies that are among the 5% worst performing companies in at least one of the mandatory PAI indicators.[11]

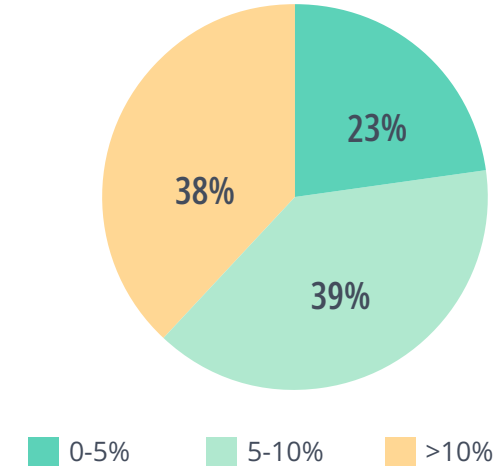

Figure 4. Distribution of Article 9 funds based on share of investments in companies that cause significant harm through other mandatory PAIs

Digging deeper, Clarity AI's analysis shows that Article 9 funds invest in poorly performing companies across all PAI indicators, but some seem to receive less attention from fund managers. If managers selected companies randomly, 5% of them would cause significant harm. When looking at indicators such as "Share of non-renewable energy consumption" and "Board gender diversity," we find that more than 10% of the companies where the funds invest have poor performance.

11. Based on an analysis of reported data from over 30,000 companies on the 11 mandatory PAI indicators that are not related to exposures and violations

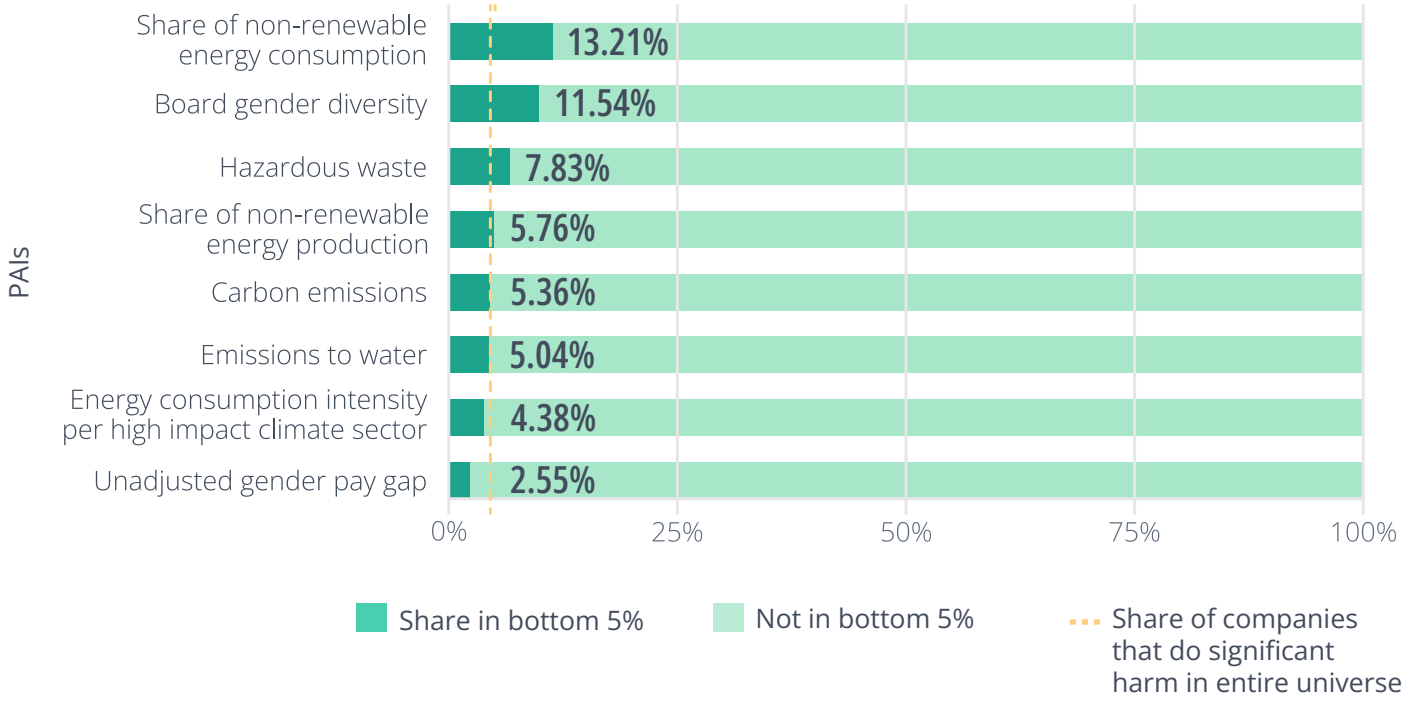

Figure 5. Share of companies in Article 9 funds that are among the 5% worst performing companies per PAI indicator

Looking further into the "Board gender diversity" indicator, we see that Article 9 funds invest in 852 companies with zero women on the board of directors (12% of the companies for which there is data available). Moreover, this is not concentrated in a couple of funds: 75% of the Article 9 funds invest in at least one company with no women on the board.

CONCLUSION

The classification of funds according to the SFDR guidelines is increasingly used by fund providers as a shorthand for communicating that a product is sustainable. However, our analysis shows that some of the Article 9 funds currently in the market might be falling short of complying with the do no significant harm criteria as defined by the regulation.

Clarity AI's assessment of Sustainable Investment gives investors the ability to dig into details of any financial product and to understand whether a fund is making sustainable investments.

Our tools allow market participants and investors to lift the bonnet, look under the hood and understand the sustainability-alignment of their investments.

By leveraging advanced technology, the detailed analysis required to vet your investments can be done more easily than you might think. Considering the number of investment vehicles in the market today, tech is the only solution that will provide the scale to assess, analyze and report with accuracy and clarity.

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ABOUT CLARITY AI

Clarity AI is a sustainability technology platform that uses machine learning and big data to deliver environmental and social insights to investors, organizations, and consumers. As of October 2022, Clarity AI's platform analyzes more than 50,000 companies, 320,000 funds, 198 countries and 188 local governments – 2-13 times more than any other player in the market – and delivers data and analytics for investing, corporate research, benchmarking, consumer e-commerce and reporting. Clarity AI has offices in North America, Europe and the Middle East, and its client network manages tens of trillions in assets.

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