EU Guidelines on ESG Funds' Names: A Great Reshuffle Ahead

New rules may force more than 1,600 funds to rebrand or divest up to $40 billion-worth of stocks.

Morningstar Sustainalytics
6 June 2024
Updated version

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Executive Summary

On May 14, 2024, the European Securities and Markets Authority, or ESMA, published its final guidelines on funds' names using ESG or sustainability-related terms. The aim of these guidelines is to protect investors against greenwashing risk and to provide minimum standards for funds available for sale in the EU that use specific ESG terms in their names. Funds will either need to comply with new portfolio requirements as laid out in the guidelines or change names.

The requirements include (1) a minimum of 80% of investments that meet environmental or social characteristics or sustainable investment objectives (80%) and (2) exclusions as set by EU regulation for Paris-aligned benchmarks, or PABs, and climate-transition benchmarks, or CTBs. The PAB exclusions are particularly impactful as they would rule out investments in companies deriving a certain level of revenues from fossil fuels. Additionally, funds with the key term "sustainable" in their names will need to invest "meaningfully" in sustainable investments, and funds using "transition" or "impact"-related terms are subject to specific qualitative requirements.

In this report, we assess the potential impact of the final ESMA guidelines on EU funds[1] using the Morningstar Direct fund database and Morningstar Sustainalytics' company ESG research.

Key Takeaways

- We identified around 4,300 EU funds with ESG or sustainability-related terms in their names that may fall in scope of the new guidelines.
- Of 2,500 funds with stock holding data,[2] we found that more than 1,600 are exposed to at least one stock potentially in breach of the PAB and CTB exclusion rules. This represents a significant number (about two thirds) of funds that may need to consider either divesting from the stocks or rebranding.
- If all these funds were to keep their names, it could lead to stock divestments worth up to USD 40 billion.[3]
- The sectors most affected by the potential divestments include energy, industrials (railroads, and defense, for example), and basic materials. The most affected countries would be the US, France, and China, in terms of market value, but China, the US, and India in terms of the number of companies. The most affected stocks would include TotalEnergies, Tencent Holdings, and Shell.

1 Our universe of EU funds includes open-end funds and exchange-traded funds available for sale in the EU, including money market funds, funds of funds, and feeder funds.

2 Bond and alternative investments in the 4,300 funds identified as potentially in scope of the guidelines are outside the scope of our quantitative impact analysis owing to a lack of complete data.

3 Estimated value based on stock market prices on May 28, 2024.

- When interpreting the PAB/CTB exclusion rules and sourcing data, managers will decide how far they need to go in a company's ownership and value chain and assess the related investment implications.
- Because of the stringent nature of the PAB exclusions, we expect many funds to drop "ESG" and related terms from their names, while some will reposition as transition funds, to which the less restrictive CTB exclusions apply, provided they can demonstrate a clear and measurable transition path.
- At best, only 56% of funds with the specific term "sustainable" in their names would be able to keep the term if the minimum threshold for a "meaningful" allocation to sustainable investments is set at 30%. The remaining 44% of funds would need to increase their allocation to sustainable investments, tweak their existing sustainable investment methodology, or rebrand.

Introduction

Funds' names are a powerful marketing tool, and to protect investors against greenwashing risk going forward, ESMA has issued new rules for funds that use ESG- or other sustainability-related terms in their names. The final guidelines were published on May 14, 2024, following a consultation in November 2022[4] and an interim update in December 2023.[5]

The requirements include (1) a minimum of 80% of investments that meet the strategy's environmental or social characteristics or sustainable investment objectives and (2) exclusions as set by EU regulation for Paris-aligned benchmarks and climate-transition benchmarks. Additionally, funds with the key term "sustainable" in their names will need to invest "meaningfully" in sustainable investments, and funds using "transition" or "impact"-related terms are subject to specific qualitative requirements.

Who do ESMA's Guidelines Apply to?

The guidelines apply to fund managers who promote UCITS (Undertakings for Collective Investment in Transferable Securities) and AIFs (Alternative Investment Funds) that use environmental-, transition-, impact-, ESG-, or sustainability-related terms in their names. Consistent with the scope of the Sustainable Finance Disclosure Regulation, or SFDR, the guidelines are directed at fund managers marketing funds in the EU.

Timeline

The new guidelines will apply after they are translated into all official languages and published on ESMA's website. We estimate that this translation process could last one month from the date of the publication of the final guidelines. ESMA has specified that once published, the guidelines will apply to new funds three months after the publication date and to existing funds nine months after the publication date. Therefore, assuming a publication date of June 15, 2024, the guidelines could apply to new funds from Sept. 15, 2024, and to existing funds from March 15, 2025.

4 esma34-472-373_guidelines_on_funds_names.pdf (europa.eu)

5 https://www.esma.europa.eu/sites/default/files/2023-12/ESMA34-1592494965-554_Public_statement_on_Guidelines_on_funds__names.pdf

Which Funds Are in Scope of the New Guidelines?

ESMA Creates Six Categories with Related Restrictions

The guidelines apply to all funds that use an ESG or sustainability-related term in their names, and to simplify, ESMA has created six distinct categories of terms that trigger minimum requirements. The six categories are environmental, sustainability, impact, social, governance, and transition, as listed in the table below, alongside a summary of their related restrictions.

Exhibit 1 Summary of the Categories of Terms and Related Restrictions

Restricted sustainability-related terms in fund names	Restrictions			
	Min. 80% of investments meet sustainability characteristics or objectives	**Exclusions**	**Invest "meaningfully" in sustainable investments as per SFDR**	**Additional requirements**
Environmental	Yes	EU PAB	No	N/A
Sustainability	Yes	EU PAB	Yes, but no minimum prescribed	N/A
Impact	Yes	EU PAB	No	Positive and measurable social or environmental impact alongside a financial return
Social	Yes	EU CTB	No	N/A
Governance	Yes	EU CTB	No	N/A
Transition	Yes	EU CTB	No	Clear and measurable path to social or environmental transition

Source: Morningstar Sustainalytics Research, based on ESMA34-472-440 Final Report on the Guidelines on Funds' Names (europa.eu). PAB stands for Paris-aligned benchmarks; CTB stands for climate-transition benchmarks.

Below we list the exclusion criteria as set by EU regulation for CTBs and PABs. These criteria are an important element of the guidelines. The PAB exclusions are particularly impactful as they would rule out investments in companies deriving significant revenues from fossil fuels. ESMA believes that this is the most meaningful approach to tackle the greenwashing risk arising from the improper use of funds' names.

Exhibit 2 CTB and PAB Exclusions[6]

	Climate Transition Benchmark (CTB)	Paris-Aligned Benchmark (PAB)
Baseline Exclusions	Any activities related to **controversial weapons** Cultivation and production of **tobacco** Violators of the **UNGC** principles* or **OECD** Guidelines**	Any activities related to **controversial weapons** Cultivation and production of **tobacco** Violators of the **UNGC** principles* or **OECD** Guidelines**
Activity Exclusions	No	**Coal** and **lignite** (revenues > 1%) **Oil fuels** (revenues > 10%) **Gaseous fuels** (revenues > 50%) **Electricity** producers (revenues > 50% from electricity emitting more than 100 g CO2 e/kWh)

Source: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R1818&from=EN, Page 23. * United Nations Global Compact principles. ** Organisation for Economic Co-operation and Development Guidelines

How Big Is the Universe of Funds in Scope of the New Guidelines?

While the guidelines list some examples of terms[7] that trigger minimum requirements, ESMA didn't provide an exhaustive list. While waiting for further guidance from local regulators, we searched the Morningstar Direct fund database to try and identify additional terms that could fall in scope and the funds using them. We searched ESG and other sustainability-related terms in all European languages.

As a result of our search, we found close to 4,300 mutual funds and exchange-traded funds available for sale in the EU that use some ESG or sustainability-related terms in their names and may fall in scope of the new guidelines. Below we share a sample of key terms under each of the six categories and their number of occurrences in fund names.

6 Exclusions for EU Paris-aligned benchmarks include:

(a) companies involved in any activities related to controversial weapons;

(b) companies involved in the cultivation and production of tobacco;

(c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises;

(d) companies that derive 1 % or more of their revenues from exploration, mining, extraction, distribution, or refining of hard coal and lignite;

(e) companies that derive 10 % or more of their revenues from the exploration, extraction, distribution, or refining of oil fuels;

(f) companies that derive 50 % or more of their revenues from the exploration, extraction, manufacturing, or distribution of gaseous fuels;

(g) companies that derive 50 % or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO2 e/kWh.

For the purposes of point (a), controversial weapons shall mean controversial weapons as referred to in international treaties and conventions, United Nations principles, and, where applicable, national legislation.

7 ESMA34-472-440 Final Report on the Guidelines on Funds' Names (europa.eu), Page 55.

"Environmental"-related terms mean any words giving the investor any impression of the promotion of environmental characteristics, for example, "green," "environmental," "climate," and so on. These terms may also include the "ESG" and "SRI" abbreviations.

"Sustainability"-related terms mean any terms only derived from the base word "sustainable," for example, "sustainably," "sustainability," and so on.

"Impact"-related terms mean any terms derived from the base word "impact," for example, "impacting," "impactful," and so on.

"Social"-related terms mean any words giving the investor any impression of the promotion of social characteristics, for example, "social," "equality," and so on.

"Governance"-related terms mean any words giving the investor any impression of a focus on governance, for example, "governance," "controversies," and so on.

"Transition"-related terms encompass any terms derived from the base word "transition," for example, "transitioning", "transitional," and so on, and those terms deriving from "improve," "progress," "evolution," "transformation," "net-zero," and so on.

Exhibit 3 Most Commonly Used Sustainability-Related Terms and Number of Occurrences for In-Scope Funds

Environmental-related terms	# funds using single term	# funds with combined terms	Total # funds
ESG	1140	27	**1167**
SRI	372	31	**403**
Responsible	194	35	**229**
Climate	155	41	**196**
Green	126	29	**155**
Ethical	63	2	**65**
Environmental	35	8	**43**
Low Carbon	20	16	**36**
Clean	7	15	**22**
Circular	19	3	**22**
Biodiversity	13	5	**18**
Planet	5	6	**11**
Renewable	0	10	**10**
Earth	3	1	**4**
Ecology	2	1	**3**

Sustainability-related terms	# funds using single term	# funds with combined terms	Total # funds
Sustainability / Sustainable	1253	40	**1293**
SDG	30	19	**49**

Impact-related terms	# funds using single term	# funds with combined terms	Total # funds
Impact	132	81	**213**
Better World	5	1	**6**

Paris-Aligned Benchmark (PAB) exclusions will apply to these funds

Social-related terms	# funds using single term	# funds with combined terms	Total # funds
Social	47	1	**48**
Solidarity	38	0	**38**
Microfinance	16	2	**18**
Diversity	7	1	**8**
Inclusion	6	1	**7**
Equality	0	4	**4**
Women	1	0	**1**

Governance-related terms	# funds using single term	# funds with combined terms	Total # funds
Governance	5	0	**5**

Transition-related terms	# funds using single term	# funds with combined terms	Total # funds
Transition	67	72	**139**
Net Zero	35	11	**46**
Improvers	1	21	**22**
Evolution	0	10	**10**
Transformation	0	4	**4**
Smart Energy	3	1	**4**

Climate Transition Benchmark (CTB) exclusions will apply to these funds

Source: Morningstar Sustainalytics Research. Morningstar Direct. Money market, funds of funds, and feeder funds are included. Numbers include ESG or sustainability-related terms in English and non-English languages. This list is not comprehensive. Additional terms were included in our search and our analysis but do not appear here.

We took a conservative approach when categorizing terms not mentioned in the ESMA guidelines. For example, we included "responsible" and "ethical" in the environmental-related term category, alongside the “ESG” and “SRI” abbreviations mentioned in the document. After all, "responsible" is one of the words making up "SRI" (socially responsible investments), and "ethical" is similar. It is reasonable for investors to expect funds with such terms in their names to apply consistent exclusions.

Additional environmental-related terms that we believe would trigger PAB exclusions include "low carbon" as well as "biodiversity" and "circular", the latter two being part of the EU Environmental Taxonomy. We have also included more debatable terms in the environmental category, such as "clean energy," "renewable," and "water." We acknowledge that applying PAB exclusions to funds carrying these terms may represent a challenge as many of these thematic funds tend to have some involvement in fossil fuels because they typically invest in utilities companies that run renewable energy operations alongside their legacy fossil fuel businesses.

In the sustainability category, we included all funds that use "sustainable" or "sustainability" in different languages, and any combination with these words, including "SDG" (sustainable development goals) and "sustainable transition," in which case PAB exclusions would apply.

ESMA has specified that where environmental terms are used in combination with "transition" terms in the name of a fund, the CTB exclusions should apply. For all other combinations of terms, we assumed that the most stringent requirements would apply. For instance, for "social impact," the PAB exclusions would apply.

In total, we identified 4,300 open-end funds and ETFs with ESG or sustainability-related terms in their names that may fall in the scope of the guidelines,[8] as per our interpretation of the rules. These represent about 15% of the overall universe of open-end funds and ETFs marketed in the EU.

How 'Meaningfully' Do Sustainable Funds Invest in Sustainable Investments?

For funds that use the specific terms "sustainable" or "sustainability" in their names, ESMA decided to remove the 50% threshold for sustainable investments that it had initially proposed. The 50% sustainable investment minimum had been criticized because the definition of Article 2(17) SFDR is considered too open to discretion by fund managers. ESMA decided to introduce instead a commitment to invest "meaningfully" in sustainable investments.

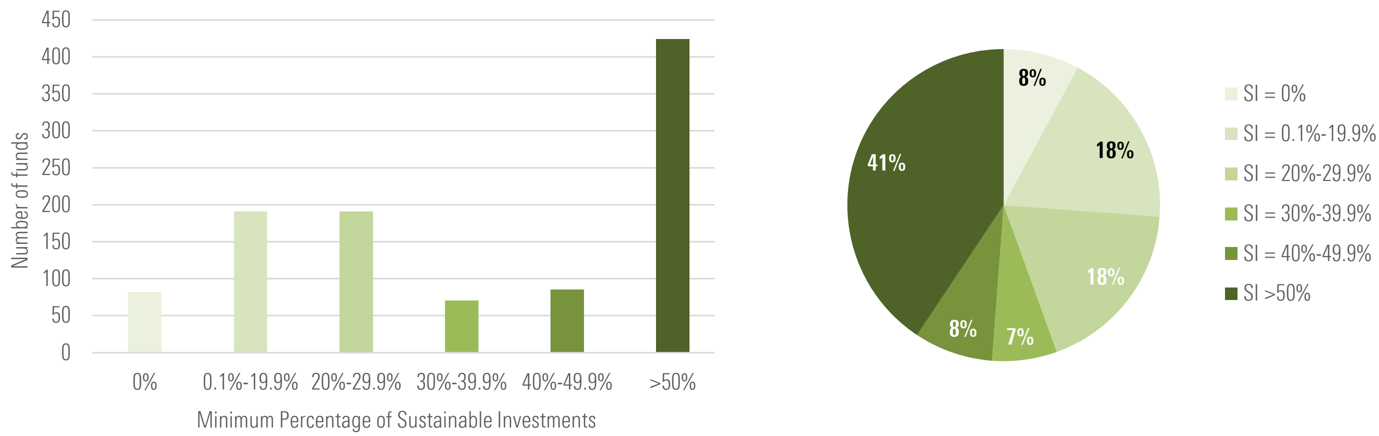
ESMA didn't provide further guidance in the final guidelines as to what it considers "meaningful." The interpretation has been left to national competent authorities.

Around 50% of Sustainable Funds Target at Least 40% in Sustainable Investments, and 56% Commit to at Least 30%

As shown in the below exhibits, currently 41% of funds (or 43% of the assets in funds) that use a sustainability-related word in their names commit to investing at least 50% in sustainable investments. Close to 50% of "sustainable" funds target more than 40% of sustainable investments. This proportion rises to 56% (or 60% of the assets) when the minimum threshold for "meaningful" sustainable investments is lowered to 30%.

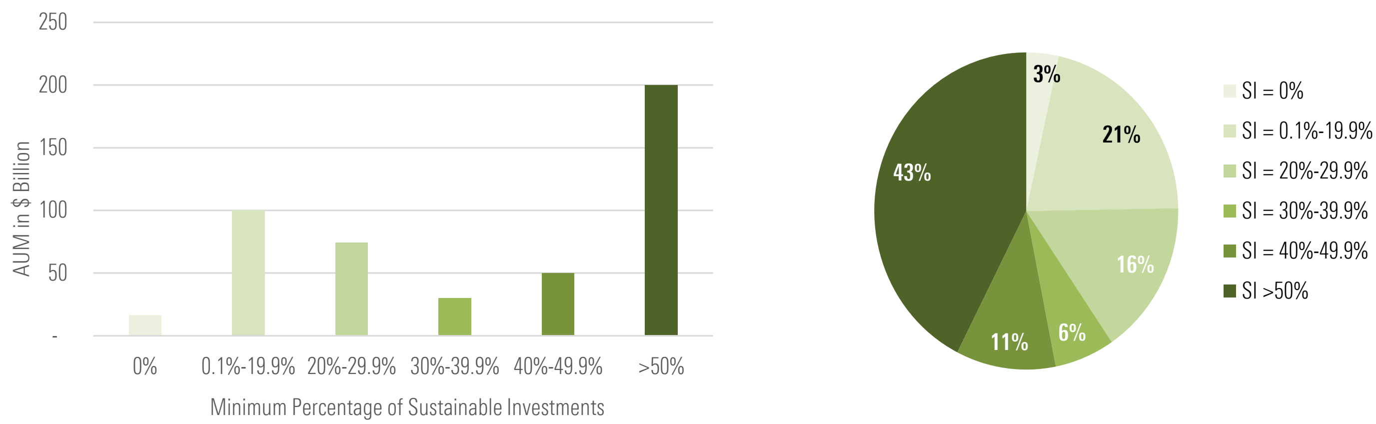
8 Funds tracking PAB or CTB indexes are excluded.

Exhibit 4 Number of Funds With 'Sustainable' in Their Names (Distribution of Minimum Sustainable Investments %)



Source: Morningstar Direct. Based on 1,043 funds with "sustainability" or "sustainable" in their names and the "EU SFDR Minimum or Planned Investments Sustainable Investments" data point populated.

Exhibit 5 Assets in Funds With 'Sustainable" in Their Names (Distribution of Minimum Sustainable Investments %)



Source: Morningstar Direct. Based on 1,043 funds with "sustainability" or "sustainable" in their names and the "EU SFDR Minimum or Planned Investments Sustainable Investments" data point populated.

Based on potential clarifications by national competent authorities, asset managers will need to assess whether they can keep the term "sustainable" in their funds' names or remove it based on this new criterion (provided they already meet the minimum 80% of assets with sustainability characteristics or objectives and the PAB exclusion rule discussed earlier).

In practice, asset managers will still be able to adjust their sustainable-investment measurement methodologies to meet additional specifications. This is because the current definition of "sustainable investment" under SFDR (Article 2, point 17) still leaves ample room for interpretation. As previously reported in our periodic SFDR research,[9] different interpretations of the regulation have led asset

9 SFDR Article 8 and Article 9 Funds: Q1 2024 in Review | Morningstar

managers to adopt different approaches to the calculation of sustainable-investment exposure. Funds with comparable exposures and portfolios have been reporting vastly different sustainable-investment allocations.

Note that there may be reluctance from the national competent authorities to set minimum thresholds for "meaningful" sustainable investments as this approach has the potential to create a fragmented EU market with varying interpretations of the term "meaningful." An additional challenge is that different asset classes may require setting different "meaningful" thresholds.

Impact Assessment of the Exclusion Rules on Companies

While we cannot fully predict the impact of the new guidelines, we can provide a sense of portfolio changes that fund managers using ESG or sustainability-related terms in their fund names will need to consider in order to comply with the exclusion rules if they want to keep their names.

To that purpose, we first identified the companies that may be in breach of the CTB and PAB exclusion rules based on Morningstar Sustainalytics' interpretation of the regulation and its company ESG research. It is important to highlight that our lists of PAB/CTB exclusions may differ from others. Product involvement and controversies data tend to vary from data provider to data provider. This is due to a host of reasons, including differences in data sources, methodologies, estimations, coverage, and timeliness. Differences may also come from different interpretations of the regulation. For example, some data providers may take a more conservative approach than others on considerations such as company ownership and value chain. (For example: how far should one go in a company's value chain to assess the company's exposure to certain controversial sectors?). A more stringent interpretation of the regulation leads to more companies on the PAB/CTB exclusion lists.

More Than 1,600 Funds Hold at Least One Stock Potentially in Breach of PAB/CTB Exclusion Rules

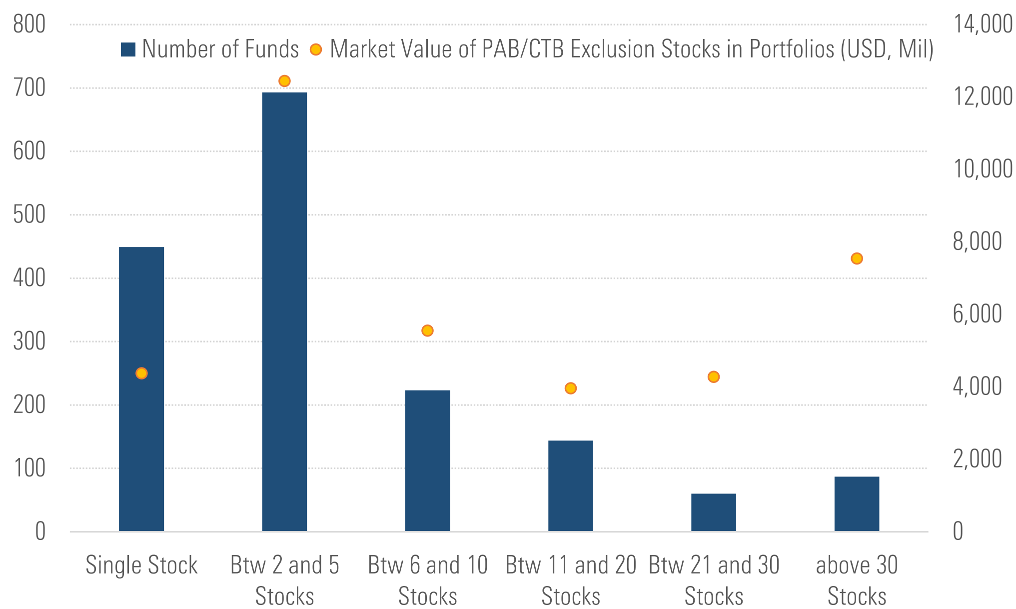
Using Morningstar Direct, we looked inside the 4,300 funds identified earlier and limited our universe to approximately 2,500 funds that have available stock-holding data.[10] Out of these, we found that slightly more than 1,600 held at least one company breaching PAB or CTB exclusion rules, as interpreted by Morningstar Sustainalytics.[11] This represents a significant proportion (about two thirds) of funds with ESG or sustainability-related terms that may need to consider to either divest from the stocks or remove the ESG key terms from their names. Managers of the vast majority of affected funds would need to consider whether or not to apply the PAB exclusion rules to their existing investment strategies. We counted only 52 funds with transition-related terms and 18 funds with social or governance-related terms in their names that include stocks potentially breaching CTB exclusion rules. We can therefore expect many, if not all, transition, social, and governance funds to keep their names, provided, in the case of transition funds, that they can demonstrate a "clear and measurable environmental or social path."

10 Only funds holding stocks are in the scope of this analysis. Bonds and alternative holdings are out of scope because of a lack of complete data.

11 We excluded passive funds that track a PAB or a CTB as we assume these are already meeting the guidelines' exclusion rules even though they may use different exclusion lists based on other data providers' interpretation of the regulation and different data sources.

In the table below, we show the distribution of the 1,600-plus funds by number of stocks potentially breaching PAB or CTB exclusion rules, as interpreted by Morningstar Sustainalytics.

Exhibit 6 Distribution of the 1,600+ Funds Holding Stocks Potentially Breaching PAB /CTB Exclusion Rules



Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024.

We can see that a majority (70%) of the 1,600-plus funds hold fewer than five stocks potentially in breach of the PAB or CTB exclusion rules. This leaves us with 30% of funds (about 500) in our analysed universe for which maintaining ESG-related terms in names would require more portfolio adjustments and would potentially be more problematic depending on strategy type and portfolio size (solely on the basis of the exclusion rules, other guidelines-related requirements being ignored here).

Analysis of the Most Commonly Held Stocks Potentially in Breach of PAB/CTB Exclusion Rules

In the table below, we list the 25 most common holdings in in-scope funds that meet our PAB or CTB exclusion criteria, alongside the number of in-scope funds that hold these companies, the aggregate holding value for each company, as well as the main reason for their exclusion.

Exhibit 7 The 25 Stocks Most Commonly Held by In-Scope Funds (Ranked by Number of Funds Holding the Stocks)

Company Name	Country	Number of Funds Holding the Stock	Stock Holding Value in Funds ($Mil)	Sector	Industry	Sustainalytics ESG Risk	Sustainalytics Exclusion Reason
Dassault Systemes SE	France	362	1,198	Technology	Software - Application	Low	Thermal Coal Supporting Products
TotalEnergies SE	France	356	3,487	Energy	Oil & Gas Integrated	Medium	Oil & Gas Production
Neste OYJ	Finland	276	570	Energy	Oil & Gas Refining & Marketing	Low	Oil & Gas Production
Union Pacific Corp	US	248	1,258	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Quanta Services Inc	US	219	984	Industrials	Engineering & Construction	High	Oil & Gas Supporting Products/Services
SGS AG	Switzerland	215	441	Industrials	Consulting Services	Low	Thermal Coal Supporting Products
BYD Co Ltd	China	212	835	Consumer Cyclical	Auto Manufacturers	Medium	Tobacco Production
Baker Hughes Co	US	200	522	Energy	Oil & Gas Equipment & Services	Medium	Oil & Gas Supporting Products/Services
CSX Corp	US	177	550	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Intertek Group PLC	UK	176	310	Industrials	Specialty Business Services	Low	Thermal Coal Supporting Products
Canadian National Railway	Canada	175	628	Industrials	Railroads	Low	Thermal Coal Supporting Products
Westinghouse Air Brake Tech.	US	175	477	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Schlumberger Ltd	US	170	445	Energy	Oil & Gas Equipment & Services	Medium	Oil & Gas Supporting Products/Services
Tencent Holdings Ltd	China	167	3,337	Comm. Services	Internet Content & Information	Low	UNGC Non-Compliant
ACS Activ. de Constr. y Serv.	Spain	165	292	Industrials	Engineering & Construction	High	Thermal Coal Supporting Products
Wartsila Corp	Finland	155	214	Industrials	Specialty Industrial Machinery	Medium	Oil & Gas Supporting Products/Services
3M Co	US	145	369	Industrials	Conglomerates	Severe	Severe Controversies
Cheniere Energy Inc	US	145	350	Energy	Oil & Gas Midstream	Medium	Oil & Gas Production
Snam SpA	Italy	145	214	Utilities	Utilities - Regulated Gas	Low	Oil & Gas Production
Shell PLC	UK	144	1,411	Energy	Oil & Gas Integrated	High	Oil & Gas Production
Albemarle Corp	US	144	380	Basic Materials	Specialty Chemicals	Medium	Oil & Gas Supporting Products/Services
Equinor ASA	Norway	141	230	Energy	Oil & Gas Integrated	High	Oil & Gas Production
ONEOK Inc	US	138	351	Energy	Oil & Gas Midstream	Medium	Oil & Gas Production
LyondellBasell Industries NV	US	138	223	Basic Materials	Specialty Chemicals	Medium	Oil & Gas Production
Daikin Industries Ltd	Japan	136	615	Industrials	Building Products & Equipment	Medium	Controversial Weapons

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. There could be several reasons why a stock meets Sustainalytics' PAB/CTB exclusion criteria. Only the primary reason may be listed here.

Dassault Systèmes, **TotalEnergies**, and **Neste** are the three most common stocks held in in-scope funds that meet the PAB or CTB exclusion criteria based on Morningstar Sustainalytics research.

Dassault Systèmes provides software applications and services to multiple industries, including the mining industry through its Port Kembla Coal Terminal, a coal-exporting facility. Through GEOVIA Minex, the company offers integrated geology and mine planning solutions for coal deposits used for resources evaluation and efficient exploration. According to Sustainalytics, Dassault Systèmes' estimated revenues derived from thermal-coal-supporting products and services account for 1% of the company's total revenue.

Neste is a refining and marketing company that provides oil refining and renewable solutions. Sustainalytics estimates that oil refining, transportation and storage revenues represent 50% of the company's overall revenues.

As seen in the table below, French oil and gas integrated major TotalEnergies also features right at the top of companies that will be most affected by the PAB exclusion rule, in dollar terms, followed by **Tencent Holdings** and **Shell**.

Exhibit 8 The 25 Stocks Most Commonly Held by in-Scope Funds (Ranked by Holding Value in Funds)

Company Name	Country	Number of Funds Holding the Stock	Stock Holding Value in Funds ($Mil)	Sector	Industry	Sustainalytics ESG Risk	Sustainalytics Exclusion Reason
TotalEnergies SE	France	356	3,487	Energy	Oil & Gas Integrated	Medium	Oil & Gas Production
Tencent Holdings Ltd	China	167	3,337	Comm. Services	Internet Content & Information	Low	UNGC Non-Compliant
Shell PLC	UK	144	1,411	Energy	Oil & Gas Integrated	High	Oil & Gas Production
Union Pacific Corp	US	248	1,258	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Dassault Systemes SE	France	362	1,198	Technology	Software - Application	Low	Thermal Coal Supporting Products
Exxon Mobil Corp	US	90	1,168	Energy	Oil & Gas Integrated	Severe	Oil & Gas Production
Berkshire Hathaway Inc	US	92	1,085	Financial Services	Insurance - Diversified	Medium	Thermal Coal Supporting Products
Quanta Services Inc	US	219	984	Industrials	Engineering & Construction	High	Oil & Gas Supporting Products/Services
BYD Co Ltd	China	212	835	Consumer Cyclical	Auto Manufacturers	Medium	Tobacco Production
BP PLC	UK	94	649	Energy	Oil & Gas Integrated	High	Oil & Gas Production
Canadian National Railway	Canada	175	628	Industrials	Railroads	Low	Thermal Coal Supporting Products
Daikin Industries Ltd	Japan	136	615	Industrials	Building Products & Equipment	Medium	Controversial Weapons
Chevron Corp	US	86	613	Energy	Oil & Gas Integrated	High	Oil & Gas Production
Canadian Pacific Kansas City	Canada	110	571	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Neste OYJ	Finland	276	570	Energy	Oil & Gas Refining & Marketing	Low	Oil & Gas Production
Airbus SE	France	94	569	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Wells Fargo & Co	US	85	555	Financial Services	Banks - Diversified	High	UNGC Non-Compliant
CSX Corp	US	177	550	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Reliance Industries Ltd	India	56	523	Energy	Oil & Gas Refining & Marketing	High	Oil & Gas Production
Baker Hughes Co	US	200	522	Energy	Oil & Gas Equipment & Services	Medium	Oil & Gas Supporting Products/Services
Safran SA	France	84	494	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Westinghouse Air Brake Tech.	US	175	477	Industrials	Railroads	Medium	Thermal Coal Supporting Products
Schlumberger Ltd	US	170	445	Energy	Oil & Gas Equipment & Services	Medium	Oil & Gas Supporting Products/Services
SGS AG	Switzerland	215	441	Industrials	Consulting Services	Low	Thermal Coal Supporting Products
Albemarle Corp	US	144	380	Basic Materials	Specialty Chemicals	Medium	Oil & Gas Supporting Products/Services

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. * Controversial weapons tailor-made and essential. There could be several reasons why a stock meets Sustainalytics' PAB/CTB exclusion criteria. Only the primary reason is listed here.

TotalEnergies is a French integrated oil and gas company currently held by 356 in-scope funds for an aggregate value of about USD 3.5 billion, accounting for about 2% of TotalEnergies' total market capitalization. TotalEnergies features in more ESG portfolios than its rivals **Shell** (144 funds), **Exxon Mobil** (90 funds), and **BP** (94 funds). According to Sustainalytics, TotalEnergies has lower ESG Risk (Medium) than Shell, (High), BP (High), and Exxon (Severe). TotalEnergies, Shell, and BP, all manage their energy transition better than Exxon, as evidenced by their "strong" Implied Temperature Rise management scores[12] of 56.5, 61.3, and 59.7, respectively, compared with a "weak " Implied Temperature Rise management score of 44.9 for Exxon.

Meanwhile, Taiwanese communication services stock Tencent Holdings, which is found in about 167 in-scope funds for an aggregate value of USD 3.3 billion, is part of Sustainalytics' list of violators of the UN Global Compact principles on human rights. Tencent is arguably the most influential internet firm in China. It is the world's largest video game vendor. It also runs China's largest social-media super app—WeChat, which is part of the fabric of life for Chinese people, who use it to chat, shop, watch videos, play games, order food and taxis, and more. However, Tencent is reported to engage in widespread censorship and surveillance of platform users without adequate management systems and disclosure to ensure the right to freedom of expression and privacy.

In the table below, we list the 20 most common companies in funds that use transition-related terms in their names. These companies fall within the scope of the less stringent CTB exclusion rules.

Exhibit 9 The 20 Most Commonly Held Stocks in Funds That Use Transition-Related Terms in Their Names (Ranked by Number of Funds Holding the Stocks)

Company Name	Country	Number of Funds Holding the Stock	Stock Holding Value in Funds ($Mil)	Sector	Industry	Sustainalytics ESG Risk	Sustainalytics Exclusion Reason
BYD Co Ltd	China	26	145	Consumer Cyclical	Auto Manufacturers	Medium	Tobacco Production
Tencent Holdings Ltd	China	13	146	Comm. Services	Internet Content & Information	Low	UNGC Non-Compliant
Daikin Industries Ltd	Japan	13	24	Industrials	Building Products & Equipment	Medium	Controversial Weapons
3M Co	US	13	15	Industrials	Conglomerates	Severe	Severe Controversies
Baidu Inc	China	10	10	Comm. Services	Internet Content & Information	Low	UNGC Non-Compliant
Wells Fargo & Co	US	9	29	Financial Services	Banks - Diversified	High	UNGC Non-Compliant
Tata Consultancy Services	India	8	19	Technology	IT Services	Low	UNGC Non-Compliant
Airbus SE	France	8	11	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Tencent Music Entertain.	China	7	5	Comm. Services	Internet Content & Information	Medium	UNGC Non-Compliant
BYD Electronic (International)	China	7	1	Technology	Electronic Components	Medium	Tobacco Production
China Literature Ltd	China	7	0	Comm. Services	Internet Content & Information	Low	UNGC Non-Compliant
Bayer AG	Germany	6	5	Healthcare	Drug Manufacturers - General	Medium	Severe Controversies
iQIYI Inc	China	6	0	Comm. Services	Entertainment	Low	UNGC Non-Compliant
Safran SA	France	5	7	Industrials	Aerospace & Defense	Medium	Controversial Weapons
ICL Group Ltd	Israel	5	2	Basic Materials	Agricultural Inputs	Medium	Controversial Weapons
Brookfield Corp	Canada	4	5	Financial Services	Asset Management	Medium	Controversial Weapons
Honeywell International Inc	US	4	3	Industrials	Conglomerates	Medium	Controversial Weapons
Thales	France	4	2	Industrials	Aerospace & Defense	Medium	Controversial Weapons
BAE Systems PLC	UK	4	2	Industrials	Aerospace & Defense	Medium	Controversial Weapons
MTN Group Ltd	South Africa	4	1	Comm. Services	Telecom Services	Medium	UNGC Non-Compliant

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. * Controversial Weapons Tailor-made and essential. ** Controversial Weapons non-tailor-made or nonessential. There could be several reasons why a stock meets Sustainalytics' PAB/CTB exclusion criteria. Only the primary reason is listed here.

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BYD Co Ltd is currently held by 26 transition-named funds (and a total of 212 in-scope funds) mainly because of the company's focus on electric vehicles, renewable energy, and rail transit. It is perhaps less known that through its 66% subsidiary **BYD Electronic** (also in the table), BYD Co Ltd also manufactures e-cigarettes and other tobacco-related products that are estimated to account for significantly less than 1% of the company's total revenue (unlike for coal and oil and gas exposure, no minimum threshold is applied to tobacco exposure).

In the table below, we list the most commonly held companies in the 124 funds we identified as carrying a social-related term in their names. Only 13 companies feature in the table, which means that most funds in that category are already well-aligned with CTB exclusion rules.

Exhibit 10 The Most Commonly Held Stocks in Funds That Use Social-Related Terms in Their Names (Ranked by Number of Funds Holding the Stocks)

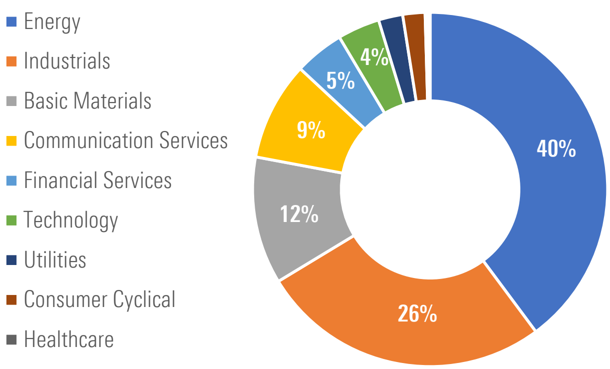
Company Name	Country	Number of Funds Holding the Stock	Stock Holding Value in Funds ($Mil)	Sector	Industry	Sustainalytics ESG Risk	Sustainalytics Exclusion Reason
Thales	France	7	4.8	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Safran SA	France	5	6.0	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Airbus SE	France	5	2.8	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Wells Fargo & Co	US	4	10	Financial Services	Banks - Diversified	High	UNGC Non-Compliant
3M Co	US	2	10	Industrials	Conglomerates	Severe	Severe Controversies
Rheinmetall AG	Germany	1	7.4	Industrials	Aerospace & Defense	Medium	Controversial Weapons
Philip Morris International Inc	US	1	0.6	Consumer Defensive	Tobacco	Medium	Tobacco Production
British American Tobacco PLC	UK	1	0.5	Consumer Defensive	Tobacco	High	Tobacco Production
Leonardo SpA	Italy	1	0.4	Industrials	Aerospace & Defense	Medium	Controversial Weapons
RTX Corp	US	1	0.2	Industrials	Aerospace & Defense	High	UNGC Non-Compliant
Lockheed Martin Corp	US	1	0.2	Industrials	Aerospace & Defense	Medium	UNGC Non-Compliant
Northrop Grumman Corp	US	1	0.2	Industrials	Aerospace & Defense	Medium	Controversial Weapons
MTN Group Ltd	South Africa	1	0.1	Comm. Services	Telecom Services	Medium	UNGC Non-Compliant

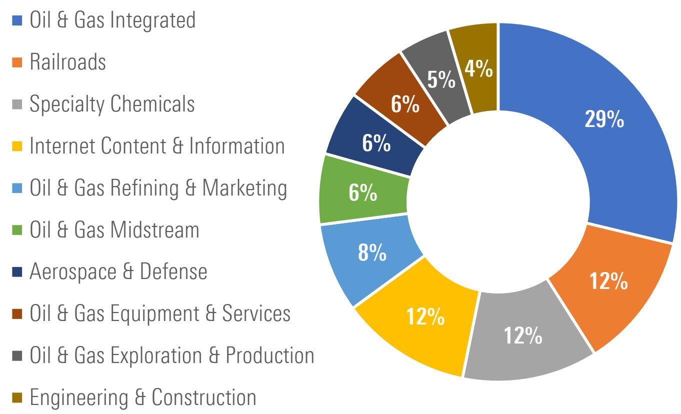
Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. * Controversial Weapons Tailor-made and essential. There could be several reasons why a stock meets Sustainalytics' PAB/CTB exclusion criteria. Only the primary reason is listed here.

Eight out of the 10 stocks are defense companies. While these stocks don't feature much in social funds, they are found in more portfolios in other ESG fund categories. Overall, **Airbus** is held by 94 funds, **Safran** features in 84 funds, while **Thales** is present in 62 funds. The reason for these holdings in many ESG funds is that while the vast majority of ESG funds tend to exclude companies involved in controversial weapons, exceptions are made for companies involved in nuclear weapons (a type of controversial weapons) that are domiciled in countries that have signed the Treaty on the Non-Proliferation of Nuclear Weapons. We expect these stocks to remain in ESG portfolios.

The chart below shows the sectors and industries that may be most affected by the PAB/CTB exclusion rules, in terms of stock holding value. Unsurprisingly, energy features at the top, followed by industrials and basic materials.

Exhibit 11 Sectors and Industries Potentially Most Affected by Stock Divestments to Comply With PAB/CTB Exclusion Rules (in Stock Holding Value)



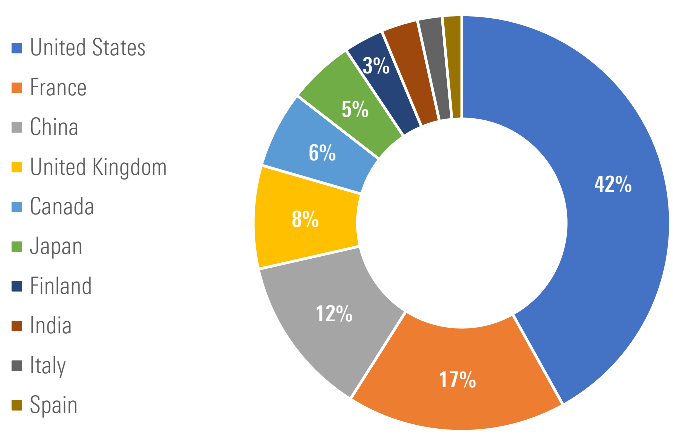


Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. For industries, only the top 10 are shown here.

Looking at industries, oil and gas integrated companies are the most represented, in terms of stock holding value, followed by railroads and specialty chemicals. The latter two can be explained by the large size of the companies offering supporting products/services to the coal, oil, and gas industries (for example, **Canadian National Railway, Schlumberger**). In terms of the number of funds holding stocks in the top 10 industries (not shown here), the highest number of companies captured by the exclusions are in oil and gas exploration and production, and oil and gas refining and marketing.

The chart below shows that the US could see the largest impact in terms of stock market value, followed by France and China.

Exhibit 12 Countries Most Affected by Potential Stock Divestments to Comply With Exclusion Rules



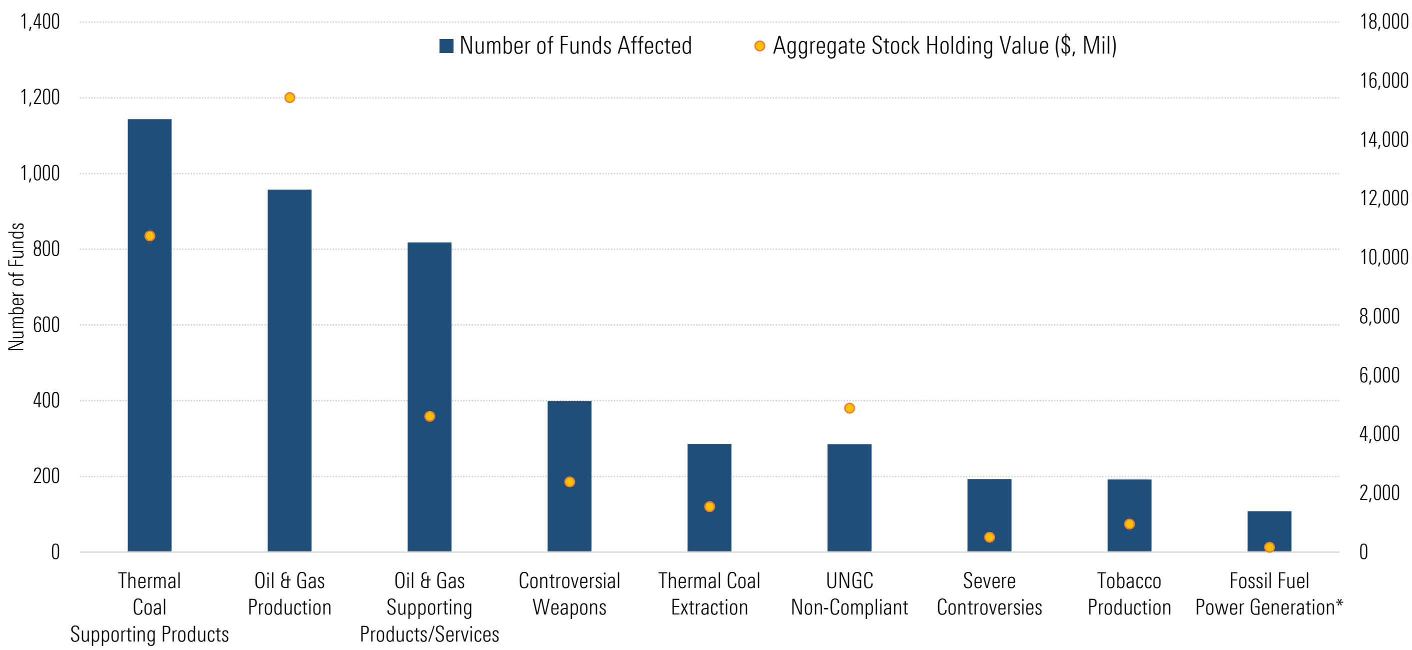
Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. Calculation based on stock holding market value.

In the US, we identified 60 companies that meet our PAB/CTB exclusion criteria. Half are oil and gas producers. In France, only 10 companies meet our PAB/CTB exclusion criteria, but TotalEnergies and Dassault Systemes skew the results in terms of stock holding value.

China will be the country the most affected by the exclusion rules in terms of the number of companies. At least 90 companies, including more than one third involved in coal, are in breach of the PAB/CTB exclusion rules. India comes third (following China and the US) with at least 35 companies excluded mostly because of their involvement in fossil fuels.

The chart below shows Morningstar Sustainalytics' exclusion reasons ranked by the number of funds affected. Thermal-coal-supporting products and services land at the top. One fourth (about 1,100) of the funds in our universe (for which PAB exclusions apply) hold at least one company that enable coal producers to continue their activities. The second most frequent reason for stock exclusion in that same fund universe is oil and gas production. More than 950 funds hold at least one oil and gas producer. And more than 800 funds hold at least one company that offers products/services supporting the oil and gas industry.

Exhibit 13 Sustainalytics Exclusion Reasons Ranked by Number of Funds Affected



Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. Based on funds' assets under management. *Combined Revenue of Thermal Coal Power Generation and Oil & Gas Generation.

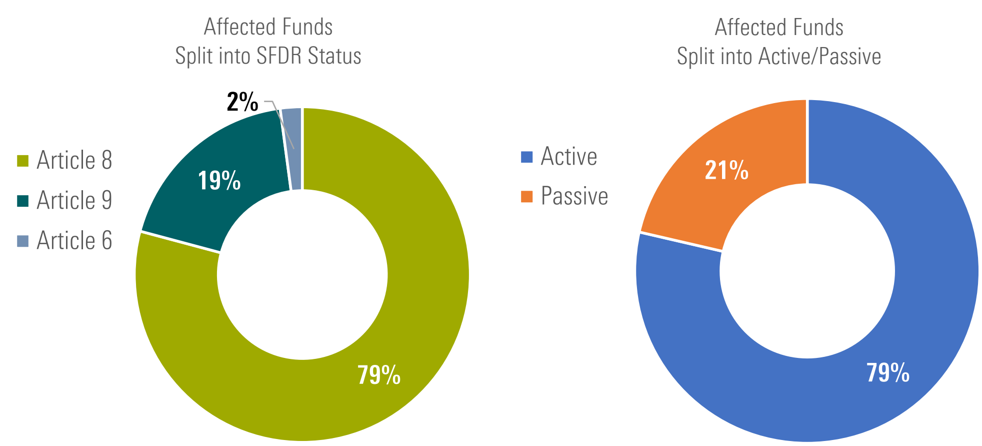
Impact Assessment of the Exclusion Rules on Funds

In this section, we examine our universe of 1,600-plus funds through the lens of several measures to see what type of funds with ESG or sustainability-related terms in their names may be the most affected by the exclusion rules.

First, we found that the vast majority (79%) are classified as Article 8, while 19% are Article 9 funds. The latter include many thematic funds that invest in companies offering solutions to environmental and/or social problems. Some of these funds would have exposure to fossil fuels because of their energy and utilities holdings that run renewable energy operations alongside their legacy fossil fuel businesses. There could be other reasons explaining this percentage. Note that green bond funds are not captured in this 19% because bonds are not included in our analysis (green bond issuers, especially in the utilities sector, may have fossil involvement).

We also found that out of our 1,600-plus fund universe, 354 (21%) are passively managed, holding almost USD 19 billion (45%) worth of stocks affected by the exclusion rules. The disproportionately larger stock-holding value for passive funds can be partly explained by the fact that many passive funds have a high number of holdings and large assets under management. We expect some passive funds (likely those with an environmental focus and the SRI best-in-class type) to change underlying indexes and align with the PAB exclusion rule so they can keep their ESG-related terms. However, many light green types of passive funds (ESG-screened, for example) will likely drop their ESG-related terms.

Exhibit 14 Funds in Our 1,600 Fund Universe Split Into SFDR Status and Active/Passive Management Style



Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024. The potentially affected funds are the 1,600 mentioned earlier that hold at least one stock potentially in breach of PAB/CTB exclusions.

The table below shows the funds with the highest number of holdings potentially in breach with PAB/CTB exclusion rules, as interpreted by Morningstar Sustainalytics.

Exhibit 15 Funds in Our 1,600 Fund Universe Holding the Highest Number of Companies Potentially in Breach With PAB/CTB Exclusion Rules

Fund Name	Number of PAB/CTB Exclusion Stocks Held	% Weight of PAB/CTB Exclusion Stocks in Portfolio	Market Value of PAB/CTB Exclusion Stocks in Portfolio (USD, Mil)	Active/ Passive
Vanguard SRI FTSE Developed II (B) World Common Contractual Fund	131	8.3	184	Passive
Vanguard SRI FTSE Developed World II Common Contractual Fund	128	8.2	85	Passive
State Street World ESG Screened Index Equity Fund	126	9.4	505	Passive
State Street World ESG Index Equity Fund	126	9.4	278	Passive
State Street CCF World ESG Screened Index Equity Fund	109	8.0	54	Passive
Xtrackers MSCI AC World ESG Screened ETF	108	6.7	280	Passive
UBS MSCI ACWI ESG Universal Low Carbon Select ETF	107	6.5	237	Passive
BankInvest BIX Globale Aktier ESG Universal KL	102	7.7	75	Passive
Northern Trust World Custom ESG Equity Index Fund	100	7.8	227	Passive
Dimensional World Sustainability Equity Fund	100	3.2	4	Active
Northern Trust World Custom ESG Equity Index Fund	98	7.8	956	Passive
iShares MSCI EM IMI ESG Screened ETF	97	11.1	403	Passive
OpenWorld plc - Russell Investments Global Low Carbon Equity Fund	97	7.7	5	Active
Invesco MSCI World ESG Universal Screened ETF	87	5.3	8	Passive
State Street Emerging Markets ESG Screened Index Equity Fund	84	8.3	6	Passive
Northern Trust FGR Fund - Emerging Markets Custom ESG Equity Index Fund	82	12.7	734	Passive
Northern Trust Emerging Markets Custom ESG Equity Index Fund	81	12.8	298	Passive
iShares MSCI World ESG Screened ETF	73	5.9	180	Passive
Xtrackers MSCI Emerging Markets ESG Screened ETF	71	12.8	7	Passive
UBS (CH) Institutional Fund - Equities Global ESG Screened Passive II I-X	70	6.1	29	Passive

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024.

Not surprisingly, given their typically large portfolios (in terms of number of holdings), many passive funds feature at the top of the list of funds that will be the most affected by the exclusion rules. Most are also ESG-screened strategies. We expect these funds to drop the term "ESG" and flag their screening approach by keeping (or adding) the term "screened" in their names.

When looking at our universe of 1,600-plus funds ranked by market value in stocks potentially in breach of the exclusion rules (exhibit below), we continue to see many passive funds, again because they tend to have a high number of holdings, but also many have gathered significant assets in recent years. The active open-end funds in this table (so excluding the JPMorgan active ETFs) have fewer than a handful of stocks potentially in breach of the exclusion rules. It is fair to expect that these will keep their names.

Exhibit 16 Funds in Our 1,600 Fund Universe With the Highest Market Value in Companies Potentially in Breach With PAB/CTB Exclusion Rules

Fund Name	Number of PAB/CTB Exclusion Stocks Held	% Weight of PAB/CTB Exclusion Stocks in Portfolio	Market Value of PAB/CTB Exclusion Stocks in Portfolio (USD, Mil)	Active/ Passive
Northern Trust World Custom ESG Equity Index Fund	98	7.8	956	Passive
Northern Trust FGR - Emerging Markets Custom ESG Equity Index Fund	82	12.7	734	Passive
BlackRock Solutions Funds ICAV - Coutts UK ESG Insights Equity Fund	2	13.0	715	Active
Mercer Passive Climate Transition Listed Infrastructure CCF	29	31.5	635	Passive
JPMorgan US Research Enhanced Index Equity (ESG) ETF	21	8.1	560	Active
iShares MSCI World SRI ETF	26	5.3	535	Passive
State Street World ESG Screened Index Equity Fund	126	9.4	505	Passive
Credit Suisse Equity Emerging Markets ESG Blue	3	11.4	484	Passive
JPMorgan Global Research Enhanced Index Equity (ESG) ETF	65	8.4	415	Active
iShares MSCI USA SRI ETF	12	5.9	405	Passive
iShares MSCI EM IMI ESG Screened ETF	97	11.1	403	Passive
UniNachhaltig Aktien Global	4	6.5	389	Active
iShares MSCI USA ESG Screened ETF	24	4.9	384	Passive
Amundi Funds - Global Ecology ESG	4	8.2	360	Active
Amundi S&P Global Energy Carbon Reduced ETF	22	99.8	319	Passive
Northern Trust Emerging Markets Custom ESG Equity Index Fund	81	12.8	298	Passive
Xtrackers MSCI AC World ESG Screened ETF	108	6.7	280	Passive
SSGA Luxembourg SICAV - State Street World ESG Index Equity Fund	126	9.4	278	Passive
DWS ESG Akkumula	4	2.4	242	Active
UBS MSCI ACWI ESG Universal Low Carbon Select ETF	107	6.5	237	Passive

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024.

Finally, we look at the funds that have the highest aggregate weights in companies potentially in breach of PAB/CTB exclusion rules.

Exhibit 17 Funds in Our 1,600 Fund Universe With the Highest Portfolio Weight in Companies Potentially in Breach With PAB/CTB Exclusion Rules

Fund Name	Number of PAB/CTB Exclusion Stocks Held	% Weight of PAB/CTB Exclusion Stocks in Portfolio	Market Value of PAB/CTB Exclusion Stocks in Portfolio (USD, Mil)	Active/ Passive
Amundi S&P Global Energy Carbon Reduced ETF	22	99.8	319	Passive
Invesco S&P World Energy ESG ETF	31	98.6	2	Passive
iShares MSCI World Energy Sector ESG ETF	49	96.4	100	Passive
BNP Paribas Energie & Industrie Europe ISR	12	32.9	8	Active
Mercer Passive Climate Transition Listed Infrastructure CCF	29	31.5	635	Passive
Xtrackers MSCI Canada ESG Screened ETF	8	26.2	93	Passive
Amundi MSCI China ESG Leaders Extra ETF	6	24.4	120	Passive
Ethius Global Impact	4	24.3	3	Active
Hugau Rendement Responsable	6	24.1	1	Active
Goldman Sachs Global Environmental Transition Equity	10	24.1	14	Active
First Sentier Responsible Listed Infrastructure Fund	5	23.8	10	Active
Schroder International Selection Fund Sustainable Infrastructure	3	23.1	1	Active
Roche-Brune Europe Valeurs Responsables	11	23.0	9	Active
Credit Suisse Equity Canada ESG Blue	5	22.8	52	Passive
Alken Fund - Sustainable Europe	11	21.9	17	Active
BNP Paribas Easy MSCI China Select SRI S-Series 10% Capped	5	20.4	27	Passive
Myria Actions Durables France	5	19.7	40	Active
UniNachhaltig Aktien Infrastruktur	8	19.7	21	Active
UniInstitutional Aktien Infrastruktur Nachhaltig	8	19.6	55	Active
Stratégie France ISR	5	19.5	27	Active

Source: Morningstar Sustainalytics and Morningstar Direct. Data as of May 28, 2024.

At the top, we can see a few energy sector funds which employ an ESG screening or tilting approach. Also featuring in this table are country-focused funds providing exposure to Canada (heavy in oil and gas) and China (relatively high involvement in controversial sectors and activities). It is fair to expect many of these products to drop the terms associated with PAB exclusions.

Correction: On Pages 1, 10, and 11, Ecolab was removed from the Key Takeaways and from Exhibits 7 and 8 after we received 2023 coal-related revenues from the company (0.3%, which is below the 1% regulatory threshold. Sustainalytics had estimated 2022 revenues derived from coal-supporting products and services at 1%). We added two companies: Daikin Industries in Exhibit 7 and Albemarle Corp in Exhibit 8.

About Morningstar Sustainalytics

Morningstar Sustainalytics is a leading ESG research, ratings, and data firm that supports investors around the world with the development and implementation of responsible investment strategies. For 30 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Morningstar Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. The firm also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices, and capital projects. With 17 offices globally, Morningstar Sustainalytics has more than 1,800 staff members, including more than 800 research analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.