Sustainable Finance FAQs | July 2021

ESG, Climate Regulation and Disclosure

MSCI and MSCI ESG Research

July 2021

Contents

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1. What is happening with Sustainable Finance?

Sustainable Finance looks set to become one of the biggest regulatory initiatives globally in the coming years. Many different organizations internationally, nationally and locally, are consulting on, creating, and publishing standards/frameworks to address ESG integration as well as ESG disclosures for issuers and investors.

The EU is pursuing an ambitious legislative package, which started in 2018, with the publication of its 10-point action plan on financing sustainable growth. The package, alongside the European Green Deal announced in December 2019, aims to redirect capital flows towards a more sustainable economy as well as meet the EU's international commitments on climate.

2. What is the EU Sustainable Finance Package?

MSCI supports the aims of the EU Sustainable Finance legislative package.
The package has broad reach, with most major financial services regulations having been amended to align with it. While many of the legislative streams are being pushed forward independently (e.g., Climate Benchmarks, Sustainable Finance Disclosure Regulation (SFDR), Taxonomy) and are currently not joined up, the idea is that over time the different streams will converge. Furthermore, the Renewed Sustainable Finance Strategy may provide renewed momentum with further announcements on upcoming measures.

The question, in the meantime, is what can be achieved in the short term, given the data challenges, not only in terms of data availability, but also in terms of data definitions across different legislative streams. In Schedule 1 (see appendix), we provide a summary of the different data requirements for select common factors across regulations.

We also outline the key legislative streams of the package below. Further information about the EU Sustainable Finance package can be found on the EU Commission's website here. MSCI has hosted several virtual events discussing the package, which can be found here.

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EU Sustainable Finance Package - Legislative Streams	Brief Description
Enhanced Corporate/Issuer Disclosures/Sustainability Reporting Directive (CSRD)	The European Commission has adopted on April 21, 2021 a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend and enhance the existing reporting requirements of the Non-Financial Reporting Directive (NFRD) by: • Extending the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises) • requiring the audit (assurance) of reported information • introducing more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards • requiring companies to digitally 'tag' the reported information, so it is machine readable and feeds into the European single access point (SEAP) envisaged in the capital markets union action plan The proposal also envisages the adoption of EU sustainability reporting standards which would be developed by the European Financial Reporting Advisory Group (EFRAG). The standards will be tailored to EU policies, while building on and contributing to international standardization initiatives such as the IFRS Foundation. The first set of standards would be adopted by October 2022. See the EFRAG reports on development of EU sustainability reporting standards.
EU Taxonomy Regulation	The EU is establishing a classification system for sustainable activities and investments. The first set of technical details (Delegated Acts/DA) arising from the Taxonomy Regulation for climate change mitigation and adaptation was published on April 21, 2021. This draft DA was approved in principle by the European Commission on April 21, 2021 and its formal adoption in all the official languages of the EU took place on June 4, 2021. Given the controversy around the inclusion or non-inclusion of natural gas and nuclear power, a subsequent, separate proposal on these topics is expected later in 2021. The final DA mentioned above is then due to be published around the summer 2021, after scrutiny at the European Parliament and Council, and will apply as of July 1, 2022. The taxonomy covering the other environmental objectives is expected to be finalized by the end of 2021, and in place by the end of 2022. The first company reports and investor disclosures using the taxonomy are due at the start of 2022. We have highlighted

	some challenges that we see with the taxonomy on Schedule 3 (see appendix).
EU Climate Benchmarks/Benchmarks ESG Disclosures	The EU established the minimum requirements for two new voluntary categories of indexes, the EU Climate Transition benchmarks and the EU Paris-Aligned benchmarks. These minimum standards are intended to address greenwashing and introduce comparability across climate benchmarks. The EU also set out disclosure requirements covering a set of ESG metrics for ESG benchmarks to improve transparency and comparability, along with methodological disclosures for ESG benchmarks and significant benchmarks. The final requirements were published in the Official Journal in November 2020 with a compliance due date for administrators of mid-December 2020. More details about the requirements can be found in Schedule 2 (see appendix).
Integration of Sustainability Risk + Sustainability Finance Disclosures Regulation (SFDR)	The EU is requiring financial market participants to integrate sustainability risk in the investment process and to disclose and report such integration at both the entity and product level, including extensive disclosure of ESG indicators in prescribed templates. Some disclosures are on a comply/explain basis for some market participants. Disclosures range from website disclosures, prospectuses, and annual or periodic reports depending on the type of market participant/financial product. At the product level, disclosures and distinctions are made between Article 6 products that may include baseline environmental or social safeguards, Article 8 products that promote environmental or social characteristics and Article 9 products that have sustainable investment as their objective. The details of the disclosure requirements are set out in the EU's Joint ESAs Final Report on Draft RTS dated February 2, 2021. Initial principles-based disclosures apply for the period beginning March 10, 2021 with prescriptive disclosures for the period beginning July 1, 2022. The consultation on taxonomy-related product disclosures was launched on March 17, 2021 to seek feedback on disclosure requirements related to products that aim to align with the EU Taxonomy. Some of the challenges presented by the SFDR can be found on Schedule 3 (see appendix).

Fiduciary Duties on sustainability when providing investment and insurance advice	On April 21, 2021 the Commission adopted the below amending Delegated Acts on fiduciary duties, investment and insurance advice, which aims to ensure that financial firms, e.g. advisers, asset managers or insurers, include sustainability in their procedures and their investment advice to clients. • Sustainable finance – obligation for alternative investment funds to advise clients on social & environmental aspects • Sustainable finance – obligation on investment funds to advise clients on social & environmental aspects • Sustainable finance – obligation for (re)insurance companies to advise clients on social & environmental aspects • Sustainable finance – obligation for investment firms to advise clients on social and environmental aspects of financial products • Sustainable finance – obligation for investment firms to advise clients on social and environmental aspects of financial products • Sustainable finance – obligation for insurance firms & brokers to advise clients on social & environmental aspects • Sustainable finance – obligation for mutual funds to advise clients on social & environmental aspects
EU Ecolabel	The EU is expanding its current voluntary Ecolabel program to retail financial products. It uses the EU Taxonomy's definition of green economic activities to determine selection, and sets exclusion criteria based on Environmental, Social, and Governance aspects. The Joint Research Centre (JRC) has published the fourth (and Final) Technical Report in March 5, 2021, two years after multiple rounds of consultations and meetings with the first Technical Report published in March 2019.
EU Green Bond Standard	The EU is establishing a uniform green bond standard. After several consultations, the EU will decide on the Renewed Sustainable Finance Strategy to be adopted in Q2/Q3 2021 for how to move the green bond standard forward and a timeline for adoption.
EU regulation of ESG ratings providers	The EU has been studying ESG ratings providers and following the study will decide whether and how to regulate them. The Commission is expected to announce its plans on ESG ratings and data as part of the Renewed Sustainable Finance Strategy to be adopted by the end of Q3 2021.

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3. What is MSCI doing in relation to the EU Sustainable Finance Package?

EU Expert Committees - MSCI is actively involved in several EU Expert Committees providing its expertise to the EU Commission.

- MSCI was a member of the EU Commission's 35-member Technical Expert Group, focusing on requirements for the EU climate benchmarks and ESG benchmarks disclosures published in the TEG Final Report in September 2019. The TEG expired in September 2020.
- MSCI supported the Ad-hoc Working Group for the EU Ecolabel, which is helping to define the standards for an EU Ecolabel for retail financial products.
- MSCI is a member of the EFRAG's European Lab Project Task Force. EFRAG has been tasked by the CSRD to develop and advise the EU on sustainability reporting standards as well as support the work of the IFRS Foundation on setting global sustainability standards

Legislative Streams – MSCI's activity is described below.

EU Sustainable Finance Package – Legislative Streams	What is MSCI doing?
Enhanced Corporate/Issuer Disclosures (CSRD amending NFRD)	MSCI is a member of EFRAG's European Lab Project Task Force
EU Taxonomy	In February 2021, MSCI ESG Research launched the EU Sustainable Finance Module which includes SFDR Adverse Impact and EU Taxonomy Alignment data and metrics for over 10,000 corporate equity and fixed income issuers, including the MSCI ACWI Investable Market Index which covers approximately 99% of the global equity investment opportunity set. The MSCI EU Taxonomy Alignment dataset identifies the percentage of revenue from activities likely to address one or more of the six environmental objectives of the EU Taxonomy and incorporates controversial practices that could indicate breach of the Taxonomy's Minimum Safeguards and Do No Significant Harm criteria. MSCI ESG Research has made available to clients an *Estimated EU Taxonomy Alignment Guide ('the Guide')* setting out possible approaches for institutional investors to identify global companies with business activities potentially aligned with the EU Taxonomy

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	in the absence of corporate disclosure of taxonomy-aligned revenue and expenses. The guide provides information on how to identify and measure companies' involvement in sustainable activities based on available data and metrics along with potential screens and results. As outlined in the Guide, there are several MSCI ESG Research datasets which may be helpful in identifying potential alignment with the EU Taxonomy. These include: • MSCI Environmental Impact Metrics to identify involvement in sustainable activities • MSCI ESG Controversies to apply the Do No Significant Harm (DNSH) and Minimum Safeguards criteria • MSCI Business Involvement Screening Research (Tobacco and Controversial Weapons) to apply the Minimum Safeguards criteria • Available now as part of the MSCI EU Sustainable Finance Module: a new screening factor that combines each of the core data elements of our standard approach into the methodology for an Estimated EU Taxonomy Alignment screening factor. MSCI ESG Research has also published a shorter outline of our approach. Download a copy of our EU Taxonomy-aligned Reporting Summary (registration required).
EU Climate Benchmarks/Benchmarks ESG Disclosures	EU Climate Benchmarks • In November 2019, MSCI launched the first provisional EU Paris-Aligned benchmarks (PAB) and EU Climate Transition benchmarks (CTB), which were based on the final report recommendations from the EU Technical Expert Group. • In October 2020, MSCI launched a series of Climate Paris Aligned Indexes, which are designed to exceed the minimum standards of the Paris Aligned Benchmark in the regulation. More information can be found here: https://www.msci.com/esg/climate-paris-aligned-indexes • In March 2021, MSCI announced the results of the consultation on the potential transition of the MSCI Climate Change Indexes. Following feedback from market participants, the MSCI Climate Change Indexes were enhanced to incorporate the minimum requirements as per the EU Climate Transition Benchmark (CTB) designation. The changes to the index methodology were implemented as part of the May 2021 Semi-Annual Index Review. Benchmarks ESG Disclosures

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	• On May 20, 2020, MSCI launched the online MSCI Index Profile Tool, a search tool that provides index-level ESG metrics based on the TEG Final Report for all regulated equity/blended indexes, which is beyond the relevant benchmark regulations' requirements to disclose for ESG indexes. Regulated MSCI Fixed Income indexes were added on July 1, 2020. More information (including details about the required methodology disclosures), can be found on the index regulation page of our website (at: https://www.msci.com/index-regulation) under "Benchmark Regulation" under "ESG Disclosures". MSCI updated the MSCI Index Profile Tool in December 2020 to reflect the requirements as per the Final Delegated Acts published in Q4 2020. • In April 2020, MSCI ESG Research launched the EU Sustainability Disclosures Reporting Tool, which measures portfolio-level exposure to key ESG metrics and potential alignment with the EU Climate Transition Benchmark and EU Paris Aligned Benchmark regulatory requirements. Please contact MSCI ESG Client Services for more information.
Integration of Sustainability Risk + Sustainability Finance Disclosures Regulation (SFDR)	In February 2021, MSCI ESG Research launched the EU Sustainable Finance Module which includes SFDR Adverse Impact and EU Taxonomy Alignment data and metrics for over 10,000 corporate equity and fixed income issuers, including the MSCI ACWI Investable Market Index which covers approximately 99% of the global equity investment opportunity set. The SFDR Adverse Impact Metrics dataset includes issuer-level data on adverse sustainability indicators*, such as GHG emissions, Energy Consumption, Biodiversity, Water, Waste, Social and employee matters, Human Rights and Anti-corruption and anti-bribery. As of July 2021, the dataset includes relevant data on the 14 principal adverse impact indicators for corporates plus 25 of the additional indicators for approximately 10,000 global companies and over 175 sovereign issuers (as applicable). A list of these indicators is available through the **MSCI Client Service Portal.** We plan to provide additional adverse impact indicators (including on sovereigns, plus dates and sources for transparency) in 2021. In July 2021, MSCI released a new index module with index-level metrics on SFDR indicators and EU BMR factors for over 6,000 reference benchmark and broad market equity and fixed income indexes. The new module allows clients to report these MSCI index-level metrics when publishing comparisons against those of their related financial products. Clients can request information about MSCI ESG Research's EU Sustainable Finance Module by

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	submitting a support ticket via the MSCI Online Case Management Portal. ** Based on the European Supervisory Authorities' final report on the draft regulatory technical standards (RTS)*
EU Ecolabel	MSCI is active in supporting the EU's Ad-hoc Working Group by providing data and guidance. The Commission utilized MSCI ESG data for a study testing draft EU ecolabel criteria on UCITS equity funds, which was published on June 26, 2020 and can be found on the EU Commission's website.
EU Green Bond Standard	MSCI ESG Research is expanding its methodology to incorporate EU standards.
EU regulation of ESG ratings providers	MSCI ESG Research is actively participating in the EU's study of the industry and has continued to engage with regulators and policy makers.

SFDR metrics for indexes: what is MSCI doing?

Q1: What index level metrics is MSCI providing for the related indicators?

MSCI recently released a new module with index-level metrics addressing index SFDR indicators and EU BMR factors for over 6,000 of its regulated reference benchmark and broad market indexes across equity and fixed income indexes (e.g. Market Cap, Issuance-weighted, ESG, Climate, and Factor indexes). Indicators are also available for custom indexes. The new module allows clients to report these MSCI index-level metrics when publishing comparisons with those of their financial products.

Q2: What SFDR indicators is MSCI looking to compute at the index level?

MSCI aims to compute 13 of the 14 mandatory principal adverse sustainability impact metrics* for over 6,000 indexes. MSCI will seek to expand index-level metrics for some or all the additional voluntary adverse sustainability impact indicators in upcoming quarters.

*Mandatory SFDR principal adverse sustainability impact metrics:

1. *GHG emissions* (not expected for indexes)
2. Carbon footprint
3. GHG intensity
4. Exposure to companies active in the fossil fuel sector

5. Share of non-renewable energy consumption and production
6. Energy consumption intensity per high impact climate sector
7. Activities negatively affecting biodiversity-sensitive areas
8. Emissions to water
9. Hazardous waste ratio
10. Violations of UNGC principles and OECD Guidelines for Multinational Enterprises
11. Lack of processes and compliance mechanisms to monitor compliance with UNGC principles and OECD Guidelines for Multinational Enterprises
12. Unadjusted gender pay gap
13. Board gender diversity
14. Exposure to controversial weapon

Q3: How does MSCI publish and distribute its BMR regulated ESG metrics for its ESG indexes?

MSCI publishes a range of index-level ESG metrics for all EU/UK regulated MSCI Benchmarks through its Index Profile tool and its new EU Sustainable Finance Index Level module. The Index Profile tool was created in response to an amendment to the EU Benchmark Regulation, which requires benchmark administrators to disclose ESG information for its ESG benchmarks. MSCI publishes monthly metrics for all its ESG and non ESG equity, fixed and blended indexes, thus exceeding the requirements of the regulation. Additionally, in response to SFDR requirements for funds that replicate indexes, MSCI has incorporated all ESG Factors that are used for the BMR disclosures or are published in MSCI's Index Profile tool in its new EU Sustainable Finance Index Level Module.

Q4: Will MSCI designate its indexes along the Articles 6/8/9 definitions?

As the SFDR is a regulation for financial market participants, and their financial products depend on how financial market participants are marketing and promoting their financial products, MSCI is not able to classify indexes as Articles 6, 8, or 9. However, MSCI index research team has updated in March 2021 its proposed Article 6/8/9 Mapping Framework (download the proposed framework from msci.com) following the release of the February 2021 draft Regulatory Technical Standards (RTS) and engagement with clients over the past few months. MSCI's aim is to provide a generic mapping of MSCI ESG indexes to key Article 6, Article 8, and Article 9 SFDR distinctions using assumptions developed from MSCI's analysis and client feedback. MSCI believes this framework will help provide transparency for clients as they work towards classifying funds as part of product level disclosure requirements.

Q5: Will MSCI provide index screens for good governance and DNSH (Do No Significant Harm)?

As per the RTS, definitions of good governance and Do No Significant Harm (DNSH) are up to financial market participants to decide. MSCI has gathered client input to help create a mapping framework for Article 6, 8 and 9 key distinctions including good governance and DNSH. If there is client demand to use the definitions explained in the mapping framework, MSCI would consider developing such screens.

Q6: Has MSCI done an analysis comparing SFDR requirements vis-à-vis France's AMF ESG Doctrine to see whether ESG funds tracking MSCI ESG Indexes will comply with neither, either, or both regulations?

MSCI has reviewed both regulations, but notes that there is no formal analysis comparing SFDR with the AMF ESG Doctrine or other regulations. While the SFDR regulation defines transparency obligations, the AMF doctrine published in March 2020 and updated in July 2020 introduces minimum standards for the marketing of non-financial communication by investment funds. The two systems therefore have complementary objectives with some overlap. MSCI encourages clients to do their own analysis as to how their product(s) need to comply with the SFDR and/or the AMF regulation. MSCI is here to assist and provide necessary tools in addressing such requirements.

SFDR metrics for reporting: what is MSCI doing?

MSCI supports clients in navigating the changing ESG and climate regulatory reporting landscape through its integrated ESG Research and Analytics solution. This solution is designed to provide a seamless process to support clients looking to align with new EU regulations and disclosure requirements with a scalable and robust reporting framework. MSCI's solution is built on leading MSCI SFDR Adverse Impact Metrics and MSCI EU Taxonomy Alignment data powered with Riskmetrics' total portfolio coverage and flexible aggregation schema for a fully customizable approach. Clients can also leverage MSCI's existing infrastructure and research to systematically incorporate sustainability considerations into their investment process.

4. What else is MSCI doing to support Sustainable Finance initiatives globally?

To support transparency generally, MSCI launched the following tools and materials:

- **January 2021** – Launch of Sustainable Finance Insights Newsletter. Sign up here
- **November 2020** – Launch of Sustainable Finance resource page on msci.com, and the launch by MSCI ESG Research of the MSCI ESG Industry Materiality Map which aims to offer a window in the MSCI ESG Ratings model
- **May 20, 2020** – MSCI ESG Research announced the launch of the MSCI ESG Fund Ratings search tool, which provides the ESG Fund Rating of mutual funds or ETFs, its peer and global rank, the ESG Rating distribution of the fund's holdings and other ESG metrics, including green vs. fossil-fuel-based revenue, board independence and diversity and social screens (such as tobacco). These other ESG metrics include elements of our approach to estimating alignment with the EU Taxonomy.
- **May 20, 2020** – Launch of the Index Profile search tool, which provides ESG metrics for all equity, fixed income and blended indexes regulated by the EU, going beyond the requirements of the EU Benchmark Regulation (BMR) relating to ESG indexes only
- **February 5, 2020** – MSCI ESG Research announced the launch of a solution enabling investors to assess exposure to climate risk.
- **January 21, 2020** – MSCI announced the "The MSCI Principles of Sustainable Investing", which can be found on MSCI's website.
- **November 25, 2019** – MSCI ESG Research announced the publication of MSCI ESG Ratings of over 2,800 companies on MSCI's website.

MSCI ESG and Index Research continue to map and expand upon MSCI's offerings in response to the various global standards and labels. Clients may submit a support ticket via the MSCI Online Case Management Portal on MSCI's client support website to find out what mappings are available. To find out more information on how indexes can be tailored in the context of labels, clients may contact MSCI Client Service.

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MSCI continues to monitor developments, engage with the regulatory community and policymakers as well as clients, and reply to consultations which can be found here.

1 Appendix

Schedule 1: Data Requirements Across the EU Sustainable Finance Package

Below is a summary of the different data requirements for select common factors across regulations.

EU Regulation	Carbon Intensity	International Standards	Exclusions	Applies to
Non-Financial Reporting Disclosure (NFRD) regulation	Does not yet specify reporting metrics, but is based on current guidelines for reporting climate-related information (on the EU Commission's website). It aims to align with existing frameworks such as TCFD which requires reporting for the ***business entity***.	Does not yet specify reporting metrics, but is based on current guidelines (on the EU Commission's website). It aims to align with existing frameworks such as OECD, UN Global Compact and UN Guiding Principles on Business and Human Rights which require reporting at the ***business activity*** level.	Not applicable. Reporting requirements do not currently include exclusionary activities.	Large public-interest companies with more than 500 employees, covering approximately 6,000 large companies and groups across the EU, including: • Listed companies • Banks • Insurance companies • Other companies designated by national authorities as public-interest entities

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EU Taxonomy Regulation	Sets ***qualifying criteria*** based on specific CO2 output for each ***business activity***.	Sets qualifying criteria based on compliance with the standards of the United Nations Global Principles, OECD and International Labour Organization.	• Activities related to dedicated storage and/or transportation of ***fossil fuels*** • Activities that do significant harm to other environmental objectives • Activities that violate United Nations Global Principles, OECD and International Labour Organization standards.	All users of the taxonomy for sustainable investment, including: • Issuers • Financial market participants that market financial products to EU investors
EU Benchmarks (CTB and PAB)	*Sets **qualifying*** ***criteria*** based on specific CO2 output for ***index constituents***.	Sets qualifying criteria based on compliance with the standards of the United Nations Framework Convention on Climate Change, Intergovernmental Panel on Climate Change, United Nations Global Principles, and OECD.	• Any activities related to controversial weapons • Any involvement in tobacco production • Violations of UNGC principles or OECD Guidelines for Multinational Enterprises • 1% or more of revenue from exploration, mining, extraction, distribution or refining of hard coal and lignite • 10% or more of revenue from exploration, distribution or refining of oil fuels • 50% or more of revenue from exploration, extraction, manufacturing or distribution of gaseous fuels • 50% or more of revenue from electricity generation with GHG intensity of more than 100g CO2e/kWh • Companies that significantly harm	Financial market participants that market financial products to EU investors

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			one or more of the environmental objectives outlined in the EU Taxonomy Regulation	
EU Benchmarks (ESG Disclosure)	***Reporting metrics*** based on emissions of index constituents. To be reported at the index level.	Reporting metrics based on specific activities (involvement or violation) related to international standards and EU regulations of the index constituents	No specific exclusions thresholds.	Benchmark administrators
Sustainable Financial Disclosure Regulation (SFDR)	***Reporting metrics*** based on emissions of invested entities for all financial products. To be reported at both entity level and product level of the financial market participant.	Reporting metrics based on specific activities (involvement or violations) related to international standards and EU regulations of the entities of the underlying investments ***(portfolio or fund).***	No specific exclusion thresholds.	Financial market participants that market financial products to EU investors
EU Ecolabel	Sets ***qualifying criteria*** based on the specific CO2 output of a company's ***products***.	Sets qualifying criteria in line with the EU Taxonomy, which is in turn based on compliance with the standards of the United Nations Global Principles, OECD and International Labour Organization.	• Environmental aspects covering activities related to Agriculture, Forestry, Energy, Waste Management, Manufacturing, and Transportation. • Social and governance aspects covering violations to international standards of groups such as the UN Global Compact and OECD; activities related to Tobacco, Weapons, and Pornography; and weak corporate governance.	Financial market participants that market financial products to EU investors.

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Schedule 2: Climate Benchmarks/ESG Benchmarks Disclosures

1. ***What are the amendments to the EU benchmark regulation?***
    - Applicable to benchmark administrators
    - The EU Benchmark Regulation has been amended in accordance with the "Financing Sustainable Growth" Action Plan
    - Introduction of climate benchmarks with minimum requirements and exclusions for:
        - EU Climate Transition Benchmarks (CTB)
        - EU Paris-Aligned Benchmarks (PAB)
    - Introduction of ESG disclosure requirements for benchmarks:
        - Disclosure of how ESG factors are reflected in each benchmark
        - Disclosure of how the benchmark methodology reflects ESG factors for each benchmark

2. ***What are the minimum requirements/exclusions and supplemental metrics for EU Climate Transition Benchmarks (CTB) and EU Paris-Aligned Benchmarks (PAB)?***
   Requirements for both CTB and PAB:
    - Average year-on-year reduction in weighted-average greenhouse gas emissions or greenhouse gas intensity by 7%, in line with the 1.5°C scenario, with no or limited overshoot.
    - Increased allocation to companies that publish their greenhouse gas emissions targets and greenhouse gas emissions and have reduced their greenhouse gas intensities or absolute greenhouse gas emissions by an average of 7% per annum for at least three consecutive years.
    - For equity benchmarks, aggregated allocation to the specific NACE (Nomenclature of Economic Activities) sectors below must be equivalent to the exposure of the underlying investable universe:
        - Agriculture, Forestry and Fishing
        - Mining and Quarrying

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  - Manufacturing
  - Electricity, Gas, Steam and Air Conditioning Supply
  - Water Supply; Sewerage, Waste Management and Remediation Activities
  - Construction
  - Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles
  - Transportation and Storage
  - Real Estate Activities

CTB Requirements:

- Greenhouse gas intensity or absolute greenhouse gas emissions should be at least 30% lower than the investable universe.

PAB Requirements:

- Greenhouse gas intensity or absolute greenhouse gas emissions should be at least 50% lower than the investable universe.
- Company exclusions:
  - Any involvement in activities related to controversial weapons
  - Any involvement in the manufacturing of tobacco products
  - Violations of the United Nations Global Compact (UNGC) principles or Organization for Economic Co-Operation and Development (OECD) Guidelines for Multinational Enterprises
  - 1% or more of revenue from exploration, mining, extraction, distribution or refining of hard coal and lignite
  - 10% or more of revenue from exploration, distribution or refining of oil fuels
  - 50% or more of revenue from exploration, extraction, manufacturing or distribution of gaseous fuels
  - 50% or more of revenue from electricity generation with greenhouse gas intensity more than 100g CO2e/kWh

    - Companies that significantly harm one or more of the environmental objectives outlined in the EU Taxonomy Regulation

3. ***What are the ESG disclosure requirements in benchmark regulations?***
   Disclosure of how ESG factors are reflected in each benchmark

    - Information in the benchmark statement includes:
        - Whether the benchmark pursues ESG objectives
        - Details in relation to a set of ESG factors ("ESG metrics")
        - Data sources and reference standards for ESG factors
        - Additional information for EU Climate Benchmarks
        - Information on alignment with the Paris Agreement for significant benchmarks and EU Climate Benchmarks
    - ESG metrics:
        - ESG Rating (optional)
        - Individual E, S and G rating (optional)
        - Environmental factors:
            - Carbon intensity
            - Exposure to high-climate impact sectors (using NACE classification)
            - Exposure to 'green' and 'fossil fuel-based' sectors
            - Renewable energy capex (optional)
            - Climate-related physical risks (optional)
        - Social factors:
            - Controversial weapons
            - Tobacco involvement
            - Social violations
            - Implementation of fundamental ILO Conventions

- Gender pay gap
- Board gender diversity – female to male ratio
- Rate of accidents, injuries, fatalities
- Number of convictions and number of fines for violation of anti-corruption and anti-bribery laws

- Governance factors:
  - Board independence
  - Board diversity

Additional disclosure requirements:

- Information for EU Climate Benchmarks (CTB and PAB)
  - Decarbonization trajectory
  - Average decarbonization achieved
  - Overlap between benchmark and investable universe
- Information on alignment with the Paris Agreement for significant benchmarks and EU Climate Benchmarks (to be extended to all benchmarks by end of 2021)
  - Alignment with the Paris Agreement (Yes/No)
  - Temperature scenario, source, and methodology used

4. ***What is the scope of the regulation regarding asset classes?***
   - The EU Climate Transition and Paris-Aligned Benchmarks requirements do not explicitly state the scope of asset classes but provide guidance on GHG intensity calculation for equity and fixed income (corporate) asset classes.
   - The ESG Disclosure requirements apply to all asset classes except interest rate and currency benchmarks

Schedule 3: EU Taxonomy

The EU Taxonomy is a classification system that provides a set of criteria for sustainable activities. It is meant to inform the other legislative streams in the EU Sustainable Finance packages (e.g., SFDR, NFRD, Green Bonds), however, the requirements within each of the regulations currently differ from the Taxonomy. Below we have highlighted some challenges around the EU Taxonomy.

1. ***What challenges are there in applying the EU Taxonomy's technical screening criteria?***
   - Lack of company disclosure specific to the EU Taxonomy criteria
     - Business activity level information is not widely disclosed by companies
   - Companies not based in the EU and not subject to EU reporting requirements or standards will not be required to disclose on many of the EU-specific elements of the Taxonomy.
   - The Taxonomy is not final and is only partially developed:
     - Only two of the six environmental objectives have defined technical criteria
     - Not all sectors are covered

   However, the EU TEG has also introduced the concept of a "potential taxonomy alignment" reporting category in the final TEG report for cases where 'the investor has good reason to believe that the underlying activity is aligned, but full compliance has not been demonstrated.' This allows for the inclusion of business activities that meet the broad principles of the EU Taxonomy without the full verification of the specific criteria.
2. ***What is the scope of the Taxonomy with regards to asset classes?***
   - The Taxonomy in its current form has been primarily developed for equity and fixed income (corporate) asset classes. However, the TEG Final Report for the taxonomy does indicate some potential methodologies for taxonomy-alignment of sovereign bonds.[1]

3. ***What applies to the fund level and what applies to the company level?***
   - The EU Taxonomy examines the 'sustainability' of business activities and is applicable to issuers and bonds but not overall financial products.

[1] p. 41 footnote 42, EU Commission, EU TEG Final report, March 2020

- The SFDR covers the reporting for product and entity level disclosures for financial market participants as defined by the EU.

4. ***What is meant by "activities without defined criteria"? When will the technical criteria for these objectives be developed for the Taxonomy?***
   - The EU Taxonomy has developed technical criteria for business activities for two of the six environmental objectives: climate change mitigation and climate change adaptation. The remaining four will be developed in 2021[2]:
     - Sustainable use and protection of water and marine resources
     - Transition to a circular economy
     - Pollution prevention and control
     - Protection and restoration of biodiversity and ecosystems.
   - The EU TEG Final report outlines areas that will need to be further developed.

Schedule 4: SFDR

The SFDR requires financial market participants to integrate sustainability risk in the investment process and to disclose and report such integration at both the entity level and ESG product level, including extensive disclosure of ESG indicators in prescribed templates. Below we have highlighted some challenges with the SFDR.

What are some of the challenges of the SFDR?

In Q3 2020, MSCI ESG Research conducted workshops with 66 clients across the U.K., U.S. and EU. Collectively, clients expressed concerns and comments regarding proposals for the technical standards, including:

1. *Data availability, prescriptiveness and quality*: Concern that many of the adverse impact indicators were not readily available. The requirements to disclose on 32+ indicators could be a burden, and the quality of company

[2] EU Taxonomy for sustainable activities

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disclosures unclear. Clients suggested that there should be a two-stage approach to reporting based on availability.

2. *Relevance*: Concerns that the adverse impact indicators were not particularly relevant from a materiality perspective. Concerns also surrounded the challenges of communicating these metrics to the end-investor as they were not seen as intuitive.
3. *Timing*: The aggressive timeline for compliance was a major concern.
4. *Ability to analyze adverse impact across asset classes*: Data availability was a general concern for all asset classes but cited as a major challenge for private equity and leveraged bonds.
5. *Need for more clarity on Article 8 vs. Article 9 products*: Among the ideas raised was that it would be helpful if the industry was provided with examples of funds that could fall into each category based on their ESG approach.
6. *Inefficiency of obtaining information directly from investee companies*: Many clients expressed concerns about how inefficient and costly it could be if financial market participants are in fact required to collect data directly from companies first rather than relying on third parties.
7. *Inconsistency among the different legislative streams*: Clients have also expressed concern about the lack of alignment between different legislative streams (in terms of metrics to be disclosed). This lack of alignment was seen as confusing and potentially costly. Clarity is needed.

MSCI's response to the European Supervisory Authorities (ESAs) consultation also highlights challenges with the SFDR, and can be found on our Sustainable Finance web page.

What are some of the challenges of the adverse impact indicators?

The Joint ESAs Final Report on Draft RTS dated February 2, 2021 introduced changes to principal (Table 1) and additional indicators (Tables 2 and 3). There are gaps in the feasibility of some of the existing "adverse impact indicators" which include:

- Definitions for some metrics remain unclear (e.g., water emissions, severe human rights issues, green securities, securities certified as social, social violations for sovereign entities)
- Some metrics are currently too granular and not widely disclosed (e.g., ozone depleting substances, recycled waste, untreated discharge water, energy consumption type, property-level data).

What are some of the challenges in the distinctions between Article 6, 8 and Article 9 products?

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According to the SFDR and ESA's Final Report on the draft RTS, ESG financial products are split based on their objectives and have different associated disclosure and reporting obligations. Financial product issuers will need to designate their ESG products as "Article 8" or "Article 9" products, while products that do not qualify as either Article 8 or 9 can be designated as "Article 6" by applying some baseline environmental or social safeguards.

The distinctions are as follows:

Article 6 Financial Products	**Article 8 Financial Products**	**Article 9 Financial Products**
Applies baseline environmental or social safeguards.	Promotes, environmental or social characteristics, or some combination of those.	Has sustainable investment as its objective as per Article 2(17).
	Must follow "Do No Significant Harm" principles (as defined in the technical standards) if an Article 8 product makes sustainable investments. Follows good governance practices.	Must follow "Do No Significant Harm" principles (as defined in the technical standards). Must take into account the principal adverse sustainability impact indicators. Follows good governance practices.

While it is expected that there will be far fewer Article 9 products, the differentiation between Article 8 and Article 9 products is not necessarily clear as MSCI notes and clients concur. (See MSCI research paper: The SFDR's Articles 8 and 9: The Funds Behind the Labels, July 2021). We will continue to engage with the EU on SFDR-related considerations. Despite the difficulty, financial product issuers will need to make determinations and associated disclosures in line with the SFDR. MSCI is exploring ways to help clients as they make their determinations.

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