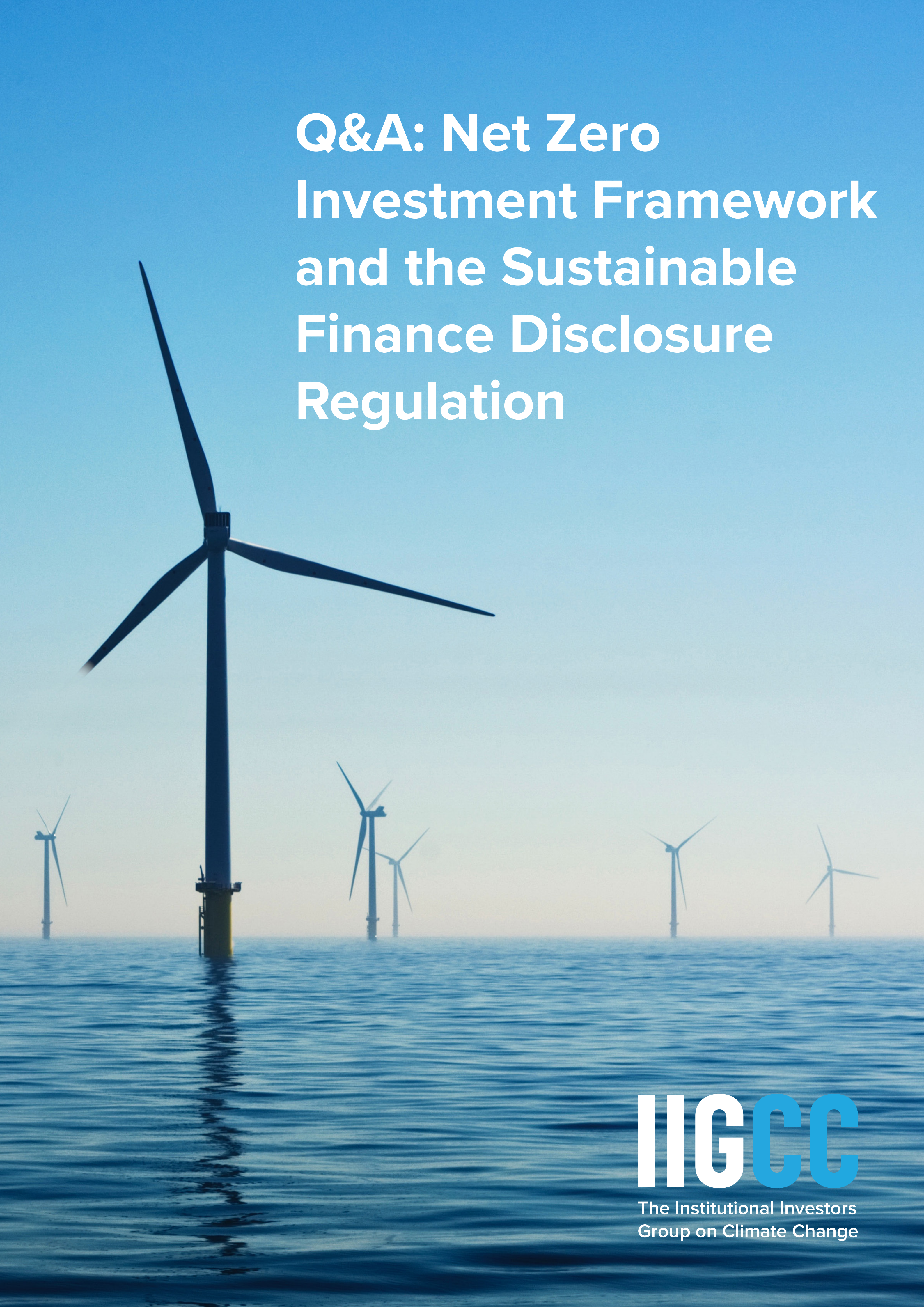
Q&A: Net Zero Investment Framework and the Sustainable Finance Disclosure Regulation



The Institutional Investors Group on Climate Change

Q&A: Net Zero Investment Framework and the Sustainable Finance Disclosure Regulation

Purpose of the document

This Q&A is intended to provide clarity on key issues relating to the implementation of the EU's Sustainable Finance Disclosure Regulation (SFDR). It also explores the interaction between members' reporting obligations under SFDR and their broader net zero commitments, including through the use of the Net Zero Investment Framework (the NZIF).

Contents

Interaction between the NZIF and SFDR

Q1. How does the NZIF interact with SFDR?

The NZIF is the product of an industry-led initiative that sets out guidance and recommendations for how investors can set and implement net zero strategies. A net zero investment strategy under the NZIF focuses on the achievement of two alignment objectives:

- Decarbonising investment portfolios in a way that is consistent with achieving global net zero greenhouse gas (GHG) emissions by 2050
- Increasing investment in the range of 'climate solutions' needed to meet that goal.

The NZIF does not create a separate reporting template or standard. Instead, investors are expected to implement disclosures in line with regulatory requirements and specific best practice relevant to their jurisdiction.

SFDR, in contrast, is a mandatory EU disclosure regulation which seeks to increase the level of transparency around how investors approach sustainability, both as an organisation and for the products they make available. To achieve this, SFDR requires:

- asset managers (including investment firms providing portfolio management, alternative investment fund managers and UCITS fund managers); and
- asset owners (including institutions for occupational retirement provision (IORPs) and pension product manufacturers)

to disclose how they integrate sustainability risks into their investment decision-making, assess the adverse impacts of their investment decisions on the environment and society, and report on the sustainability credentials and performance of their funds.

Investors implementing the NZIF across funds in scope of SFDR can incorporate recommended actions and disclosures under the NZIF as part of their SFDR reporting. However, the implementation of the NZIF alone will be insufficient in ensuring compliance with SFDR, as the coverage and focus of disclosures to be made under SFDR is much broader than the NZIF.

Q2. What are the key concepts established by SFDR, and how do they relate to the NZIF?

Concept: Sustainability risk

What does it mean?

Under SFDR, sustainability risks are defined as environmental, social and governance (ESG) events or conditions that, if they occur, could cause an actual or potential negative material impact on the value of investments.

A core focus of SFDR is to encourage the integration of sustainability-related risks across a broad range of funds (not just those with explicit sustainability characteristics and objectives). Funds that do not consider sustainability risks to be relevant need to explain why this is the case.

How does it relate to the NZIF?

The recommendations set out in the NZIF are designed to complement traditional approaches to risk/return expectations and investment decisions, but with a focus on aligning portfolios with net zero. Sustainability risks are defined broadly under SFDR (covering the full ESG spectrum), whereas the NZIF primarily focuses on achieving positive climate related impact consistent with the goal of achieving net zero emissions by 2050, alongside managing risk and return more broadly.

Concept: Sustainability factors

What does it mean?

Defined in SFDR as environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

Investors are required to measure, on a comply or explain basis (mandatory for firms with over 500 employees), the principal adverse impacts of their investment decisions on sustainability factors. This assessment is undertaken with reference to detailed, backward-looking principal adverse impact indicators (PAIIs) across a range of sustainability themes. In relation to climate change, this includes Scope 1, Scope 2 and Scope 3 emissions.

How does it relate to the NZIF?

SFDR requires disclosure against backward-looking PAIIs to provide transparency on the actual and potential negative effects of a fund's investments on the environment and society. While the NZIF does expect measurement of current Scope 1, 2, and 3 GHG emissions data at portfolio and asset level, it also incorporates a forward-looking perspective for these and additional climate-related metrics to enable investors to assess the alignment or alignment potential of investments with the specific goal of achieving net zero emissions by 2050 or sooner.

Concept: Sustainable investments

What does it mean?

Sustainable investments are defined under SFDR as investments in activities contributing to environmental and social objectives, provided these investments do not significantly harm any environmental or social objective, and that investee companies adhere to good governance practices (e.g. robust management structures, employee relations, remuneration and tax compliance).

Investments that align with the EU Taxonomy form a subset of sustainable investments under SFDR. Investors must disclose how and to what extent the activities undertaken by these investments are Taxonomy-aligned.

SFDR requires the sustainability of activities to be measured using sustainability indicators, but provides relative flexibility for investors to determine what these indicators are. In contrast, sustainable investments that align with the Taxonomy are subject to specific criteria for assessing compliance:

- substantial contribution to an environmental objective(s), in line with technical screening criteria (TSC)
- confirmation that the investments do not cause significant harm to the remaining environmental objectives, with reference to TSC
- compliance with minimum social safeguards (e.g. OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).

How does it relate to the NZIF?

The NZIF assesses investments specifically in terms of their consistency with, and relative contribution to, achieving net zero emissions by 2050 or sooner. Investments are broadly assessed within two categories:

1. Climate solutions where the NZIF uses the EU Taxonomy as the primary means to assess whether an investment, asset or activity should be considered a 'climate solution'
2. All other investments, which are assessed on their relative current and forward-looking alignment to a net zero pathway.

IIGCC considers that an investment could be considered 'sustainable' for the purposes of SFDR if it qualifies as a climate solution or if it can be categorised as 'achieving net zero' or 'aligned' using the NZIF assessment indicators (see sections 7.1, 7.2 and 7.3 of the NZIF implementation guide for detail on the assessment indicators). 'Sustainable' investments must also meet the tests required under SFDR (e.g. do no significant harm and adherence to good governance practices, as well as the Taxonomy's criteria for assessing sustainable investments for Taxonomy-aligned investments).

SFDR does not prescribe the sustainability indicators to be used to assess whether an activity is sustainable (unless the activity is a Taxonomy-aligned sustainable investment). On that basis, the current and forward-looking criteria used to measure alignment under the NZIF could be treated as relevant sustainability indicators.

Concept: Do no significant harm (DNSH)

What does it mean?

There are two relevant DNSH concepts to consider under SFDR – the broad definition established by SFDR itself, and as it applies to a subset of Taxonomy-aligned investments.

The concepts are not fully aligned – the broader SFDR definition of DNSH covers environmental and social objectives, whereas the Taxonomy provision only covers harm to the Taxonomy's environmental objectives.

In addition, DNSH assessments under SFDR are made at the investment level (e.g. assessing a company against PAIIs), whereas the Taxonomy DNSH criteria assesses harm to environmental objectives at the activity level against TSC.

DNSH assessments under SFDR are less prescriptive, and must include an explanation of how PAIIs are considered, and whether an investment complies with the Taxonomy's social safeguards. However, SFDR does not set thresholds for significant harm in the context of the PAIIs (which are always considered to lead to adverse impacts). In contrast, DNSH assessments under the Taxonomy are explicitly based on breaches of the thresholds established by the TSC for in-scope activities.

Assessments of whether the investee company adheres to good governance practices and minimum social safeguards are undertaken at the investment level. There is a lack of clarity on precisely how to measure whether a sustainable investment is aligned with social safeguards. Some investors are opting to base this assessment on whether an investee confirms its compliance with the relevant standards in its public disclosures. Others are taking a more stringent approach, including ongoing monitoring for potential breaches.

In order for a Taxonomy-aligned investment to be considered 'sustainable', it must meet both the broader DNSH criteria under SFDR and the Taxonomy DNSH test.

How does it relate to the NZIF?

There is no direct equivalent of the DNSH concept in the NZIF. Where investors are implementing the NZIF for funds in scope of SFDR, they will need to ensure that their sustainable investments are able to meet the DNSH tests established by SFDR (no harm to environmental and social objectives, and adherence to good governance practices).

Funds implementing the NZIF to scale investments in climate solutions will need to demonstrate how these investments do not harm the other environmental objectives established under the Taxonomy (with reference to the relevant TSC thresholds). These investments will also need to meet the broader DNSH criteria established by SFDR above.

Concept: Binding elements of investment strategies

What does it mean?

SFDR requires disclosures on the binding elements of investment strategies for Article 8 and Article 9 funds. Binding elements of an investment strategy are those criteria used to select underlying assets which an investor may not disapply or override at their discretion. These can include positive selection criteria (e.g. 'best-in-class') or negative exclusion/screening criteria.

How does it relate to the NZIF?

As part of their portfolio construction activities, investors using the NZIF are recommended to apply screening criteria and positive / negative weightings, amongst other criteria, to support alignment and investment in climate solutions.

The NZIF does not contain any 'binding' criteria, and operates on an 'implement or explain' basis. However, an investor could elect to use the recommended actions for portfolio construction under the NZIF as the basis for determining 'binding elements' for their investment strategy, which would then be subject to disclosure requirements under SFDR. It should be noted that making these criteria binding on the investment strategy may trigger an Article 8 or Article 9 classification for the fund (see Q4 for more information).

Disclosure requirements under SFDR and interaction with net zero commitments

Q3. What NZIF-related disclosures can I make as part of my reporting obligations under SFDR?

The table below provides some examples of how members using the NZIF to align their portfolios with net zero can report this information in line with SFDR. The table is not an exhaustive list of disclosure requirements under SFDR – it is intended to illustrate where disclosures relevant to the application of the NZIF can be made. It should also be noted that some of the more detailed disclosure requirements relate to the Level 2 SFDR Regulatory Technical Standards (RTS), which were adopted by the Commission in April 2022, and which will apply from 1 January 2023.

SFDR disclosure requirement: **Sustainability risk policy**

What is required?

Investors must formulate a policy on the integration of sustainability risks in its investment decision-making process.

At what level do I need to make this disclosure?

Entity-level (website).

What NZIF-related disclosures can I make?

[See recommended disclosures under Section 9 of the NZIF implementation guide, unless alternative sections are specified]

(Governance): The board/CEO level commitment to the goal of achieving net zero portfolio emissions by 2050 or sooner, as relevant for asset owners or asset managers, and responsibility for implementation of the commitment and strategy.

(Governance): How climate objectives have been incorporated into mandates and objectives for asset managers, portfolio managers, and other personnel as relevant.

(Governance): Undertake risk assessment and management, including scenario analysis.

SFDR disclosure requirement: Due diligence policy

What is required?

Due diligence policy assessing principal adverse impacts of investment decisions on sustainability factors (comply or explain for investors with fewer than 500 employees; otherwise mandatory). At entity-level, the statement covers:

- summary
- description of principal adverse impacts (including actions taken to address principal adverse impacts, and actions planned and targets set for next reference period)
- description of policies to identify/prioritise principal adverse impacts
- engagement policies
- references to international standards (including degree of alignment with the objectives of the Paris Agreement, where relevant)
    - any forward-looking climate scenarios used, and, if so, the name and provider of that scenario and when it was designed
- historical comparisons.

At what level do I need to make this disclosure?

If implemented, entity-level (website) and fund-level (pre-contractual disclosures and periodic reporting).

What NZIF-related disclosures can I make?

[See recommended disclosures under Section 9 of the NZIF implementation guide, unless alternative sections are specified]

(Management): Engagement, stewardship and direct management actions undertaken in line with recommendations in Section 7 of the NZIF implementation guide (Asset Class Alignment), performance in relation to the engagement threshold, and key outcomes achieved.

(Management): Voting policy and voting record, including an explanation of any deviations from the policy.

(Management): Policy in relation to exclusions or phase out of fossil fuel investments.

(Management): Information on direct and collective policy actions undertaken across the key areas for advocacy mentioned.

(Governance): Public commitments (e.g. Paris Aligned Asset Owner or Net Zero Asset Manager commitments).

(Section 6, Strategic Asset Allocation): Forward-looking metrics that capture the transition potential of an asset, including exposure to fossil fuel reserves (a mandatory principal adverse impact indicator under SFDR).

(Metrics and Targets): The science-based scenario(s) or pathway(s) used to guide target setting and assess the alignment of companies, including the name of the relevant model(s), alignment with a 1.5c pathway, and critical assumptions used.

SFDR disclosure requirement: **Assessment of impact of sustainability**

What is required?

Assess the likely impacts of sustainability risks on the returns of the fund (comply or explain basis).

At what level do I need to make this disclosure?

If implemented, fund-level (pre-contractual disclosures).

What NZIF-related disclosures can I make?

[See recommended disclosures under Section 9 of the NZIF implementation guide, unless alternative sections are specified]

(Section 6, Strategic Asset Allocation): Incorporation of scenario analysis into risk-return expectations.

SFDR disclosure requirement: Environmental characteristics (Article 8) or pursuit of sustainable objectives (Article 9)

What is required?

Where a fund promotes environmental characteristics (Article 8)/pursues sustainable investment objectives (Article 9), additional disclosures must be made across funds' pre-contractual disclosures, website disclosures and periodic reporting.

If the fund pursues sustainable investments that align with the EU Taxonomy, additional disclosures will need to be made. These disclosures take the form of two graphical representations of the minimum percentage of investments that align with the Taxonomy (one including sovereign exposures, the other excluding these exposures). The calculation should be based on a standardised metric (investee turnover by default, unless capex/opex are more representative of the investment), with the numerator consisting of the market value of investments in Taxonomy-aligned activities, and the denominator consisting of the market value of all investments. In addition, Article 8 products pursuing sustainable investments must disclose the reasons for investing in any activities which are not Taxonomy-aligned.

Pre-contractual disclosures

Environmental characteristics promoted/objectives pursued – description of environmental characteristics promoted/objectives pursued, list of sustainability indicators used to measure these characteristics.

Investment strategy – description of investment strategy used to attain environmental characteristics/objectives, binding elements of strategy and how strategy is implemented on a continuous basis.

Asset allocation – narrative explanation of product's investments; explanation of how sustainable investments contribute to sustainable investment objectives and DNSH to environmental objectives (with reference to PAIIs and social safeguards), minimum proportions of sustainable investments held (including those aligned with the Taxonomy) and purpose of remaining investments.

Website disclosures

Monitoring of environmental characteristics/objectives – description of how the environmental characteristics/objectives and sustainability indicators are monitored through the product lifecycle.

Methodologies – description of the methodologies used to measure the attainment of the environmental characteristics/objectives, using sustainability indicators.

Engagement policies – description of the engagement policies implemented where engagement is part of the investment strategy, including any management procedures applicable to sustainability-related controversies in investee companies.

Periodic reporting

Extent to which environmental characteristics/objectives were met – description of the extent to which the environmental characteristics/objectives pursued by the product were attained during the reference period, including the performance of the sustainability indicators.

Actions taken to attain environmental characteristics/objectives – actions taken within the reference period to attain the environmental characteristics/objectives pursued by the product, including shareholder engagement and any other engagement.

At what level do I need to make this disclosure?

Fund-level (pre-contractual disclosures, website, periodic reporting).

What NZIF-related disclosures can I make?

[See recommended disclosures under Section 9 of the NZIF implementation guide, unless alternative sections are specified]

Pre-contractual disclosures

Environmental characteristics promoted/objectives pursued – (Metrics and Targets): The targets set, including how these targets were calculated and evidence and information that was used to inform the target setting process.

(Section 5, Targets and Objectives): <10-year CO2e emissions reduction target, covering listed equity and corporate fixed income, and real estate.

(Section 5, Targets and Objectives): <10-year goal for allocation to climate solutions representing a percentage of revenues or capex from Assets Under Management (AUM) (based on EU taxonomy mitigation criteria), increasing over time, in line with investment trajectories based on a net zero pathway.

Investment strategy – (Strategy): The key principles and components of the strategy for achieving the commitments to net zero and implementing the NZIF, and how the strategy and targets represent an investor's maximum possible effort to reducing emissions and increasing allocation to climate solutions.

(Management): Portfolio construction approaches implemented to facilitate allocation to products that support net zero aligned investing.

Asset allocation – (Strategic Asset Allocation): Recommended actions from Section 6 of the NZIF implementation guide.

(Section 7, Asset Class Alignment): The NZIF's alignment objectives of emissions reductions in the real economy and investment in climate solutions, alongside relevant indicators used to measure how net zero alignment is attained.

(Metrics and Targets): Methodologies used to assess alignment of assets, and the extent to which these are consistent with the key features of the methodologies recommended in sections 7.1-7.3 (Asset Class Alignment).

Website disclosures

Monitoring of environmental characteristics/objectives – (Metrics and Targets): Performance against targets over time, and any updates or adjustments to targets that are relevant. Referencing alignment criteria set out in sections 7.1-7.3 (Asset Class Alignment).

Methodologies – (Metrics and Targets): Methodologies used to assess alignment of assets, and the extent to which these are consistent with the key features of the methodologies recommended in sections 7.1-7.3 (Asset Class Alignment).

Engagement policies – (Strategy): The key principles and components of a net zero engagement and stewardship strategy, including escalation and milestones.

(Management): Voting policy and voting record, including an explanation of any deviations from the policy; policy in relation to exclusions or phase out of fossil fuel investments.

Periodic reporting

Extent to which environmental characteristics/objectives were met – (Metrics and Targets): Performance against targets over time, and any updates or adjustments to targets that are relevant, referencing alignment criteria set out in sections 7.1-7.3 (Asset Class Alignment).

Actions taken to attain environmental characteristics/objectives – (Management):

Portfolio construction approaches implemented (e.g. screening, positive and negative weighting, tilted benchmarks) and/or products developed to facilitate allocation to products that support net zero aligned investing.

Engagement, stewardship and direct management actions undertaken in line with recommendations in sections 7.1-7.3 (Asset Class Alignment), performance in relation to the engagement threshold, and key outcomes achieved.

Voting policy and voting record, including an explanation of any deviations from the policy.

Where divestment or exclusion has been used, the rationale, and the extent to which this has been the means to achieve targets.

Information on direct and collective policy actions undertaken across the key areas for advocacy mentioned in Section 8 of the NZIF implementation guide, including outcomes achieved.

Information on market engagement actions undertaken, including outcomes achieved.

Fund classifications under SFDR

Q4. How would I classify a fund pursuing net zero emissions by 2050 or sooner under SFDR?

SFDR establishes three categories for classifying funds, based on the fund's level of sustainability integration. The below table sets out the three categories, and how these relate to alignment objectives under the NZIF.

SFDR is first and foremost a disclosure framework – not a labelling regime. However, it has been treated as a de facto labelling system by the market, with Article 9 funds interpreted as a 'gold standard' for sustainability ambition. SFDR does not therefore prescribe how investors should treat "net zero" products, although firms in scope of the requirements will need to determine the appropriate classification for these funds. The category into which a fund integrating net zero commitments will fall will likely depend on the extent to which it promotes/commits to this commitment in relevant disclosures and marketing materials. While these funds therefore have the potential to be classified as Article 8 or Article 9, these classifications will not necessarily be triggered automatically.

Fund classification under SFDR

Article 6 funds (baseline to be met by all funds)

Funds which do not market themselves as sustainable, but which either integrate ESG considerations into the investment decision-making process, or explain why sustainability risks are not relevant to the fund.

Article 8 funds ('light green')

Funds promoting environmental or social characteristics, and which can make sustainable investments (including Taxonomy-aligned investments), but do not have sustainable investing as a core objective or attribute of the product.

The Commission defines 'promotion' of environmental and social characteristics very broadly, with no defined materiality thresholds for promotion of these characteristics set out in the rules. This means that even restrictions on investments that are required by law in some jurisdictions (e.g. cluster munitions), and which are therefore not actively promoted by the investor, could still be enough to qualify a fund as Article 8.

Article 8 products can invest in a wide range of underlying assets, not all of which need to contribute to the environmental or social characteristics promoted by the product (e.g. hedging instruments, unscreened investments for diversification purposes, or investments for which data is lacking).

The market sometimes refers to Article 8 funds that pursue some sustainable investments that align with the Taxonomy and/or consider and mitigate principal adverse impacts alongside the promotion of environmental characteristics, as 'Article 8+'.

Unlike Article 9 products, and particularly Article 9 products pursuing a specific objective of carbon emissions reductions, there are currently no specific requirements for determining whether a product can be classified as Article 8. For example, there are no required minimum thresholds or prescribed targes, investment strategies or methodologies. However, the Commission intends to propose minimum sustainability requirements for Article 8 funds under SFDR, to guarantee minimum sustainability performance. This could indicate that Article 8 funds will in future need to hold a certain percentage of investments promoting environmental and/or social characteristics, which could potentially trigger re-classification of funds which are currently marketed as Article 8.

In addition, national regulatory authorities have also introduced their own guidance and polices on how firms should approach the construction of Article 8 products, including prescribed thresholds for sustainable investments.

Article 9 funds ('dark green')

Funds which have an explicit sustainable investment objective (e.g. a reduction in carbon emissions).

These funds must be invested almost entirely in sustainable investments per the SFDR definition, with remaining 'neutral' investments permitted for specific purposes such as liquidity or hedging (which themselves must meet minimum environmental/social safeguards). A lack of guidance around how these 'neutral' investments should be treated could mean that they will also need to be assessed against do no significant harm tests. The final RTS also notes that Article 9 products can 'to some extent' make other investments where they are required to do so under 'sector specific rules'. However, no further guidance as to what this means in practice is provided. Article 9 products need to disclose the amount and purpose of any other non-sustainable investments, so that investors can verify that the underlying investments do not prevent the product from attaining its sustainable investment objective.

ESMA's July 2021 Q&A notes that:

By virtue of Article 9(3) of [SFDR], the objective of 'a reduction in carbon emissions' is a specific category of 'sustainable investment' and, consequently, must comply with [SFDR provisions on sustainable investments].

The Q&A guidance seems to suggest that a product with an objective of a reduction in carbon emissions is a specific type of Article 9 product, rather than an independent category in its own right. However, the associated expectation that Article 9 products must track a PAB or CTB where available would restrict the type of carbon reduction objectives investors can feasibly pursue (see Q5 for more information).

Alignment with the NZIF

Article 6 funds (baseline to be met by all funds)

Funds seeking to align with net zero and which apply the NZIF criteria would **not likely to be classified** Article 6. However, where such criteria are not actively promoted, or where they do not constitute a specific objective of the fund, there could be scope to categorise the fund as Article 6. For example, funds may seek to apply certain NZIF criteria (e.g. actions to manage climate-related financial risk) as part of a process to integrate ESG factors into risk management and investment decision-making. In addition, where NZIF criteria and targets are non-binding elements of a fund investment strategy, they may not trigger an Article 8 or 9 categorisation.

Article 8 funds ('light green')

Funds applying the NZIF **may be classified** as Article 8. Article 8 funds can promote environmental characteristics, which could include reductions in emissions and increased investments in climate solutions. However, the classification of products incorporating these elements as Article 8 will likely depend on the extent to which net zero alignment (e.g. through emissions reductions and/or investment in climate solutions) is actively 'promoted' as a core feature of the product within the fund disclosures and marketing materials. For example, a fund which promoted reductions in emissions and investment in climate solutions as part of its investment strategy, and applied NZIF criteria as 'binding' elements of the fund's investment strategy, would likely fall into scope of Article 8.

While sustainable investment is not the focus of Article 8 funds, it is still possible to pursue sustainable investments under the classification, as noted above. Article 8 funds can invest in assets that are Paris-aligned/aligning, as determined by the NZIF criteria, as well as investment in climate solutions.

Classification as an Article 8 fund would also provide more flexibility to hold assets that may not be presently assessed as 'sustainable' – e.g. aligning or non-aligned assets.

Article 9 funds ('dark green')

Emissions reductions

Funds applying the NZIF, **may be classified** as Article 9, where emissions reductions are specified in fund disclosures and marketing materials as a sustainable investment objective of the fund. In this case, the fund would likely be considered a specific category of Article 9 product under SFDR (per Article 9.3).

Article 9 funds are required to be almost entirely comprised of 'sustainable investments' per the SFDR definition – e.g. investments that are contributing to environmental objectives (including the subset of Taxonomy-aligned environmental objectives), and which do not significantly harm any other environmental objectives. Investors classifying a net zero fund as Article 9 would therefore need to consider whether the bulk of investments in the fund can verifiably be measured as sustainable.

As noted previously, an investee assessed as 'achieving net zero' or 'aligned' against the NZIF criteria would likely qualify as a 'sustainable investment'. Including within an Article 9 fund an investee which has made commitments to net zero without setting targets, that is non-aligned but subject to engagement, or aligning, could be perceived as contradicting the spirit, if not the letter, of an Article 9 classification. This is because these investees do not yet have a credible, measurable decarbonisation strategy in place to align with the goals of the Paris Agreement. Investors should consider these nuances in the context of an Article 9 classification for net zero products, and how they would justify the inclusion of such assets in a portfolio.

In addition, an Article 9 fund which has an explicit objective of carbon emissions reductions (e.g. an NZIF-aligned fund) would need to track a PAB or CTB where they exist (see Q5 for more information).

Climate solutions

Funds with a specific objective of investing in climate solutions per the NZIF **are likely to be classified** as Article 9, on the basis that they pursue investments that are aligned with the Taxonomy's climate mitigation and adaptation criteria. However, the investable universe that is currently aligned with the Taxonomy is very small – recent assessments of the Taxonomy-alignment of the EURO STOXX 50 index has been estimated at 2%. Climate solutions that are not currently captured by the Taxonomy could also be included in such products, provided they make a measurable contribution to climate objectives and meet the broader DNSH test under SFDR.

Q5. Do I have to use a Paris-Aligned Benchmark (PAB) or a Climate Transition Benchmark (CTB) to classify my fund as sustainable?

In its July 2021 Q&A, the Commission confirmed that Article 9 funds with the objective of carbon emission reductions must track a PAB or CTB if they exist. In practice, this could mean using the benchmark as a reference for the fund's portfolio composition, or as a target or comparator for investment performance, rather than tracking it, leaving scope for funds with these objectives to be actively managed. Where no benchmark is available, an explanation of how the fund attains the objective of reducing carbon emissions in line with the Paris Agreement must be provided, and the extent to which the fund complies with the methodological requirements set out in the EU Benchmarks Regulation.

The Paris Aligned Investment Initiative wants to incentivise the allocation of capital to assets whose emissions are declining over time and to climate solutions. However, it considers this may be more effectively achieved by maintaining investment in assets, where there is an opportunity to maximise real world impacts by driving reductions in companies that need to transition through stewardship and engagement, rather than initially excluding issuers from a benchmark to achieve an immediate, ambitious emissions reduction target. Investors applying the NZIF would, therefore, not necessarily need to meet the PAB requirements for benchmarks used as part of alignment strategies. CTBs may be a better option for investors using the NZIF. This is because they incorporate a less aggressive initial emissions intensity reduction, which takes account of the transition potential of assets in the short term while also meeting overall emissions reduction requirement through index constituent's weighting towards best-performing assets, according to alignment criteria. However it would also be possible to fulfil the recommendations of the NZIF without tracking either a CTB or PAB. In addition, requirements to track or reference a PAB/CTB may create challenges for thematic funds seeking to pursue investments in climate solutions, rather than focusing on the decarbonisation of their holdings. Given the concerns around the extent to which PABs and CTBS can accommodate for the range of strategies relevant to net zero alignment, IIGCC will be looking to engage with the Commission on this issue.

Article 8 funds are not required to track a PAB or CTB (although they may choose to do so if they wish). As such, investors could potentially choose to classify a fund that incorporates emissions reductions as an element of the investment strategy alongside other objectives (such as financial return), as an Article 8 fund without triggering the requirement to track a PAB or CTB. These funds could track tilted benchmarks that better support the objectives of allocating capital to support alignment and invest in climate solutions. However, the overall alignment objective would need to be complemented by (and potentially subordinate to) an explicit financial investment objective, meaning it would no longer be a pure net zero-focused product (which would most likely need to be classified as Article 9).

Q6. My organisation has committed to net zero by 2050 across all our assets – what are the implications of this for my fund classifications?

Asset owners

Signatories of the Paris Aligned Investment Initiative's Net Zero Asset Owner Commitment commit to aligning their investments with net zero by 2050 or sooner. Asset owners will need to engage with their managers to ensure that the funds and products they invest in are consistent with achieving this objective, and will therefore likely seek to increase the proportion of their funds classified with Article 8 or Article 9 over time. However, while all assets under management (AUM) are subject to the net zero by 2050 commitment, this entity-level commitment will not trigger an immediate requirement to re-classify the full range of investments in scope of SFDR as Article 8 or Article 9, unless or until such commitments are actively promoted at product-level as well.

Asset managers

While asset owners have the jurisdiction to set a net zero goal and targets across their AUM, the scope for asset managers to align investments with net zero will depend on the mandates agreed with clients and clients' and asset managers' regulatory environments. Asset managers will therefore need to engage with clients over time to secure mandates and adjust or design products to enable an increasing proportion of funds in scope of SFDR to be classified as Article 8 or Article 9 over time, and managed in line with net zero. It should also be noted that asset managers pursuing entity-level commitments to net zero (which may only cover a proportion of assets under management initially) would still be able to offer Article 6 products as part of their fund range sitting outside the scope of funds to be managed in line with net zero goals.

In the context of SFDR, asset manager signatories to the Net Zero Asset Managers Commitment should therefore seek to:

- Set interim targets for the proportion of assets to be managed in line with a net zero investment strategy, and which are Article 8 or 9 compliant
- Review interim targets at least every five years, with a view to ratcheting up the proportion of AUM covered until 100% of assets are included (and therefore managed in line with Article 8 or 9 requirements).

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