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Response to EC 7th May 2021 Draft Delegated Regulation, Taxonomy

From Morningstar Inc. and Sustainalytics, a Morningstar Company

Submitted via the European Commission portal for feedback

1st June 2021

Dear Sirs,

Morningstar welcomes the opportunity to comment on the proposed delegated regulation, or DR, specifying the content and presentation of information to be disclosed concerning environmentally sustainable economic activities. We bring several perspectives to this comment letter. First, we have a long track record of categorizing and rating mutual funds that pursue different sustainability strategies. Second, our equity analysts use environmental, social, and governance (ESG) analysis as part of their approach to assessing investments. Third, Sustainalytics, which is now part of the Morningstar family, is a leading global provider of ESG ratings, research and data to asset owners, investment managers, financial institutions, issuers/corporates, and a variety of other financial intermediaries.

As highlighted in the preamble of the DR, the Taxonomy Regulation is an important piece of legislation for enabling and scaling up sustainable investment and shifting investment to economic activities considered as environmentally sustainable.

It is disappointing therefore to see the proposed one-year delay to company reporting of Taxonomy alignment. While there will undoubtedly be challenges for companies assessing the compliance of activities, a hallmark of the Sustainable Finance Action Plan to date has been the setting of ambitious timelines in creating leading standards of disclosure.

We outline below our specific concerns with, potential consequences of, and possible remedies to the DR.

1. The 2022 reporting of revenue or capex associated with eligible activities, without their corresponding degree of alignment with the Taxonomy, will be of no material use to investors. Indeed, they could have unintended consequences and perpetuate, rather than minimize, the risks of greenwashing.

   By way of example, a cement manufacturer might show a similar or even higher proportion of eligible activities than a solar company, despite almost certainly having minimal alignment with the Taxonomy. This would not become evident until the 2023 disclosures and whilst the context may be discernible at the level of individual companies, at the level of a financial products' portfolio the aggregated level of eligible activities will be meaningless.

To avoid undermining the credibility of the Taxonomy, if corporate reporting is delayed, then financial product reporting requirements should similarly be deferred by 1-year, or at worst, be accompanied by warnings of what the information is reflecting.

2. The mandatory two-year exclusion of voluntarily reported information from financial undertakings key performance indicators removes any incentive for smaller, or non-EU or private companies to start any form of Taxonomy reporting.

   This contrasts with the ambitions of the Corporate Sustainability Reporting Directive proposals, which actively encourage non-required firms to actively use the reporting framework. Increasing the reporting from as many companies as possible is vitally important to investors, both from the perspective of minimizing greenwashing and reorienting capital flows to the most sustainable companies.

   The Morningstar database currently identifies 4,642 Article 8 and 9 funds as defined by the Sustainable Finance Disclosure Regulation, 56% of which have a primary geographic focus outside of the EU. This indicates that a large proportion of European ESG funds, as defined by SFDR, would be highly impacted by the proposed exclusions. The situation is further exacerbated when analyzing the individual holdings of 2,807 of this SFDR defined ESG fund universe - excluding all micro-cap and half of small-cap holdings as a proxy for companies that would not meet the 500-employee threshold for NFRD reporting, would reduce by 65% the number of holdings for which funds would have potentially useable Taxonomy-related information.

   We urge the Commission to remove this restriction in the interests of providing the maximum possible encouragement to use the Taxonomy to as many firms as possible as soon as possible, resulting in more complete and comparable information for investors.

3. Previous Taxonomy-related documentation referred to the use of coefficients or estimates in respect of companies that are not obligated to conduct Taxonomy reporting. There is no reference at all in the DR, which will further reduce the opportunity to identify, and channel investment to, firms which are making progress in conducting sustainable economic activities.

   This is in contrast to ESMAs 26th February 2021 Final Report[1] on Article 8, supported by SMSG, which concluded its advice on this point by saying '*Such a methodology will be particularly important for financial undertakings during the first year of application of the reporting requirements, since reports from non-financial undertakings under the*

[1] https://www.esma.europa.eu/sites/default/files/library/esma30-379-471_final_report_-_advice_on_article_8_of_the_taxonomy_regulation.pdf

delegated act showing the Taxonomy-alignment of their activities as a share of turnover will not yet be available.'

4. The same ESMA report included an estimated Taxonomy-alignment of EU fund equity and corporate bond holdings as low as 1.4%, or €73 billion. The DR as it stands, with its exclusion of non-NFRD company data at least until 2025, would further reduce this.

   An unintended consequence could also ensue. Financial products seeking to enhance their degree of Taxonomy-alignment, would be implicitly incentivized to favour investment in large EU companies. Smaller EU and non-EU companies that may in many cases actually be more Taxonomy-aligned might, as a result, be deprived of investment, thereby inhibiting the Action Plan goal of reorienting capital flows toward sustainable investments.

   The Commission should clarify how financial products should fulfil their 2022 SFDR Taxonomy-related reporting obligations in light of them not having, or being able to use, any Taxonomy-alignment data from their investee companies. This is especially pertinent in respect of pre-contractual disclosures requiring an indication of a products' targeted level of Taxonomy-alignment.

5. We understand that a suitable methodology is pending in respect of sovereign bonds, but it is unclear to us why they are excluded from both the numerator and denominator of KPI calculations, while other non-eligible securities such as cash, commodities and non-NFRD companies are only excluded from the numerator.

On behalf of Morningstar we again thank you for the opportunity to contribute and will be happy to engage further, answer any questions or provide any additional information that may be helpful.

Yours faithfully,

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