SKY Harbor Global Funds

Responsible Investing for a Sustainable Future

Our Purpose

To grow our clients' assets by investing in high yield sustainable corporations that have committed to benefit all their stakeholders and society as a whole.

How We Do It

By compounding current income over time, protecting principal and giving our clients the returns they expect and the information they need.

Why We Do It

We believe that Sustainable Corporations will prosper over the long term, attract lower cost capital, and generate superior returns to their investors.

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High Yield Issuers: For whom the bell tolls; it tolls for thee

This month's edition of *Sustainability SKYSights* invokes a phrase inspired by a famous sermon by John Donne in 1624, (and reminiscent of the title of a Hemingway novel). While the bells that John Donne penned nearly four hundred years ago rang for the victims of an epidemic of spotted fever, for the purpose of this column the bell refers to corporate sustainability and stakeholder primacy.

The bell should ring loud and clear for corporate governing boards and their executive managements, especially for companies that issue high yield debt. We assert that no asset class should be more embracing of the current trend toward corporate sustainability and stakeholder primacy than the corporate high yield asset class. The tolling bell is intended to convey the notion that integrating corporate sustainability into corporate culture is not another company's or another industry sector's problem. Rather, it is a reminder that corporate sustainability has long passed the point of being a part of the Directors' duty of oversight. Directors of companies established under the laws of the state of Delaware should give careful consideration to whether the commitment to corporate sustainability has now reached a point of implicating their *Caremark*[1] duty of oversight. Companies established in other jurisdictions should consider following suit.

The foundation of our belief may be palpably obvious, but we state them here for completeness: the typical corporate high yield issuer by definition is highly leveraged, rated below investment grade, deemed by professional rating agencies to possess higher probabilities of default, has its bonds disparagingly referred to as "junk," and limited by a universe of investors who are prohibited by statute, bylaws or risk aversion from investing in high yield debt. We could go on, but the point should be clear enough: with worldwide focus on sustainability, investors large and small are looking to direct or re-direct capital to sustainable investment portfolios. High yield debt issuers and their governing boards would be well advised to embrace corporate sustainability in form and substance to ensure their place in line when market conditions tighten and capital becomes more selective.

As the well-worn phrase, "past performance is not a guarantee of future results," suggests: there is no guarantee that the recent era of very low interest rates and a receptive capital market — which has seen record amounts of high yield corporate debt issuance — will last forever. Simply put, companies whose businesses depend on issuing high yield debt can neither take for granted their access to capital nor fail to address the priority preferences of their investors. When — not if — the market turns, those high yield issuers that have aligned themselves on a pathway to sustainability, we submit, should be much better positioned to benefit from the financial flexibility that comes with a business model that investors and capital providers alike view more favorably and worthy of continued support.

As evidenced by recent developments discussed in this month's column, it is unlikely the bell that rings for action on climate change, social justice, employee welfare and the plethora of factors that promote a sustainable corporation will soften its decibels any time soon — especially under the Biden/Harris agenda. Given the convergence of public policy, private initiatives, and corporate activism[2] relating to

[1] Reference to Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996) and its implications for Board governance for corporations established under the laws of the state of Delaware was further explained in our *Sustainability Outlook 2021*.
[2] As we go to press, major corporations in the US are publicly voicing strong objections to the rise of voting restriction legislation in a number of state legislatures throughout the country while also protesting the recent restrictions voted into law in the state of Georgia. These corporations have indicated a willingness to express further action by restricting political donations to the campaign coffers of politicians who support such voting right restrictions. As a reminder, these actions are entirely consistent with SDG 16, which is about peace, justice and strong institutions.

sustainability generally and stakeholder primacy in particular, responsible corporate governance may soon be judged against the yardstick of a global ESG reporting framework with associated metrics and targets, which in turn will be closely scrutinized by investors.

Accordingly, we continue to urge forward-leaning corporate Boards looking for a meaningful response to these developments to consider joining SKY Harbor and thousands of other like-minded companies and investors worldwide in subscribing to the Principles for Responsible Investment ("PRI")[3] and the UN Global Compact.[4] Based on our review of a number of public corporate social responsibility reports or similar narratives while performing our ESG integrated investment analysis, we believe many companies may have already embraced the principles promulgated by PRI and/or the Global Compact without being consciously aware of how their corporate values in fact largely align with these initiatives. For many of these companies, publicly proclaiming their corporate values by supporting PRI and the Global Compact should not be a bridge too far to cross. As the trend toward corporate sustainability and stakeholder primacy accelerates it should not come as a surprise if public support of the PRI and the UN Global Compact become de facto minimum credentials in evaluating a company's corporate sustainability *bona fides* in the near future.

LuxFLAG ESG Label awarded to SKY Harbor Global Funds

This edition of *SKYSights* is pleased to announce that the Board of Directors of LuxFLAG has resolved to award all of SKY Harbor Global Funds' sub-funds with the LuxFLAG ESG Label for a period starting on April 1, 2021 and ending on March 31, 2022 (at which time we shall re-apply). LuxFLAG is an independent and international non-profit association created in Luxembourg in July 2006 by seven private and public founding partners including the Luxembourg Government, the European Investment Bank, the Association of the Luxembourg Fund Industry, and others to promote the raising of capital for sustainable investments and to ensure investors that the investment vehicle awarded the ESG Label invests in the responsible investment sector.

Climate Action: the social cost of GHG emissions

The first quarter of 2021 saw a revitalized global effort on climate action, which if not sparked then certainly encouraged by the inauguration of President Biden and Vice President Harris on January 20, 2021. As pledged during the presidential campaign, Biden promised immediate efforts to address climate action and social justice if elected. True to his word, President Biden immediately issued a series of executive orders[5] ("EOs") specifically addressing climate, social justice and other matters that the new administration views as high priority (e.g., COVID-19 vaccinations, income inequality, health care and other priorities).

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[3] See www.unpri.org

[4] See www.unglobalcompact.org

[5] An executive order is a signed directive by the President of the United States that manages operations of federal government. Executive orders, while not legislation and require no approval from Congress, nevertheless, have the force of law, much like regulations issued by federal agencies. Only a sitting US President may overturn existing executive orders by issuing another executive order to that effect, which is exactly what President Biden did on the first day of his administration by Executive Order 13992 of January 20, 2021, Revocation of Certain Executive Orders Concerning Federal Regulation, targeted at a series of executive orders by the prior administration. See "What is an Executive Order?", American Bar Association, January 25, 2021, available at: What Is an Executive Order? (americanbar.org), https://www.americanbar.org/groups/public_education/publications/teaching-legal-docs/what-is-an-executive-order-/.

As we foreshadowed in our *2021 Sustainability Outlook*, despite press reports that President Biden was unlikely to pursue a carbon tax, the prospect for a carbon tax we believed was, nevertheless, a development that should not be ruled out. Developments in the past few weeks appear to support the notion that the new administration may yet want or need to re-visit this topic as partly evidenced by its efforts to resuscitate Obama-era calculations on the social cost of greenhouse gases ("GHG") coupled with indications from the energy sector of a more receptive posture toward the idea.

Buried in one of President Biden's executive orders issued on Day 1 of this presidency is Section 5 of EO 13990, which, among other things re-established the Interagency Working Group on the Social Cost of Greenhouse Gases (the "Working Group"). Former President Trump had disbanded the Working Group within months of taking office in 2017. The re-born Working Group has been charged with publishing interim estimates on the social costs of carbon ("SCC"), social cost of nitrous oxide ("SCN") and the social cost of methane ("SCM"). The purpose of the effort is to "capture the full costs of greenhouse gas emissions as accurately as possible, including by taking global damages into account." These are intended as "estimates of the monetized damages associated with incremental increases in greenhouse gas emissions." As set forth in EO 13990, the Biden administration believes that "an accurate social cost is essential for agencies to accurately determine the social benefits of reducing greenhouse gas emissions when conducting cost-benefit analyses of regulatory and other actions." EO 13990 directs the Working Group to publish an interim SCC, SCN and SCM within 30 days of the EO and a final SCC, SCN and SCM by no later than January 2022, and to provide recommendations to the President no later than September 1, 2021 with respect to actions and budgeting.

The Working Group issued its interim report on February 26, 2021, entitled "Technical Support Document: Social Cost of Carbon, Methane, and Nitrous Oxide, Interim Estimates under Executive Order 13990" (the "TSD").[6] The TSD built on work that was done in 2013 and 2016 before the Working Group was disbanded in 2017. As explained in the TSD, this is only an interim report and is subject to further refinement when the Working Group expects to issue its final report in January 2022. The 48-page TSD contains detailed explanations of the background, methodologies and uncertainties embedded in the TSD's GHG cost estimates. The integrated assessment models ("IAM") employed for this exercise offer probabilistic estimates on the social cost of carbon, methane and nitrous oxide for 2020 and subsequent years in 5-year increments through to 2050. The IAMs discount the projections using 2.5%, 3% and 5%. The peer-reviewed consensus apparently is to use the 3% discount rate although the TSD notes that evidence suggests the discount rate could be substantially lower than 3%, which would result in an even greater social cost figure.

As it is, at the 3% discount level, the TSD estimates the social cost of carbon in 2020 at $51 per metric ton; the social cost of methane at $1,500 per metric ton; and the social cost of nitrous oxide at $18,000 per metric ton. Those who follow climate science should recognize that the reason methane and nitrous oxide are so much higher than carbon dioxide is due to the much longer impact and life spans in the atmosphere those gases have relatively to CO_2. The sensitivity to the discount rate is significant. For example, using a 2.5% discount rate would increase the social cost of carbon dioxide and nitrous oxide by about 50% and about 33% for methane in terms of 2020 projections.

Perhaps because of the arcane nature of the topic, the TSD did not receive much if any publicity by the general media or for that matter, the financial press, but we discuss it here more fully because we

[6] Available at: Technical Support Document: Social Cost of Carbon, Methane, (whitehouse.gov), https://www.whitehouse.gov/wp-content/uploads/2021/02/TechnicalSupportDocument_SocialCostofCarbonMethaneNitrousOxide.pdf

believe the exercise of putting a price on GHG emissions will be a central element in future initiatives by the Biden/Harris administration. Moreover, support for putting a cost on carbon is building among the private sector, including the energy and fossil fuel industry. With sufficient support from traditionally Republican corporate sectors, a climate package that includes a carbon tax or some form of private sector carbon credit mechanism may be the only viable path to crafting bipartisan climate legislation. Obviously, the imposition of a carbon tax would have important implications for many sectors and industries, including among the high yield asset class.

One of the few media outlets that covered the TSD was POLITICO (POLITICO's article was also noted by Axios), which reported the interim social cost of carbon dioxide of $51 per metric ton and noted that the restored cost estimate (which compared to the Trump administration's estimate of $8 per metric ton) was "a step that will make it easier for [Biden's] agencies to approve aggressive actions to confront climate change." POLITICO also reported that the $51 figure was in line with prior estimates in 2010 and 2016 under the Obama administration, which was the first administration to attempt to calculate the social cost of carbon.[7] As we have previously noted in our *2021 Sustainability Outlook*, groups such as the Climate Leadership Council (of which Treasury Secretary Yellin is a founding member) and others have been advocating for a private market mechanism to address GHG emission starting with a price on carbon, which the Climate Leadership Council estimated at $40 per ton in 2017 dollars.

Along these same lines, and to the surprise of some environmentalists, Axios reported on March 25, 2021, that the American Petroleum Institute ("API") came out in favor of putting a price on carbon emissions, which is "a term that typically refers to emissions taxes or permit trading systems." [8] In explaining why this news matters, Axios sustainability reporter Ben Geman writes: "The new posture [of the API] marks a major shift for the powerful [Washington, DC] lobbying group," while noting that the API was a fierce opponent of cap-and-trade proposed legislation a decade ago. According to Axios, a number of the largest oil companies already support carbon pricing, which also has the backing of many economists, including Treasury Secretary Janet Yellin.

UNFCCC: Nationally Determined Contributions

President Biden's re-entry to the Paris Agreement obligates the United States to provide its updated goals to cut GHG emissions, which are referred to as "National Determined Contributions" or NDCs. In that regard, on February 26, 2021 the United Nations Framework Convention on Climate Change ("UNFCCC") published the Initial NDC Synthesis Report, which concluded that "nations must redouble efforts and submit stronger, more ambitious national climate action plans in 2021 if they're to achieve the Paris Agreement goal of limiting global temperature rise by 2^{o} C — ideally 1.5^{o} C — by the end of the century." The Report concludes that "2021 is a make or break year to confront the global climate emergency." To achieve the Paris Agreement target of 1.5^{o} C global emissions must be cut by 45% by 2030 from 2010 levels. The Report is available at: [Nationally determined contributions under the Paris Agreement. Synthesis report by the secretariat (unfccc.int)].

[7] Lorraine Woellert and Zack Colman, *Biden hikes cost of carbon, easing path for new climate rules,* sub-text: *The social cost of carbon could have ripple effects throughout industry,* POLITCO , February 26, 2021 available at: Biden hikes cost of carbon, easing path for new climate rules - POLITICO, https://www.politico.com/news/2021/02/26/biden-carbon-price-climate-change-471787?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosgenerate&stream=top.

[8] Ben Geman, *Top US oil lobbying group officially endorses carbon pricing,* Axios, March 25, 2021 available at: Oil industry's most powerful lobbying group officially endorses carbon pricing - Axios, https://www.axios.com/american-petroleum-institute-carbon-pricing-dcc5cd19-ff8b-46f6-8fcb-55576347b49b.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosgenerate&stream=top.

According to the White House website, the US "will announce an ambitious 2030 emissions target" in its NDCs under the Paris Agreement by the time of a scheduled virtual meeting billed as the "Leaders Summit on Climate." President Biden has invited 40 world leaders, including Chinese President Xi Jinping and Russian leader Vladimir Putin, to the virtual White House climate summit April 22-23, 2021, which will be live streamed for public viewing. The Leaders Summit on Climate is intended to "underscore the urgency — and the economic benefits — of strong climate action" ahead of the UN Climate Change Conference (the "COP 26") scheduled this November in Glasgow.[9]

The SEC signals that ESG matters matter

The Securities and Exchange Commission ("SEC") under former Trump-appointed Chairman Jay Clayton was generally satisfied with the SEC's principles-based approach to matters of ESG disclosure, which is largely governed by the notion of materiality. After Mr. Clayton resigned as Chair in December 2020, President Biden tapped Democratic Commissioner Allison Herren Lee for the position of Acting Chair. President Biden has nominated Gary Gensler for the position as Chair, but as of this posting his nomination has yet to be approved by the US Senate although it is likely to happen soon.

Acting Chair Lee has long been a proponent of greater ESG disclosure and has in prior speeches exhibited a receptive attitude toward investor demands for consistent, comparable and reliable data with respect to ESG. Under Acting Chair Lee, Q1 2021 has seen a cascade of ESG initiatives by the SEC. Presumably, these initiatives will continue once the Senate confirms Gary Gensler as the new Chair.

On February 24, 2021, Acting Chair Lee directed the SEC's Division of Corporate Finance (the Division that sets many of the required disclosure obligations by registrants) to enhance its focus on climate-related disclosure in public company filings.[10] The last time the Commission provided guidance to public companies regarding climate change transparency was in 2010. The Acting Chair directed the SEC Staff to:

- Review the extent to which public companies address the topics identified in the 2010 guidance
- Assess compliance with disclosure obligations under federal securities laws
- Engage with public companies on these issues
- Absorb critical lessons on how the market is currently managing climate-related risks

The aim of the review is to begin updating the 2010 guidance to take into account developments in the last decade. The Guidance that Acting Chair Lee refers to was published in the Federal Register on February 8, 2010. 17 CFR Parts 211, 231 and 241, an interpretive release entitled "Commission Guidance Regarding Disclosure Related to Climate Change."

Shortly after the directive to re-visit the Commission's climate-related disclosures, the SEC's Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations or OCIE) issued its 2021 Exam Priorities on March 3, 2021 that included, among other things, an enhanced focus on climate-related risks, meaning the Division of Examinations can be expected to focus its exams on ESG funds and their investment managers. As many registered investment advisers know, when the Division

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[9] The White House briefing on the Summit is available at: President Biden Invites 40 World Leaders to Leaders Summit on Climate | The White House, https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/26/president-biden-invites-40-world-leaders-to-leaders-summit-on-climate/.

[10] See SEC.gov | Statement on the Review of Climate-Related Disclosure, https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure.

of Examinations believes a registrant has materially violated federal securities laws or the rules and regulations promulgated thereunder it will refer the matter to the Division of Enforcement, which in turn can make referrals to the Department of Justice for criminal prosecution (the SEC itself is limited to civil prosecutions, not criminal). In this regard, on March 4, 2021 the SEC announced the creation of an enforcement task force focused on climate and ESG issues, with 22 members drawn from the SEC's headquarters, regional offices and Enforcement specialized units.

In its release, the SEC explained that, consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct. The task force will also coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations. The initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. Its work will complement the agency's other initiatives in this area, including the recent appointment of Satyam Khanna as Senior Policy Advisor for Climate and ESG. As an integral component of the agency's efforts to address these risks to investors, the task force will work closely with other SEC Divisions and Offices, including the Divisions of Corporation Finance, Investment Management, and Examinations.

The combination of ESG-related initiatives by both the Divisions of Examinations and Enforcement signals not so much forthcoming changes in the climate-related disclosures but rather an effort toward ferreting out misleading disclosures about ESG practices or representations — in a word: greenwashing.

The juxtaposition of what appears to be a receptive review and enhanced focus on climate-related disclosures while at the same time announcing a somewhat zealous effort to ferret out greenwashing may appear to some observers as contradictory impulses — regulation by enforcement rather than guidance. We believe these initiatives simply reflect the tension among the Commissioners themselves. The two Republican Commissioners, Hester Peirce and Elad Roisman, have both made clear in public speeches and appearances a degree of skepticism toward investor demands for more clarity in ESG and climate-related disclosures.[11] Democrat Commissioner Caroline Crenshaw on the other hand tends to side with Acting Chair Lee in recognizing the need for better ESG and climate-related disclosure by registrants. It will be up to incoming Chair Gary Gensler to decide where and how to balance these contradictory impulses.

In the meantime Acting Chair Lee continued to press ahead by requesting public comment on climate change disclosures. In a parallel effort to her directive to the Division of Corporate Finance cited above, on March 15, 2021 Acting Chair Lee issued an invitation for public input from investors, registrants and other market participants on climate change disclosure "in light of demand for climate change information and questions about whether current disclosures adequately inform investors."

The invitation for public input sets forth 15 questions for input beginning with Question number 1: "How can the Commission best regulate, monitor, review, and guide climate change disclosures in order to provide more consistent, comparable, and reliable information for investors while also providing greater

[11] See Public Statement by Commissioners Peirce and Roisman on March 4, 2021 making the point that the meaning of announced "enhanced focus" on climate or ESG-related initiatives is "unclear," and concluding that, "these new climate-related announcements raise more questions than they answer." Available at: SEC.gov | Enhancing Focus on the SEC's Enhanced Climate Change Efforts, https://www.sec.gov/news/public-statement/roisman-peirce-sec-focus-climate-change.

clarity to registrants as to what is expected of them?" The rest of the 14 questions cover more detailed questions concerning enforcement, pros and cons of industry standards, the desirability of "comply or explain," current reporting frameworks such as the TCFD and SASB, private company disclosure requirements, and other related questions. Public comment will be open until June 13, 2021.[12]

Among the 15 questions, Question No. 9 in the request for public input asks, "What are the advantages and disadvantages of developing a single set of global standards applicable to companies around the world, including registrants under the Commission's rules, versus multiple standard setters and standards?" This is an important question for foreign registrants as well as US institutional investment managers offering products in Europe in light of the differing disclosure regimes emerging out of the EU and now the UK and other non-US jurisdictions.

In this regard, international organizations such as IFRS (the international accounting standards board equivalent to FASB), IOSCO (the International Organization of Securities Commissioners, in which the SEC is an active member), and others are currently studying the feasibility of a global sustainability accounting standards board. As a reminder, the SEC does not establish GAAP standards although it mandates GAAP disclosures while relying on a separate and independent standards setting organization for that purpose (i.e., FASB). Similarly, the debate concerning ESG-related disclosures must settle a key gate-keeping question: Should the SEC move ahead with its own version of ESG standards or rely on (and wait until) an independent global or regional standards setting organization emerges?

Some of these issues and others were debated at a live-stream meeting of the SEC's Asset Management Advisory Committee on March 19, 2021 featuring the Committee's ESG subcommittee. One of the speakers representing issuers advocated strongly that any new disclosure regime must in the speaker's opinion be rooted in materiality as defined by the US Supreme Court, noting that materiality is the bedrock of the US disclosure regime. The speaker also recommended that any ESG-related disclosure continue to be principles based and not prescriptive. These remarks harken back to our *2021 Sustainability Outlook* where we wrote that a key challenge to any new ESG-related disclosure regime will be the need to establish consensus on the meaning of "materiality."

If all the above were not enough, on March 22, 2021 the SEC also launched for the first time a page on its website devoted expressly to ESG "to bring together agency actions and the latest information about climate and environmental, social and governance (ESG) investing." According to the press release, the SEC posted the new webpage in response to increased investor demand for this kind of information and will feature it on the home page of SEC.gov. Acting SEC Chair Allison Herren Lee is quoted: "Our all-of-SEC approach looks at how climate and ESG intersect with our broader regulatory framework to get investors the information they need to plan for their financial future."

The NASDAQ listing proposal on diversity disclosure

Readers of this column may recall that Nasdaq proposed a rule change in December 2020 that will require listing companies on the Nasdaq to disclose board diversity.[13] The proposed rule change would

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[12] SEC.gov | Public Input Welcomed on Climate Change Disclosures, https://www.sec.gov/news/public-statement/lee-climate-change-disclosures?utm_medium=email&utm_source=govdelivery.

[13] See Federal Register Vol. 85 No. 239, 80472, December 11, 2020 (*inter alia* proposed Rule 5605(f) would require Nasdaq-listed companies, subject to certain exceptions, (A) to have at least one director who self-identifies as a female, and (B) to have at least one director who self-identifies as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, two or more races or ethnicities, or as LGBTQ+, or (C) to explain why the company

require SEC approval, but on March 10, 2021 the Wall Street Journal ("WSJ") reported that, in a notice posted on the SEC website, the SEC said it would take additional time to rule on the Nasdaq proposal, while also seeking further public comment. The decision means that a final decision on whether to approve or reject the proposal will likely come out this summer according to the WSJ.[14] The SEC's final decision may be an indication of how far incoming Chair Gensler will press for further ESG-related disclosure.

DOL will not enforce Trump era ERISA guidance

Finally, in light of the Biden administration's priorities on climate action and ESG generally, it should come as no surprise that the Department of Labor announced on March 10, 2021 that it intends to revisit the recently adopted ESG rule promulgated under the prior administration that effectively discouraged ERISA fund managers from taking ESG criteria into account in their investment decision-making. Specifically, the DOL "will not enforce either final rule or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with those final rules with respect to an investment, including a Qualified Default Investment Alternative, or investment course of action or with respect to an exercise of shareholder rights." Notably, this enforcement statement will not, however, preclude the DOL from "enforcing any statutory requirement under ERISA, including the statutory duties of prudence and loyalty in section 404 of ERISA."

Au courant à Europe

On March 1, 2021 the European Securities and Markets Authority (ESMA), the EU's securities markets regulator, published its final report on advice under Article 8 of the Taxonomy Regulation, which covers the information to be provided by non-financial undertakings and asset managers to comply with their disclosure obligations under the Non-Financial Reporting Directive (NFRD). The Report is available at: esma30-379-471_final_report_-_advice_on_article_8_of_the_taxonomy_regulation.pdf (europa.eu).

"The recommendations define the Key Performance Indicators (KPIs) disclosing how, and to what extent, the activities of businesses that fall within the scope of the NFRD qualify as environmentally sustainable under the Taxonomy Regulation. The key recommendations relate to the definitions to be used by non-financial undertakings for the calculation of the turnover KPI, the CapEx KPI and the OpEx KPI, and the KPI that asset managers should disclose."

ESMA Chair Steven Maijoor is quoted that, "These disclosures are essential to provide investors with the information needed to direct investments towards environmentally sustainable activities. They will also be a key building block for the reporting of other financial market participants under the EU Taxonomy."

ESMA's Recommendations:

ESMA's proposals focus on how to further specify the three KPIs set out in Article 8(2) of the Taxonomy Regulation for non-financial undertakings and those provided by asset management companies that fall within scope of the NFRD:

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does not have at least two directors on its board who self-identify in the above listed categories). The proposed rule changes require the SEC's approval.

[14] See Ruling on Nasdaq Diversity Plan for Boards Is Delayed by SEC - WSJ, https://www.wsj.com/articles/ruling-on-nasdaq-diversity-plan-for-boards-is-delayed-by-sec-11615419177 (Subscription. req'd).

- **Non-financial undertakings** – the proposals set out the definitions that should be used for the calculation of the turnover KPI, the CapEx KPI and the OpEx KPI. These are complemented with the minimum information that should accompany these disclosures and the methodology, including the level of granularity, for the reporting of the three metrics; and

- **Asset managers** – the proposals set out the KPI that asset managers should disclose, the methodology to be applied to that KPI and recommendations for the development of a coefficient methodology to assess Taxonomy-alignment of investments in investee companies that do not report under the NFRD.

ESMA also proposes that non-financial undertakings and asset managers use standardized templates for their reporting under Article 8 in order to facilitate comparability of these disclosures and enhance their accessibility to investors that will reuse this information.

ESMA Report on Trends, Risks and Vulnerabilities: ESG Ratings

The widespread and increasing use of ESG rating vendors by investors, issuers and asset managers is the subject of increasing focus by regulators anchored on the notion of investor protection. That is, the risk of ESG rating products leading to confusion and misunderstanding that can lead to significant asset misallocation whether by good faith unconscious divergences in methodologies or worse from greenwashing. While regulators have not yet proposed regulating the industry — think credit rating agency regulation — recent tremors of regulatory impulses have been heard, particularly from Europe where the trend of green finance is much more evolved than in the US or elsewhere in the world. ESG ratings and their vendors will no doubt continue to play an important role in the exploding number of investment funds labeled as socially responsible or green investment strategies. Because of the importance of this segment of the market for ESG investment products, this issue of *SKYSights* commends the following study and provides readers with our summary.

ESMA's first issue for 2021 of its *Report on Trends, Risks and Vulnerabilities* (the "TRV") released on March 17, 2021 devoted a section addressing the growing importance of ESG ratings for investors and issuers alike.[15] The TRV concludes that the "lack of a common definition and comparability, together with transparency issues, could be ultimately detrimental to the transition towards a more sustainable financial system." While acknowledging the potential benefits of ESG ratings, the TRV points out a number of potential impediments to these benefits that may result in investor and issuer confusion and misunderstanding.

The TRV takes stock of the current situation by (1) exploring the diversity of ESG rating products and its key players (Credit Rating Agencies, Benchmark administrators, Data vendors, Specialized firms, and Consultancies); (2) summarizing the issues documented in the literature and media – in particular with regard to the lack of comparability and reliability of ratings (most of the literature focuses on the relationship between ESG ratings and asset performance without a clear consensus emerging — which may reflect disagreement on materiality and how to measure it); and (3) presenting some use cases and illustrating the impact these issues can have. For example, according to the TRV, asset managers use ESG ratings to construct portfolios according to their mandates or to monitor and manage certain types of exposure such as climate related, or asset managers may use ESG ratings as a screening tool to identify

[15] ESMA Report on Trends, Risks and Vulnerabilities, No. 1, 2021, March 17, 2021, ESMA50-165-1524 available at: Webinar on ESMA's report on trends, risks and vulnerabilities no.1 2021 (europa.eu), https://www.esma.europa.eu/press-news/hearings/webinar-esmas-report-trends-risks-and-vulnerabilities-no1-2021.

relative outperformers and underperformers. The TRV found many asset managers rely on in-house expertise because they believe it to be more reliable and tailored to their specific research needs.

According to the TRV, some credit rating agencies are integrating ESG ratings into their credit ratings while other providers are using ESG ratings to create new ESG indices. The study also found that the lack of consistency between ratings is particularly problematic in the context of ESG index construction, which in turn can lead to misallocation of assets as some of these indices are used for passive investing. As an illustration, the TRV replicated the methodology from a leading ESG index provider by using another ESG Rating vendor's ratings and found significant differences in results — the highest rate of agreement of identified "ESG Leaders" was 43% — leading the TRV to conclude that "methodologies and data sources play a key role" and can "lead to significant skews in the data due to company size," meaning that, some raters that rely exclusively on publicly available information are skewed toward larger companies that have the resources to devote to ESG non-financial reporting. On the other hand rating agencies that look to capturing reputational risk such as controversial activities penalize larger companies because larger companies are more exposed to media scrutiny.

According to its study, the TRV reports that the current situation creates a number of risks. First, the lack of common definitions prevents authorities and investors from mapping the market and leaves the definition of ESG risk to the rating vendor. This increases the risk of misunderstandings about the objectives and comparability of ESG ratings and creates high rates of disagreement between providers of the ESG bona fides of the companies they rate.

The second problem the TRV finds concerns the lack of transparency of methodologies that underpin the ratings. Echoing recent studies, the TRV observes that methodological differences stem from vendor choices in terms of scope, factor weights or aggregation methods. Significant differences can also reflect differing measurement metrics to value the same attribute, which can in turn be affected by the quality and consistency of ESG-related company disclosure. The TRV notes that these inconsistencies have led the French and Dutch securities market authorities to warn that such lack of transparency may lead to investment misallocation, mismatches between expectations and ESG outcomes, or even greenwashing, while preventing the integration of sustainability risks and opportunities in the investment-making process.

The TRV cites yet another risk from competition among ESG rating raters. Recent consolidation in the market may lead to a greater concentration of a few large rating vendors, which over the medium term can lead to an oligopoly situation similar to the current credit rating market. Oligopolistic markets, the TRV writes, "enable firms to exercise market power to increase prices or reduce quality of output."

Finally, the TRV notes that conflicts of interest may stem from the coexistence of ESG rating services with other business products. Citing the example of benchmark administrators, the TRV points out that ratings from benchmark administrators may be influenced by their core activity, either to suit investors' needs for representativeness or underlying liquidity, or to ensure sufficient robustness of index composition. The TRV finds that the risk of ratings inflation from these and other conflicts of interest may, if unchecked, result in "a lack of comparability and trust."

Questions and comments welcome by email to Gordon Eng at geng@skyhcm.com.

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