RESULTS OF THE REVIEW OF THE FIRST PHASE OF IMPLEMENTATION ON THE CIS OF REGULATIONS RELATED TO SUSTAINABILITY

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In its Activity Plan for 2022, the CNMV established the "monitoring of the implementation of ESG regulations: Transparency and investment policies of CISs" with the goal to learn the degree of adaptation of the Spanish investment fund industry in this regard and to transmit any appropriate guidelines to the industry.

Said review was particularly **centred on adjusting practices of investment fund managers in the case of funds registered with social or environmental characteristics or with a sustainable investment objective as of March 2022**. The review is the first phase of the supervisory analysis on this matter, which will be followed by other actions, such as those foreseen in the CNMV's activity plan for 2023, considering the gradual time frame in which European sustainability regulations are being approved.

In March of 2021, Regulation (EU) 2019/2088 on sustainability disclosures in the financial services sector (SFDR) came into force, requiring financial market participants and financial advisors to disclose certain information regarding environmental, social and governance risks and factors when making investment and advisory decisions. In regard to those participating in markets, the regulation establishes obligations of transparency at both entity and financial product level.

Obligations at the entity level include the integration of the risk of sustainability into the investment decision-making process and remuneration policy, and the consideration, in the given case, of principal adverse impacts of investment decisions on sustainability factors. In relation to the consideration of the principal adverse impacts, there are currently no financial market participants in Spain that exceed the thresholds established for the application of the obligations at entity level, although there are entities that have voluntarily decided to consider the principal adverse impacts of investment decisions in the sustainability factors.

The obligations at the financial product level are specifically related to those that promote social or environmental characteristics, or both, as long as the companies in which they invest follow good governance practices (known as financial products under art. 8) **and those that aim at sustainable investments** (known as financial products under art. 9). In the latter cases, the regulation clearly establishes the pre-contractual and periodic information to be provided, as well as that to be made available on their websites. SFDR was developed by the delegated Regulation 2022/1288, which came into force on 1/1/2023[1].

In any case, it is important to highlight that the SFDR is a regulation on disclosure, and therefore the categorisation as financial products in article 8 or 9 of the SFDR does not constitute a “label” that guarantees execution relating to sustainability, but only a transparency regime resulting from the characteristics promoted by the fund, whose objective is to make the necessary information available to investors to enable them to make an informed investment decision on sustainability.

In this context, the supervisory activity carried out by the CNMV has focused on reviewing the content of the websites of all fund managers managing funds with ESG characteristics (Art. 8 and Art. 9), as well as the content of their corresponding annual report for 2021 (published in April 2022), in order to verify compliance with the provisions of the SFDR, as well as assessing the coherence of the portfolios of the analysed funds with the information published in their prospectus and on their manager's website.

Specifically, all those managing a fund under article 8/9 as of March 2022 (37 fund managers under art. 8 and 3 under art. 9) were analysed, as well as a sample of 57 funds under art. 8 and 3 under art. 9.

As of the date of the sample selection, March 2022, CISs under article 8 did not foresee the execution of sustainable investments within the terms of art 2.17 of the SFDR nor for taxonomy (article 6 of the Taxonomy Regulation).

Characteristics of funds under Article 8

Investment funds that are classified as funds under Article 8 are those that promote social and/or environmental and governance characteristics, for which they apply certain non-financial selection criteria.

In general, the **promoted ESG characteristics, as well as the value criteria for the selection of investments**, are described excessively generically and imprecisely (fight against climate change, respect for human rights, gender diversity, employee health and safety, etc.), except in those funds considered "thematic", where sectors and economic activities in which investments are made receive greater specification.

In this context, a greater level of precision, clarity and specification of ESG characteristics to be promoted by the fund is preferable by fund managers. This is relevant in order to be able to measure the accomplishment of such characteristics. In fact, it is worth highlighting that the Annex to the prospectus on sustainability (mandatory since last 1 January, when the SFDR’s delegated Regulation came into force) must detail the sustainability indicators applied to measure the achievement of each of the social or environmental characteristics promoted.

[1] The Delegated regulation (EU) 2022/1288 was modified by the delegated Regulation (EU) 2023/363 (transparency on economic activities related to fossil gas and nuclear energy in compliance with taxonomy), entering into force on 17 February 2023, date of its publication in the EU’s official journal.

In regard to the selection of investments, in addition to financial criteria, the analysed fund managers set both exclusionary and value-based extra-financial selection criteria for funds under Article 8, without any fund applying excluding criteria having been identified[2].

With regard to said criteria, there is proof that exclusion policies are generally applied, with different nuances and specifications, with the aim of eliminating or reducing investment of one or more controversial sectors such as tobacco, weapons, alcohol, gambling, etc., although it is often assessed with exclusions, specifically for sectors related to fossil fuels that may negatively affect the environment, with different levels of ambition depending on each fund manager.

Regarding **sustainability methodologies and indicators to measure the achievement of the promoted ESG characteristics**, in addition to the exclusion criteria:

- **In the case of equities**, 93% of the managers have chosen ESG ratings provided by third parties, of which 69% set a minimum required rating for asset selection (best in class strategy). The use of ESG ratings as an asset selection criterion is complemented by 11% of managers with additional sustainability indicators such as the carbon footprint of the underlying investments, compared to that of a benchmark index so that it can be properly assessed.

- **In the case of private fixed income investment**, part of it corresponds to the debt considered as "green" or "social", whose funds are dedicated to projects with a positive environmental or social impact, and the rest has generally been governed by the same selection criteria as in the case of equities. **Investment in public debt** is carried out, in some cases, according to ESG ratings for States from different agencies, and in other cases, taking into account the scores of certain indexes (such as the UN's Human Development Index), or internal ratings developed by fund managers on the basis of indicators from the World Bank, the UN and other international organisations.

The above strategies for funds under Article 8 are considered to be in line with those set by the European Commission in its Q&A published on 14 July 2021 that highlights that the SFDR regulation does not establish minimum criteria or thresholds for application, nor suitable strategies or methodologies.[3]

While the regulation does not require a minimum percentage of investments to achieve ESG characteristics, four-fifths of the sample of funds analysed reach 50%, and one-fifth set percentages between 70 and 90%.

Characteristics of funds under Article 9

[2] One way to incorporate such characteristics may imply for a fund to choose the securities to incorporate to the portfolio certain positive characteristics (energy efficiency, biodiversity, social inclusion), considering the latter as a positive element for securities' selection (valuation criterion) or simply exclude (exclusionary criterion) from its portfolio certain securities with negative characteristics (weaponry, tobacco, deforestation, etc.) that it does not wish to incorporate to its portfolio.

[3] sfdr_ec_qa_1313978.pdf (europa.eu) (page 6 to 8)

As of the date of analysis, 86% of Spanish funds registered under article 9 established the UN Sustainable Development Goals as selection criterion for investments, while only 25% chose the specific SDGs in which they wished to have a positive impact, with the remaining funds referring to the 17 SDGs generically.

In this sense, **a higher level of specification identifying the most relevant SDGs and targets on which an impact is desired would be preferable**.

Additionally, determining which indicators or metrics, when selecting investments, will help achieve said goals, taking into account that, in general, issuers report with metrics and parameters on the specific SDGs on which they have the greatest impact, without quantifying the rest.

This would also apply to funds under article 8 that set or may set SDGs as an investment selection criterion.

Today, SDGs continue to be the main selection criterion for investment. Furthermore, among the total of 18 registered Spanish funds under article 9, 5% include environmental and climate objectives exclusively, 17% only include social objectives and 78% a combination of both. The gradual increase of information from companies on the percentage of alignment of their activities with the taxonomy and the different climate and environmental indicators could favour a change in the supply of funds.

Website transparency

In line with article 10 of the SFDR, for each of the funds under art. 8/9, their managers must provide the following information on the website:

- Description of environmental and/or social characteristics (funds under art. 8) and sustainable investment objective (funds under art. 9);
- Methodologies to assess and measure ESG characteristics or the impact of sustainable investments;
- Data providers;
- Asset selection criteria and sustainability indicators.

However, as of the date of the review (April 2022), the SFDR delegated Regulation was not in force, applicable since January 2023 and which specifies and develops the information to be provided on the website, going on to be more structured in its presentation.

The analysis carried out proved that the information published on the website could be improved, considering only 30% of the fund managers included all the information. The majority of cases of managers with issues, there was a lack of information on the methodology used and the data providers and, in some cases, there was no information on environmental and social characteristics and investment selection criteria, although the latter two aspects can be found in the prospectus published on the manager's website.

In this regard, **entities are reminded that all of the website's sections included in the delegated Regulation must be published separately**, including any future overlaps with the Annex to the prospectus.

Regarding the above, entities are reminded of the importance of having a methodology to assess, measure and monitor the promoted ESG characteristics or the impact of sustainable investments, which will include the criteria for asset selection, sustainability indicators and data providers to be used.

In this sense, i**t is deemed advisable to identify providers in cases where the manager makes significant use of metrics, scores or ratings** facilitated by a particular data provider. Moreover, **managers that apply their own methodologies** to assess and measure promoted environmental and social characteristics or sustainable investment objectives **must detail the key aspects of such methodologies.**

It is also important to remember that, in the case of funds under art. 8, the delegated Regulation requires reporting on the sustainability indicators to measure each of the characteristics set out.

In the case of funds that use SDGs as an investment selection criteria, a satisfactory level of detail regarding the methodology is recommended to better understand their implementation and subsequent reporting in the annual report, including an example to facilitate understanding.

Transparency in the annual report

The revised information on sustainability refers to the 2021 financial year (included in the management report attached to the annual accounts and published in April 2022). At the time, the only applicable regulation was the SFDR, which provides little specification, as it only states, in the case of funds under art. 8, that it must have information on the degree to which environmental or social characteristics have been met and for funds under art. 9, the overall impact in relation to sustainability using sustainability indicators.

However, **with the entry into force of the SFDR delegated Regulation last January, information on sustainability for the 2022 financial year, to be published in April 2023, is now more detailed** and must be provided in the Annex on sustainability of the annual report (annex attached to the annual accounts, without being part of the management report) in line with the template provided by said Regulation.

The CNMV has sent a communication to managers to share the special supervisory attention to certain aspects of the Annex on sustainability of the annual report, including, among others, that information on the degree of compliance with promoted ESG characteristics and sustainable investment objectives must be provided based on the performance of the sustainability indicators used and that there should be appropriate traceability between sustainability indicators and those of adverse events (and their thresholds, if established) and those whose performance is reported in the annual report.

In this regard, **the use of ESG ratings as sustainability indicators** has proven that the ratings issued by some agencies are designed to compare companies within the same sector, while others allow for both intra- and inter-sectoral comparison.

This has affected the way the performance of sustainability indicators is presented in the annual report, given that in the case of intra-sector ratings, the CNMV **does not consider deem appropriate to provide an average rating at portfolio level, but should be broken down by economic/industry sectors/activities**. Therefore, it is important for entities to make sure to show ESG ratings in the best way possible when chosen as sustainability indicators, in order to provide meaningful and consistent information to investors.

Moreover, it is considered appropriate for the information on ESG ratings to also be broken down in the corresponding environmental, social and governance pillars.

Analysis of the consistency of portfolios with information included in the prospectus and the website

The review did not identify any relevant inconsistencies between the actual portfolio and the information in the prospectus and on the website of the funds analysed, which leads to the conclusion that the part of the portfolio promoting ESG features or making sustainable investments complies with the criteria and "sustainability indicators" (mostly ESG ratings) provided in the prospectus and website.

Upcoming supervisory actions regarding sustainability

One of the CNMV's lines of strategy is facilitating the role of the stock market in the transition to a more sustainable economy. To such effects, the CNMV will participate in the design and execution of ESMA's Common Supervisory Action regarding sustainability in UCITS and AIF, as reflected in the 2023 Activities Plan.

Specifically, how managers comply with the SFDR and its delegated regulation will be researched, as well as with the amendments to UCITS and AIFMD Level 2 in relation to the integration of sustainability risks. Also, ESMA's Supervisory briefing on sustainability of May 2022 shall be taken into account. The CSA methodology is expected to be approved by ESMA in the first half of 2023 and fieldwork is expected to be carried out between the third quarter of 2023 to the third quarter of 2024. ESMA's approval of the final report is expected by the end of next year.

Therefore, with this participation in the CSA by all of Europe, the CNMV will continue to carry out supervisory actions in relation to the implementation of sustainability regulations, which will be complemented by the corresponding specific domestic analyses. Such works will take into account the guidelines transmitted in this communication.