# Bloomberg Environmental Social Goverance - Module 7

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## Reporting Sustainability Activities

### Increasing Demand for ESG Regulations

A few years have passed and the ESG movement in capital markets is showing no signs of slowing down. This steady increase in demand has fuelled a proliferation of ESG funds and strategies that integrate ESG considerations into the investment process. At the same time, investors are increasingly demanding better, comparable, and reliable ESG information from companies. As a result, ESG is emerging as a risk and compliance issue. In order to stamp out greenwashing and product mis-selling, regulators around the world are setting requirements with detailed rules to increase the level of high-quality and standardized ESG information in the market. Then this happened. On December 31, 2019, practitioners at Worthing Capital Management were celebrating New Years Eve with family and friends, anticipating a brilliant year ahead. On January 30, 2020, the World Health Organization declared the outbreak a public health emergency of international concern. Two months later, the world shut down as a deadly new coronavirus disease named Covid-19 spread rapidly, flooding hospitals and taking millions of lives. The economic toll of the coronavirus crisis was massive. Its spread prompted the most severe market crash since the global financial crisis of 2008 as economies were forced to shut down due to life-saving stay-at-home orders. This pandemic triggered a huge debate about what societies truly value. It shined a light on inequalities and poverty around the world. Many countries are using the pandemic recovery as an opportunity to build back greener and focus on social issues. Some key examples are the U.K. and the European Commission. Europe has been the global champion for ESG, with the EU in particular paving the way forward with regulations such as SFDR and the EU Taxonomy. The U.S. and Asia Pacific regions are also taking concrete steps to push ahead with policy agendas around ESG and climate risk. For example, on May 25, 2022, the U.S. Securities and Exchange Commission (SEC) proposed a new slate of restrictions seeking to standardize ESG disclosures to ensure ESG funds accurately describe their investments. Some funds would also need to disclose the aggregated greenhouse gas emissions of companies they're invested in, according to the SEC. In the Asia Pacific region, regulators are increasing their focus on ESG risk and compliance, particularly in Hong Kong, Singapore, and Malaysia. In the post-Brexit era, the U.K. government has issued its own regulatory agenda in the ESG space now that it has left the EU because it also wants to be a global leader in sustainable finance regulation.

### Reporting Sustainability Activities

The ESG investment team at Worthing Capital Management are confident they are in a better position as it relates to ESG investing. Initially, the ESG investment team did a lot of negative exclusionary screening, choosing not to invest in certain industries, such as weapons manufacturing and companies not aligned with criteria around the use of fossil fuels. Today, their view has shifted and become more sophisticated. Now they look at companies from a positive perspective: choosing to engage with them to influence change rather than divesting from them. Portfolio managers are now looking for the most sustainable companies within various sectors and regions. Worthing Capital Management needs to report its sustainability activities to the market, so the investor relations team starts to measure all of their funds and calculate aggregate positions.

## Regulation Themes

ESG regulation primarily revolves around two key themes: fostering the transition to becoming sustainable and embedding sustainability into wider prudential risk management practices.

For each fund distributed to EU clients or manufactured in the EU, Worthing Capital Management needs to explain the sustainable nature of the product in accordance with two primary regulations: the EU Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR).

## EU Taxonomy

There is confusion in the market about what is defined as "sustainable." The EU Taxonomy solves this problem by providing a simple list of economic activities that are aligned to European environmental objectives. The list includes activities such as energy supply, transport vehicles, and the manufacturing of steel or cement. It recognizes the level of environmental performance that these activities must have in order to meet environmental goals, like limiting global warming to 1.5 degrees Celsius. The European Commission in a Technical Expert Group (TEG) brought together experts in sustainable finance to determine what a taxonomy should include and appropriate criteria for each industry it covers. The TEG carried out a rigorous process that substantially informed the EU Taxonomy. The EU Taxonomy is essentially a framework used to classify green economic activities. It also creates new disclosure requirements under Article 8 of the regulation for non-financial and financial undertakings within the scope of the Non-Financial Reporting Directive (NFRD), which is currently being revised by the Corporate Sustainability Reporting Directive (CSRD) to report taxonomy eligibility and alignment. The objective of the Taxonomy Regulation is to provide the ultimate science-based tool for investors and other stakeholders to understand which economic activities are deemed as "sustainable" and in line with the EU environmental objective. This would ultimately help drive private capital towards more sustainable outcomes. It also helps companies access finance to transition their activities, giving credit for capital and operating expenditure and any debt financing aligned to the EU Taxonomy. Under Articles 5 and 6 of the Taxonomy Regulation, EU fund managers who have financial products that either promote environmental or social characteristics (Article 8 SFDR) or promote sustainable objectives (Article 9 SFDR) are subject to additional detailed disclosure rules. These rules require them to report how and to what extent the activities funded by these products are aligned with the EU Taxonomy framework. To read about the EU Taxonomy on the Terminal, go to `BESG<GO>` and select European Regulation.

## Checking for EU Taxonomy Alignment

The EU Technical Expert Group (TEG) report on sustainable finance is a short report that explains what the taxonomy is and how it should be used in practice. Cinzia, a portfolio manager on the ESG investment team at Worthing Capital Management, follows a five-step process from the TEG to understand the taxonomy characteristics of the Worthing ESG Focus Fund. **Step one:** Eligible Revenue — Cinzia needs to check if companies' revenues in the Worthing ESG Focus Fund are considered "eligible" as defined by the Taxonomy Regulation. **Step two:** Estimate Substantial Contribution — Next, Cinzia must determine whether the economic activities substantially contribute to one of the six environmental objectives of the EU Taxonomy. The six objectives are: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems. Cinzia can go to ESG EUTAXO on the terminal to see if a company has revenue streams which substantially contribute to one of the environmental objectives of the EU Taxonomy regulation. She types a ticker in the amber field on the top left to look at Volkswagen. She can see the percentage of the company's revenue streams which substantially contribute to one of the environmental objectives. For example, she can see that Volkswagen has 4 percent estimated substantial contribution with the EU Taxonomy. This makes sense to Cinzia because a small percentage of the vehicles sold by Volkswagen are zero emission vehicles. Cinzia can click through to the Peer Comparison tab to see how this compares to peers. **Step three:** Check Whether DNSH Criteria Is Met — Now Cinzia must check that the activities do no significant harm (DNSH) to any of the other remaining environmental objectives. DNSH is not a controversy screening. Instead, it is an assessment that looks at specific data requirements around each of the six environmental objectives to ensure that where a company is substantially contributing to one, they aren't doing harm to the remaining five. In ESG EUTAXO, Cinzia analyzes aggregate DNSH (Do No Significant Harm) Bloomberg Level 1 scores for each of the six environmental objectives of the EU taxonomy. The DNSH Level 1 Tests evaluate general, entity level criteria of DNSH to the specific environmental objective. The pass rate is represented by the percentage of underlying tests passed, where 100% represents a full pass. For more details on the methodology for this data field, Cinzia can go to `BESG > European Regulation` to look at Bloomberg's EU Taxonomy methodology documents. **Step four:** Check For Negative Impacts on Minimum Social Safeguards — Cinzia needs to check that companies and their supply chain are in compliance with minimum social safeguards. This is adherence to standards like the UN Guiding Principles and the eight International Labor Organization conventions. Cinzia can see these estimates at the bottom of the ESG EUTAXO`<GO>` screen. Clicking into the number will show a company's strengths and weaknesses with respect to minimum social safeguards vs peers. **Step five:** Calculate Alignment of Investments — Cinzia needs to calculate alignment of investments. Whether reported by the company, or estimated by Bloomberg, the final alignment numbers are shown on ESG EUTAXO`<GO>`. The formulas practitioners use to calculate taxonomy alignment differ by job role. For example, a bank uses a different formula than a portfolio manager and a corporate practitioner. As a portfolio manager, Cinzia needs to calculate a green investment ratio. She reads the European Commission's FAQ document on the EU Taxonomy Article 8 Delegated Act for more details on this.

## SFDR

The Sustainable Financial Disclosure Regulation (SFDR) broadly requires financial market participants to disclose information related to their sustainability policies and due diligence processes. The purpose of SFDR is to promote transparency and accountability in sustainable finance and help investors compare investments. The SFDR offers a specific template for disclosure. There are generic sustainability disclosure requirements that apply to any fund distributed in the EU, whether it is green or not. All asset managers in the EU are in scope of SFDR and therefore must disclose whether or not sustainability considerations were taken into account in decision-making processes. Is there a due diligence policy in place? Article 8 (Light Green) funds and Article 9 (Dark Green) funds are subject to more detailed disclosure rules. Article 8 funds promote environmental or social efforts, but do not have them as the overarching objective. Article 9 funds have sustainable goals as their objectives. These have a positive impact on the environment and society (for example investing in companies whose goal it is to reduce carbon emissions). Under the SFDR, Article 8 and Article 9 funds must report Principal Adverse Impacts (PAIs) which are the negative externalities that are part of their investments.

## Taxonomy and SFDR Reporting

The Worthing ESG Focus Fund is registered in the European Union as an Undertakings for the Collective Investment in Transferable Securities (UCITS) vehicle. UCITS are investment funds regulated by the European Union. This means the Fund is subject to the Sustainable Finance Disclosure Regulations (SFDR) and disclosures under Article 8 of the Taxonomy Regulation. A key part of these regulations is linked to transparency. There is the need for an investment manager to explain how they take adverse impacts on sustainability into account, and to disclose how investments are compliant with the 'do no significant harm' principles laid out in each of the regulations. Given that the Worthing ESG Focus Fund makes claims of sustainable characteristics and objectives, the firm is required to make product-level disclosures in accordance with the regulatory technical standards under SFDR. To see which fields Worthing is required to report under SFDR reporting requirements, Cinzia runs `ESGD SFDR <GO>` in the command line. This opens Bloomberg's ESG Data Discovery tool. Under frameworks in the menu on the left, she ticks the checkbox next to EU Taxonomy to add the data fields. From here, she can see the relevant descriptions and Bloomberg mnemonics that she can add to her PORT Characteristics view.

## External Reporting

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