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Response to EFRAG draft EU Sustainability Reporting Standards

From Morningstar Inc. and Morningstar Sustainalytics

Submitted by email via EU survey

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Executive summary

Morningstar welcomes the opportunity to comment EFRAG's draft EU Sustainability Reporting Standards. Sustainable investing and understanding sustainable business practices are integral to Morningstar's mission of empowering investor success. In our response to the standards, we draw from our experience evaluating environmental, social, and governance, or ESG, risks associated with equity issuers and pooled funds as well as our status as a Nasdaq listed equity issuer. Through our Sustainalytics subsidiary, we track ESG data for individual companies and supply investors with ESG research and data, including the industry's first sustainability rating for funds, a global sustainable index family, and a large span of portfolio analytics that includes carbon metrics and product involvement data.

We welcome the progress made by EFRAG and acknowledge the considerable amount of work put in the draft proposals to capture all ESG issues in an exhaustive way. Our comments mainly relates to the general principles underpinning the standards and the specific ESG standards.

1. **General principles**: We support overall the main definitions and concepts but have strong reservations regarding the fact that all sector-agnostic disclosures requirements established by standards are presumed material. The extensive draft standards and conditions attached to the rebuttable presumption means that most likely a very large pool of regulatory information would have to be provided by all companies (potentially regardless of materiality judgement). Although we could benefit from an increased set of quantitative and qualitative information for our research and various solutions , we would like to highlight that this does not correspond to our materiality assessment (e.g. ESG Risk Rating) which is done at subindustry level. EFRAG needs to find the right balance between prescriptiveness and usability. While we certainly agree that some information may be material across sectors (e.g. corporate governance and climate-related), we believe that stakeholders would be better served by standardising sector-specific disclosures (based on SASB standards and these sector-agnostic standards), where most financial and impact materiality presumptions should be made. This would ease the materiality assessment, which would be particularly helpful for smaller issuers, and foster international convergence and compatibility of sustainability standards (i.e. ISSB draft standards).

2. **ESG standards**: We believe that the thematic ESG standards are overall sound and helpful. We note however that the standards do not always require to disclose plans for future Taxonomy alignment plans. This should be required consistently for each environmental standard (not just climate) and included either under the plan or risk/opportunities section. We also suggest considering that companies disclose, for their core activities, data according to technical screening criteria and information related to minimum safeguards and DNHS assessments (and not just the aggregated figure on Taxonomy alignment). We have also summarised below our main recommendations on selected ESG standards: Climate, Water, Biodiversity, Own work force, Value Chain worker, Affected communities, Governance and Business Conduct (see annex below).

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Annex: detailed comments on EFRAG draft EU Sustainability Reporting Standards

1. General principles

Materiality

- **Double materiality: While we believe that companies should focus on financial materiality, we also acknowledge that it does not respond to all the needs of investors**. Investors are indeed increasingly interested in sustainability issues which affect a broad range of stakeholders as these are likely to affect the enterprise value. There is a diversified pool of investors who seek to allocate capital to create measurable environmental and social impacts. Impact investors in particular may want to know the sustainability impact of a firm alongside financial materiality. Further, there is a growing retail investment market where individuals are being more inclined to think of ESG investing as a way to invest according to their personal values, rather than from a risk perspective. The focus on double materiality is also being driven by regulation. In 2023, asset managers in the EU will have to report on Principal Adverse Impacts indicators (PAIs) at the entity level. The EU SFDR also demands that a financial product seeking a sustainable investment does not harm significantly (DNHS) other sustainable objectives.
- **Financial materiality:** We consider an ESG issue to be financially material if its presence or absence in financial reporting is likely to influence the decisions made by a reasonable investor. To be considered relevant, an issue must have a potentially substantial impact on the economic value of a company and, hence, its financial risk- and return profile from an investment perspective. The use of financial materiality is indeed different as a concept from narrower legal or accounting-focused definitions. Not every issue we consider as material is legally required to be disclosed in company financial reporting. We also concur to say that financial materiality may be forward looking. We do consider some ESG issues as material from an ESG perspective even if the financial consequences are not fully measurable today.
- **Impact materiality:** From our perspective, impact is about shining a light on who or what is causing impacts, how much impact is created (positive or negative), and are those impacts aligned with global, regional, national, or even individual views about a sustainable world (eg SDGs). These impacts can be positive, negative, or often they are positive in some areas while negative in others. The standard should therefore more explicitly recognise that there are also positive and not just negative impacts. "A sustainability matter is material from an impact perspective if it is connected to actual or potential significant ***positive or negative*** impacts by the undertaking on people or the environment over the short-, medium- or long-term."
- **While we agree that Impact materiality and Financial materiality could be considered separately, the two may overlap:** the first step of our financial materiality assessment is always an impact assessment and some ESG issues as financially material from an ESG perspective even if the financial consequences are not fully measurable today.
- **Rebuttable presumption:** We do not agree that all mandatory disclosure requirements established by ESRS should be presumed material. We believe standardising sector-specific disclosures where most materiality presumptions would be made should be the main priority under EFRAG standards. This would help issuers prioritise most valuable disclosures.

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Sector-specific vs sector-agnostic materiality judgement

- **According to the draft standard all sector-agnostic disclosures requirements established by ESRS are presumed material.** This extensive proposal and conditions attached to the rebuttable presumption means that most likely a very large pool of regulatory information would to be provided by all companies. Although we would certainly benefit from a large set of quantitative and qualitative information for our research and various solutions offered, we would like to highlight that this is not how we perform our materiality assessment in the context of our flagship product which our ESG Risk Rating solution and that as result some information may not be factored in. Although we have identified 20 material ESG issues across sectors, the assessment of these material ESG issues starts at the subindustry level. The differentiation between subindustries occurs via the assessment of the issues' materiality for each subindustry. We then determined the exposure of a given company that operate in a given subindustry by factoring its specific profile (e.g. company-specific deviations from the subindustry norm).That being said, we do believe that poor corporate governance poses material risks for all companies/sectors.
- **So while we recognise that some information is material across sectors, we believe that standardising sector-specific disclosures where most materiality presumptions would be made should be the main priority under EFRAG standards**. This would help issuers prioritise most valuable disclosures. Issuers could also provide a rationale supporting their materiality judgment supporting disclosures on top of mandatory EFRAG sector-specific disclosures.
- **While we understand the need to close the regulatory data gap (e.g. SFDR and MiFID sustainability preferences),** SFDR PAIs are not sector specific and therefore not always material nor applicable to all issuers. It would better to acknowledge that the SFDR PAIs should be reported by issuers so that investors to meet their own regulatory requirements, not because this information is presumed material.

Governance

We support governance-related provisions (allocation of responsibilities and reporting lines, incentive schemes) incentivising executives accountability towards meeting targets within all thematic areas (including water, climate, biodiversity etc.).

2. **Specific standards**

Environmental standards

We believe the sustainability standards should further leverage the EU Taxonomy which is activity/sector-based. We note for instance that standards do not always require to disclose plans for future Taxonomy alignment plans. This should be required consistently for each environmental standard (not just climate) and included either under the plan or risk/opportunities section. We also suggest considering that companies disclose, for their core activities, data according to technical screening criteria and information related to minimum safeguards and DNHS assessments (and not just the aggregated figure on Taxonomy alignment).

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<u>Climate standard</u>

We broadly support the climate standard which is comprehensive and would like to share the following comments:

- **Focus on transition plan**: We want to stress the importance of disclosure related to companies' preparedness and execution of climate transition plans. From our perspective, it's crucial to understand the financial resilience (i.e. the ability to sustain needed transition investments in the event of economic downturns) and progress made on an annual basis on the execution of climate transition plans according to international/European goals (limiting global warming to 1.5 °C and carbon neutrality by 2050. It is encouraged that reports such as Capital Markets Day Presentations or disclosed Medium Term Plans integrate these considerations directly in forecasts or projections.
- **Financial connectivity:** Linking cost estimates to material actions, e.g. as represented in the graph under AG 30, is encourage where possible. Disclosure of decommissioning costs and impairments is encouraged, as well as information of potential pollution risks during the decommissioning process under ESRS-2, if relevant. Disclosure is furthermore encouraged on actions being taken to address transition and physical risks and opportunities, ideally in quantitative terms, including disclosure of material past physical risk events and costs.
- **GHG emissions:** It would be helpful if the company references the protocol or process by which GHG emissions are calculated, and how organizational boundaries have been applied, including for 50%-50% joint ventures. We recognize that scope 3 disclosure is still in progress, it would be helpful to have disclosure on those upstream and downstream categories that are material, based on all the 15 GHG Protocol categories.
- **Targets:** Discussion is encouraged on both absolute emissions and emissions intensity level, even if targets are not set for both. Expansion plans could potentially outpace gains from emissions intensity reductions, while economic contractions could falsely signal absolute reduction emissions, while disguising a lack of progress in managing emissions intensity.
- **Other impacts on climate change**: Clarification is also requested on potential disclosure of other impacts on climate change (e.g., from land use changes, black carbon, tropospheric ozone etc.), which EFRAG indicates are not addressed by this draft Standard but should be included as part of the assessment of material climate change impacts.

<u>Water and marine resources</u>

We broadly support the water and marine resources standard and have identified several areas that could be improved:

- **Scope**: The standard should broaden the scope of water risks. It should go beyond physical risks (such as water scarcity) and address contextual water risks consistently throughout. The standard should take full account of all water-related physical (supply, discharge, quality and quantity), regulatory (water use restrictions, tighter pollution controls) and reputational (stakeholder perceptions on company water uses and impacts) risks. This is in order to ensure that companies move from internal risk management practices to addressing shared challenges and opportunities in the surrounding catchment which is where most water risk "lives**.**"
- **Supply-chain**:
  - We note the standard does not address supply-chain related disclosure on marine resources, which we identify as a gap.
  - We believe that the standard should be more comprehensive and clear about supply-chain related (fresh)water risk assessment and management practices and disclosure. Supply-chain risks are more applicable to generate material risks and impacts by some industries than others (such as within Textiles and Apparel, Food and Agriculture, or metals and mining).

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- **Standardisation**: For consistency reasons and in order to reduce disclosure burden, we encourage that the EFRAG standard aims to be consistent with other disclosure standards such as GRI, SASB, CDP, and the CDSB Water Application Guidance. For example, disclosure on operations-related water management and the sourcing of water is recommended to follow GRI 303 as that entails all sources and types of water use that multiple companies already follow.
- **Metrics**: While disclosure must already improve at entity level, we also recommend, when possible and relevant, asset level disclosure of withdrawal and consumption in high water stress areas (regarding number and location of key assets). Disclosure on wastewater should be also linked to highly sensitive biodiversity hotspot areas at both entity and the asset level. This would also have positive spillovers for other objectives such as climate.

Biodiversity

We broadly support the biodiversity standard and have identified several areas that could be improved:

- **Scope and definitions:**
  - We suggest enlarging the scope to include impact on 'agrobiodiversity' and 'fungi and protists' to fully captures risks on biodiversity.
  - We suggest clarifying the term 'biodiversity friendly production' which is too vague.
  - It is not always clear how raw materials should be understood in relation to the required disclosures. Consider whether the term can be replaced with 'raw materials and sourced commodities' or similar. Given a company's placement within the supply chain, it may source very little 'raw materials' but rather commodities that also have significant impacts and dependencies on biodiversity.
  - The current standard may not allow to capture impact of beef cattle which contributes heavily to biodiversity loss
- **Targets:** To our understanding the targets/strategies do not reflect the Post-2020 Global Biodiversity framework but rather Global Goal for Nature. It should be made clear that the strategies/targets are from the Global Goal for Nature and not the Post-2020 Global Biodiversity Framework.
- **Biodiversity no net loss or biodiversity no net gain**: we believe mitigation efforts must be in the same geographical area and targeting the same ecosystems and species which are negatively impacted by the project.
- **Metrics**: We recommend adding a few more useful metrics as part of the application guidance:
  - High Conservative Value areas (AG 15)
  - Beyond geographical location of the sites impacting biodiversity the % of the business that sites represent is key (AG 26)
  - The location and type of activities of sourced/produced raw material are also key (AG 28).
  - Distinction between company-wide and local action plan would be helpful (AG 45)

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Own work force

We broadly support the own work force standard and have identified suggestions to improve the standard:

- **Characteristics of the Undertaking's Employees**: we suggest adding the following metrics (paragraph 51): Hiring rates, Turnover rates, Promotion rates. All the metrics should be disclosed by d gender and age.
- **Training and Skills Development indicators**: it would be helpful to have a narrative explaining to what extent the trainings are effective and a skill gap assessments to upgrade own workers' skills and ensure employability (paragraph 56). It's also important to disclose this information by gender and age (paragraph 57).
- **Mental health** aspects should be captured under coverage and performance of the health and safety management system. One KPI could be added to capture this (paragraph 63): absenteeism rates due to mental health.
- **Work-life balance indicators**: We suggest considering sick care leave as part of work-life balance.
- **Fair remuneration and living wage**: It is important to provide a definition of fair remuneration (article 23 - Universal declaration of Human Rights) and of a living wage (Home - Global Living Wage Coalition or OECD Guidelines for MNE - 48004323.pdf (oecd.org) p. 38: " When multinational enterprises operate in developing countries, where comparable employers may not exist, provide the best possible wages, benefits and conditions of work, within the framework of government policies. These should be related to the economic position of the enterprise, but should be at least adequate to satisfy the basic needs of the workers and their families.").
- **Equal opportunities**: we suggest considering disclosure on strategies and programs to increase diversity across the business and ensure equal opportunities to employees.

Workers in the value chain

We broadly support the own work force standard and have identified suggestions to improve the standard:

- **Scope of disclosures**: Companies can be allowed a couple years to cascade to full value chain, but at least Tier 1 and 2 suppliers should be applied. Ultimately, disclosures similar than the owns required under the workforce standard would be helpful for value chain workers.
- **Living wage**: As mentioned before it would good to introduce the definition of living wage.
- **Policies related to value chain workers**: all core ILO conventions should be assessed and mentioned in the HR policy of the company. Regarding paragraph 17, we want to highlight that is very unlikely that a company with global supply chains have no risk on value chain workers.
- **Channels for value chain workers to raise concerns** : Regarding paragraph 24, the company should explain how it can prove the effectiveness of such grievance systems against clear criteria. For instance, the UN Guiding Principles on Business and Human Rights (UNGPs) spell out eight criteria for effective grievance mechanisms: Legitimate, Accessible, Predictable, Equitable, Transparent, Right-compatible, A source of continuous learning, Based on engagement and dialogue.

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Affected communities

We broadly support the affected communities standard and have identified suggestions to improve the standard:

- **Objective:** we suggest adding a reference to impact on access to land (this is particularly relevant for companies in the agricultural business, that operate in areas where land grabbing or limiting land access to local communities is an issue).
- **Metrics:** we suggesting adding a mandatory disclosure with regards to companies with operations (or value chain) in protected indigenous areas.

Governance

We broadly support the governance standard and have identified suggestions to improve the standard:

- **Governance Structure and Composition:**
  - Consider requiring companies to disclose the responsibilities of key members of the Board e.g. the Chairman and CEO's responsibilities. This is particularly useful when a company has a "non-standard" structure or uses different nomenclature.
  - Clarify that representation of "stakeholder groups" presumably includes disclosure of whether directors are representatives of specific shareholders. Including highlighting any deviation from the basic principle of all directors being elected by all shareholders.
- **Nomination Process**: Encourage the use of a "Board Skills Matrix" - an overview of the collective set of skills that the Board considers to be needed to fulfill its responsibilities and how each Director aligns to these requirements. This would also highlight and gaps that the company could or should aim to fill as part of the Nomination Process.
- **Remuneration Policy**: The requirements appear to focus on the oversight of the remuneration policy rather than disclosure of the content. Specifically, we would like to see disclosures that increase transparency around how remuneration is calculated i.e., the targets that have been set and the weighting of each element that contributes to the final figure. Including whether the company has ESG targets that are considered as part of the assessment.
- **Ownership & Shareholder Rights**: consider requiring companies to assess and disclose potential risks for minority investors resulting from either company specifics (e.g. deviations from one share one vote or the existence of anti-takeover mechanisms) or thematic market requirements that benefit certain shareholders.
- **Stakeholder Governance**: consider requiring companies to disclose the actions that the Board has taken to ensure that the company is appropriately considering the needs of stakeholders beyond the shareholder.

Business conduct

The Business conduct standard is overall comprehensive and will enrich our analysis. We have identified a few suggestions to improve the standard:

- **Anti-bribery and corruption**: We recommend defining terms such as bribery, corruption, conflicts of interest and facilitation payments in a way that is explicit as well as readily available within a company. The standard could also consider the following disclosure items either in the standard or application guidance:

- Regular formal corruption risk assessment or an overall risk assessment that includes corruption factors, pre-screening mechanisms for agents and business partners that address bribery and corruption, etc.
- Operating guidelines addressing record keeping, approval procedures and appropriate behaviour
- Annual signoff of the policy on bribery and corruption by employees

- **Mechanisms for employees to consult on ethical issues:** The standard could also suggest to disclose if the company has established an Ethical Committee, Ethics Officer or ethics hotline that can be consulted by employees in case of dilemmas.
- **Whistle-blower programmes**: there are a few avenues for further strengthening the standard by including clauses that touch upon :
- Whistleblowing tools are proactively communicated to employees: The programme is communicated to employees through training sessions, regular signing of the code of conduct, intranet, posters, etc.
- Whistleblowing tools are available to suppliers, customers and other third parties
- Availability of an independent, reporting hotline, 24/7: The company has a 24 hours a day, seven days a week hotline that is operated by a third party.
- **Governance structures** the standard can be further strengthened by including clauses that touch upon:
- Ethical risk assessments: The company assesses its exposure to ethical risks before starting new operations, entering a joint venture, acquiring a company, etc.
- Operating guidelines: Written protocols to support employees with the implementation of the Code of Conduct.
- Measures to deter non-compliance and reduce exposure to unethical opportunities: E.g., Measures to reduce conflict of interests by sharing information internally on a need-to-know basis, implementing Firewalls or Chinese Walls (for financials), pre-screening employees for ethical conduct.

**

Should you wish to discuss these and other comments, please do not hesitate to contact either of us as indicated below:

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Sincerely,

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