7 July 2023

European Commission's Draft Delegated Act on the European Sustainability Reporting Standards (ESRS)

MSCI[1] welcomes the European Commission's publishing of the Draft Delegated Act and the intention to finalize the ESRS in a timely manner. We are a leading provider of ESG data and analytics to the world's largest financial institutions and have collected climate and environment, social, and governance (ESG) related disclosures from thousands of companies globally for over two decades.

MSCI appreciates the opportunity to provide feedback on what are a comprehensive and robust set of disclosure standards. The sustainability information disclosed as a result of the ESRS will be important for investors and other users and will help direct capital towards those activities that will shape the transition to a more sustainable economy.

Below we list four broad observations that may further enhance the effectiveness of the ESRS and provide a more detailed response in the Annex.

1. Make the ESRS on climate change mandatory for all companies, this is critical information.
2. Treat biodiversity as a core sustainability topic; remove voluntary and phasing-in provisions.
3. Information needed for SFDR PAI reporting should be mandatory
4. Reduce the extent of voluntary-only disclosures, materiality assessments and phase-in delays to prevent significant data gaps on key sustainability information.

We welcome further engagement with the European Commission on this important topic.

Yours sincerely,

/s
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1 MSCI ESG Ratings, research and data are produced by MSCI ESG Research LLC. MSCI ESG Research (UK) Limited is a subsidiary of MSCI ESG Research LLC.

ANNEX

General Comments

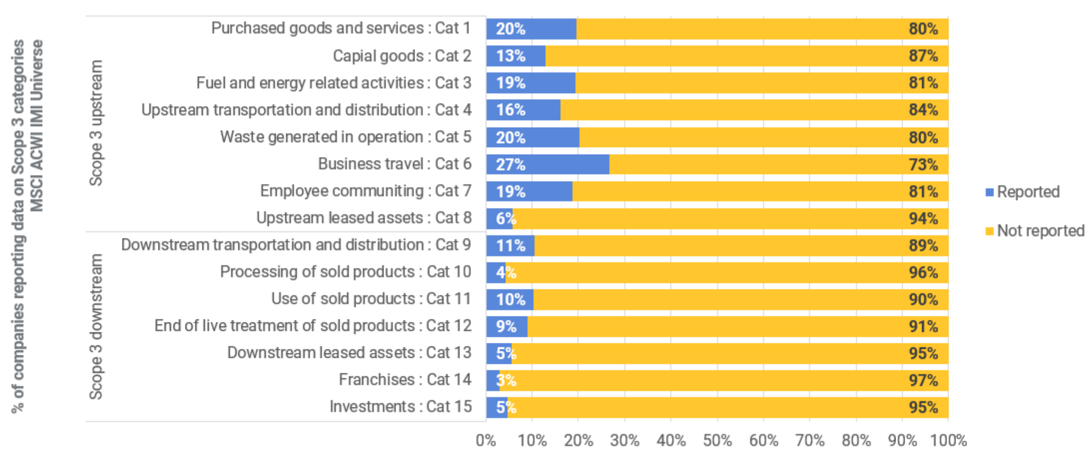
1. Make the ESRS on climate change mandatory for all companies; this is critical information.

Investors would benefit from consistent, comparable and timely climate disclosures in order to better assess the nature, size and timing of the investment risks they face related to climate change. Making some of the most essential climate disclosures such GHG emissions, climate targets and transition plans subject to a materiality assessment may make it more difficult to achieve wider EU regulatory and policy objectives. We propose that ESRS E1 (Climate Change) is not made subject to materiality assessment and is mandatory, like ESRS 2 (General Disclosures).

Core set of mandatory climate metrics, including Scope 1, 2 and 3 GHG emissions
The ESRS should require all companies to disclose a core set of climate indicators on a mandatory basis without the need to conduct a materiality assessment. This should include the company's full carbon footprint and a detailed breakdown of its Scope 3 GHG emissions including all 15 categories listed by the GHG Protocol. The ESRS should look to align with the ISSB standard *IFRS S2 Climate-related Disclosures*[2] which includes the requirement for companies to disclose Scope 3 GHG emissions. The disclosure of GHG emissions will help narrow the reporting and information gap that currently exists.

Recent MSCI research shows the relevance of Scope 3 emissions for most sectors. However, investors seeking to measure their exposure to Scope 3 emissions face a big challenge of scarce and inconsistent disclosed data. For example, Figure 1 shows that only 11% of companies report their emissions from "downstream transportation and distribution". An even smaller ratio of companies, 5%, reported emissions from downstream leased assets.

Figure 1: Percentage of companies disclosing detailed breakdown of Scope 3 emissions[3]



2 ISSB, IFRS S2 Climate-related Disclosures, June 2023, can be accessed via https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/.

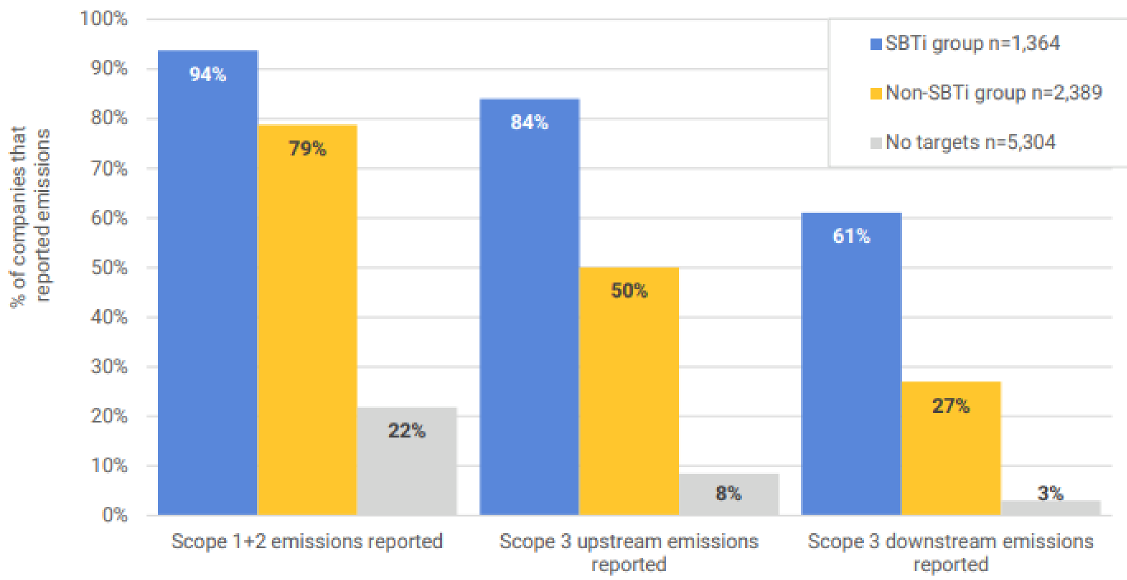
3 CDP, MSCI ESG Research, as of February 2023.

Mandatory reporting of climate targets

The ESRS should include the need to disclose climate-related targets on a mandatory basis irrespective of a materiality assessment. Assessing whether companies can achieve their climate targets is a critical input for investors aiming to decarbonize investment portfolios and reduce real-economy GHG emissions. Investors need to have access to detailed and credible information on a company's climate targets and ambitions. According to recent MSCI research, while 40% of companies have set climate targets, only 15% of those targets are based on science-based commitments and had the necessary transparency needed by investors.[4]

As can be seen in Figure 2 below, disclosing detailed information on climate targets by companies is important as it can trigger the reporting of other critical disclosures such as GHG emissions, namely Scope 3 emissions. Only 8% of companies which had not set climate targets disclose Scope 3 upstream emissions, whereas this number is 84% for those companies which have set detailed science-based targets.

Figure 2: Corporate scope 1, 2 and 3 emissions disclosure according to targets set[5]



Prescribing target setting methodologies

To support companies report any climate targets they may have set, ESRS E1 (Climate Change) provides application guidance for them to use either a sector-specific or cross-sector contraction emissions reduction factor.[6] However, this is in effect prescribing a fixed rate of reduction approach which is not in line with market best-practice, particularly with regard to

[4] MSCI ESG Research, *Assessing Science Based Corporate Climate Target Setting,* June 2023. Number of companies based on MSCI ACWI Investible Market Index.

[5] MSCI ESG Research, *Assessing Science Based Corporate Climate Target Setting,* June 2023, accessed via [Assessing Science-Based Corporate Climate Target-Setting - MSCI]

[6] ESRS E1-Climate Change, paragraph AR.2, AR.28, AR.29 and AR.30.

recent recommendations put forward by the Glasgow Financial Alliance for Net Zero ("GFANZ").[7]

A fixed rate of reduction approach to climate targets expects all companies in a given sector to achieve the same emissions reductions in a given timeframe, regardless of their cumulative emissions. Therefore, this penalizes companies which have already achieved significant emissions reductions compared to their sector peers, who may have a higher emissions profile today and can thus achieve reductions more easily.

We suggest that a more appropriate requirement would be to simply require the disclosure of the specific 1.5°C-aligned decarbonization pathway the company's target is based on, and explanation of how this leads to the target value. Companies should be permitted to use other approaches other than the fixed rate of reduction, including the convergence approach that "assume[s] that all companies in a sector are expected to converge to a required sector average level of emissions intensity, considering the starting position of each company in a sector compared to this average."[8]

2. Treat biodiversity as a core sustainability topic; remove voluntary and phasing-in provisions.

Investors are now facing growing pressure to address nature-related financial risks. More than half of the world's economic output is either highly or moderately dependent on intact ecosystems and their benefits. In December 2022, a landmark agreement made at the United Nations COP15 biodiversity conference highlighted the role of companies and investors in conserving nature and ecosystems. The Global Biodiversity Framework aims to protect 30% of the planet's land and water by 2030 and includes as one of its main targets the need for companies and investors to "regularly monitor, assess and transparently disclose their risks, dependencies and impacts on biodiversity" throughout their operations, supply and value chains, and investment portfolios.

Despite the increasing focus of biodiversity, the ESRS draft Delegated Act makes disclosure of companies' nature-related risks and impacts non-mandatory. There are also new relief measures such as the provision for small companies (750 employees or less) to not report any of the biodiversity-related disclosure requirements (ESRS E4) for the first 2 years of reporting. Regarding biodiversity transition plans, the ESRS Draft Delegated Act now makes reporting of this completely voluntary, whereas previously it was a mandatory requirement.

Biodiversity-related disclosures should be enhanced and not reduced
The ESRS framework should consider biodiversity as a mandatory component of corporate sustainability reporting, and explicitly reference the ongoing work of the TNFD as a basis for guidance. As can be seen in Figure 3, the majority of sectors have either a high or medium

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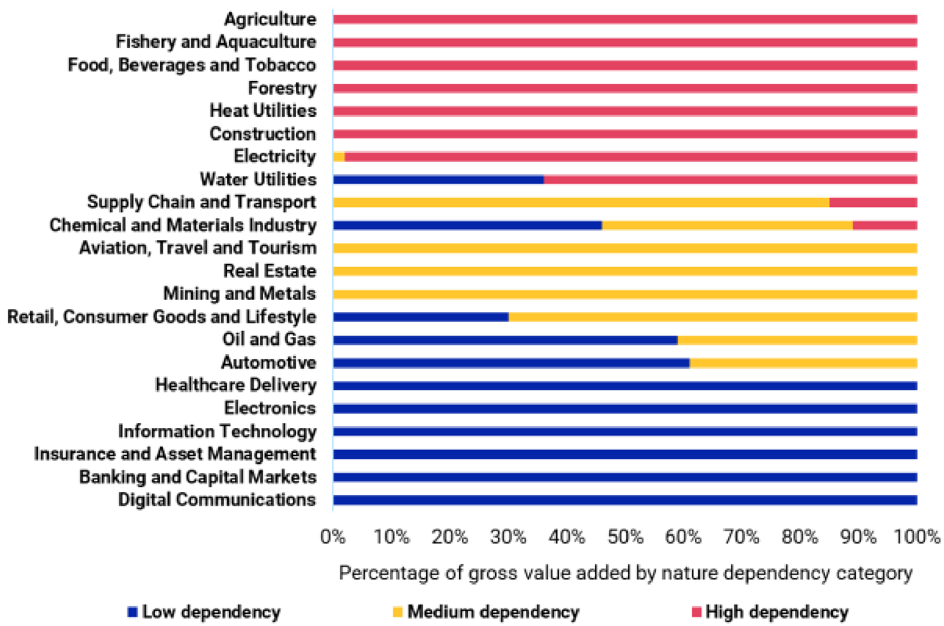
7 GFANZ, Measuring Portfolio Alignment, August 2022, accessed via [GFANZ-Portfolio-Alignment-Measurement-August2022.pdf (bbhub.io).](GFANZ-Portfolio-Alignment-Measurement-August2022.pdf)

8 *Id.*

dependency on biodiversity, with certain sectors such as agriculture having a completely high reliance on the risks associated with biodiversity loss.

Figure 3: Many sectors have strong dependency on natural capital[9]



3. Information needed for SFDR PAI reporting should be mandatory

As part of the EU Sustainable Finance Disclosure Regulation (SFDR), financial market participants (FMPs) are required to disclose the adverse impacts of their investment decisions. This includes a set of mandatory Principle Adverse Impact (PAI) indicators. When finalising the first set of ESRS in 2022, EFRAG ensured that all SFDR PAI indicators would be covered by the disclosure requirements. This was to make sure that the information needed by FMPs for their SFDR reporting could be easily identified.

However, the current ESRS draft Delegated Act reduces the requirement for companies to disclose the information needed by FMPs, thereby creating an information gap for investors to get the information they need from investee companies. Figure 4 below shows that companies are required to disclose information related to only 3 of the PAIs regardless of materiality[10] with the remaining PAI indicators falling under materiality assessment. Important PAI indicators such as emissions to water and share of non-renewable energy consumption are subject to a company's materiality assessment.

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9 MSCI, What biodiversity loss and the COP15 agreement mean for investors? February 2023, accessed via [What biodiversity loss and the COP15 agreement mean for investors (msci.com)]

10 Please note that this table includes PAI indicators from SFDR, Annex I, Table 1: Indicators applicable to investments in investee companies, prior to the April 2023 publication of the ESA review of SFDR delegated regulation.

Companies should report all mandatory PAI-related disclosures
To support FMPs meet their SFDR PAI reporting requirements and ultimately to help them direct investment towards more sustainable economic activities, the ESRS should require companies to report on all PAI-related information on a mandatory basis, regardless of whether they deem it to be material to them or not. In April 2023, the European Supervisory Agencies (ESAs) proposed new additional social PAI indicators, e.g., the share of employees earning under the minimum wage. This has only added to the importance of ensuring companies reporting within the ESRS framework disclose the PAI-related information needed by FMPs.

Figure 4: The majority of the PAI indicators will only be reported subject to materiality[11]

PAI Indicator	Mandatory reporting regardless of materiality	Reporting required only subject to materiality
1. GHG emissions		
2. Carbon footprint		
3. GHG intensity of investee companies		
4. Exposure to companies active in 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 and radioactive waste ratio		
10. Violations of UNGC Principles/OECD Guidelines		
11. Lack of mechanisms to monitor compliance with UNGC Principles/OECD Guidelines		
12. Unadjusted gender pay gap		
13. Board gender diversity		
14. Exposure to controversial weapons		

4. Reduce the extent of voluntary-only disclosures, materiality assessments and phase-in delays to prevent significant data gaps on key sustainability information.

One of the major revisions the European Commission has introduced to the ESRS is making all of the standards, except ESRS 2, subject to materiality assessment. All ESRS topical standards, disclosure requirements and data points will now only need to be reported by companies if they deem the subject to be material for them. This means that if a company decides that a particular topical ESRS does not pose a material influence on its business it is permitted to not report any of the disclosure requirements or data points in that particular standard.

Combined with the added flexibility and time delays companies have now been given in reporting their information, this would effectively allow companies to leave out entire parts of their sustainability disclosures. For investors, this could mean less insight as to where to allocate their capital so that they can deliver on their net zero transition commitments. The potential lack of meaningful corporate sustainability disclosures as a result of a reduced ESRS framework could undermine wider policy goals such as those of the European Green Deal.

11 European Commission, Draft Delegated Act on the ESRS, Annex I.

Reduce the extent of voluntary-only disclosures for companies

The European Commission has converted a large number of mandatory disclosure requirements into voluntary requirements, in an effort to reduce the reporting burden for companies. However, many of these voluntary-only requirements are critically important parts of a company's sustainability profile and hence the ESRS should require the information to be reported on a compulsory basis. Therefore, the European Commission should look to reduce the extent of voluntary-only requirements as this risks wider EU sustainability objectives.

Materiality assessments should not lead to non-disclosure

The ESRS should not permit companies to make a blanket assessment of non-materiality to an entire topical ESRS and therefore not report any disclosure requirements within that ESRS. If the European Commission maintains its view that all of the topical ESRS should be subject to materiality assessments, then the materiality assessment should be carried out at the individual disclosure requirement level; not an overarching materiality assessment at the topical ESRS level as this may then lead to the complete omission of all information within that particular ESRS, even of those disclosures which may actually be material.

Remove the phasing-in provisions; this delays the reporting date to 2030 in some cases.

The ESRS contains a number of phasing-in provisions for companies with 750 or less employees. This includes an allowance to omit datapoints on Scope 3 GHG emissions in their first year of reporting, and an allowance to omit all of the biodiversity disclosure requirements for the first two years of reporting. In some cases, this results in the pushing back of reporting certain sustainability information to 2030 at the earliest, for example, non-EU companies with less than 750 employees will not need to report their biodiversity-related information until 2030.