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Qontigo's SFDR Article 2 (17) Sustainable Investment Methodology

QONTIGO

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1. Introduction

This document presents Qontigo's methodology for reporting the sustainable investment percentage ("SI %") of its indices in line with the EU's Sustainable Finance Disclosures Regulation (SFDR) requirements ("sustainable investment methodology" or "SI methodology").

This document highlights some key elements of context to understand how the concept of Sustainable Investment is being considered under the European regulation. It contains an overview of Qontigo's methodological approach and a more detailed presentation of the individual steps within it and too shows how portfolio aggregation of the SI % is calculated.

2. Definition of sustainable investment & regulatory guidelines

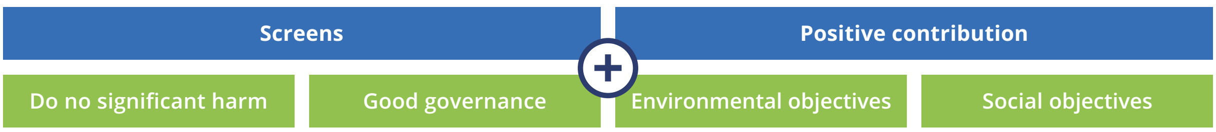
Article 2 (17) of the SFDR[1] defines sustainable investment as follows:

"'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance".

While the definition provides clear guiding principles (mentioned below), it does not set specific criteria underpinning the assessment. An investee company can only qualify as a sustainable investment if:

1. It follows good governance practices
2. It does no significant harm to environmental and social objectives
3. Investee companies deliver a positive contribution in one or both of the following ways:
    a. By investing in an economic activity that contributes to environmental objectives
    b. By investing in an economic activity that contributes to social objectives

Figure 1: Key building blocks for defining sustainable investment.



Source: Qontigo.

[1] Official Journal of the European Union, Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, Article 2(17).

Additionally, Article 2 (17) of the SFDR defines sustainable investment as an investment in social integration, human capital or socially disadvantaged communities.

This document shows how Qontigo has identified pragmatic solutions within this overarching framework that allow investments to be classified as sustainable or not. This methodology was developed using a "best efforts" approach, taking the following facts into account:

- The SFDR does not provide any clear indications on measurement metrics. Whereas this allows for flexibility, different stakeholders may have diverging views, depending on their own sustainability preferences.
- Data availability remains a constraining factor when it comes to implementing specific criteria and is temporarily limiting the operational viability of the target methodology. Phased implementation is therefore required, while proxies may be needed during the transition period until satisfactory data reporting at the corporate level is guaranteed.
- Regulatory uncertainties still exist in relation to major components of the methodology (see below).

In view of the above, Qontigo will periodically review its methodology and adapt it to reflect the latest regulatory developments, data availability and market practices.

2.1. Regulatory uncertainties

Several uncertainties regarding implementation of the EU SFDR's definition of sustainable investment were flagged by the European Supervisory Authorities (ESAs) in their letter to the European Commission dated September 9, 2022[2]. These include the following:

- Should a company be considered to be a "sustainable investment" as a whole (binary approach, i.e., 0% or 100% based on a particular threshold of sustainable economic activity that qualifies it as such) or in part (i.e., reflecting the exact share of its economic activity that can be considered as is sustainable)?
- Can transition plans be considered beyond actual performance metrics?

On April 14, 2023, the EU Commission published the answers to those questions stating the "SFDR does not set out minimum requirements that qualify concepts such as contribution, do no significant harm, or good governance, i.e. the key parameters of a 'sustainable investment'. Financial market participants must carry out their own assessment for each investment and disclose their underlying assumptions".

Regarding transition plans we can read that "investments considered as 'sustainable investment' under Article 2, point (17) SFDR shall not significantly harm any of the objectives referred to in that Article. Therefore, referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient".

While these responses put the onus back on Investment Managers to determine the thresholds to be adopted, they also hint at the possibility that certain rules may become more restrictive.

It is therefore our task, at Qontigo, to use the most selective criteria in interpreting the rules, to remain as faithful as possible to the spirit of the SFDR, and to monitor legislative developments in the field.

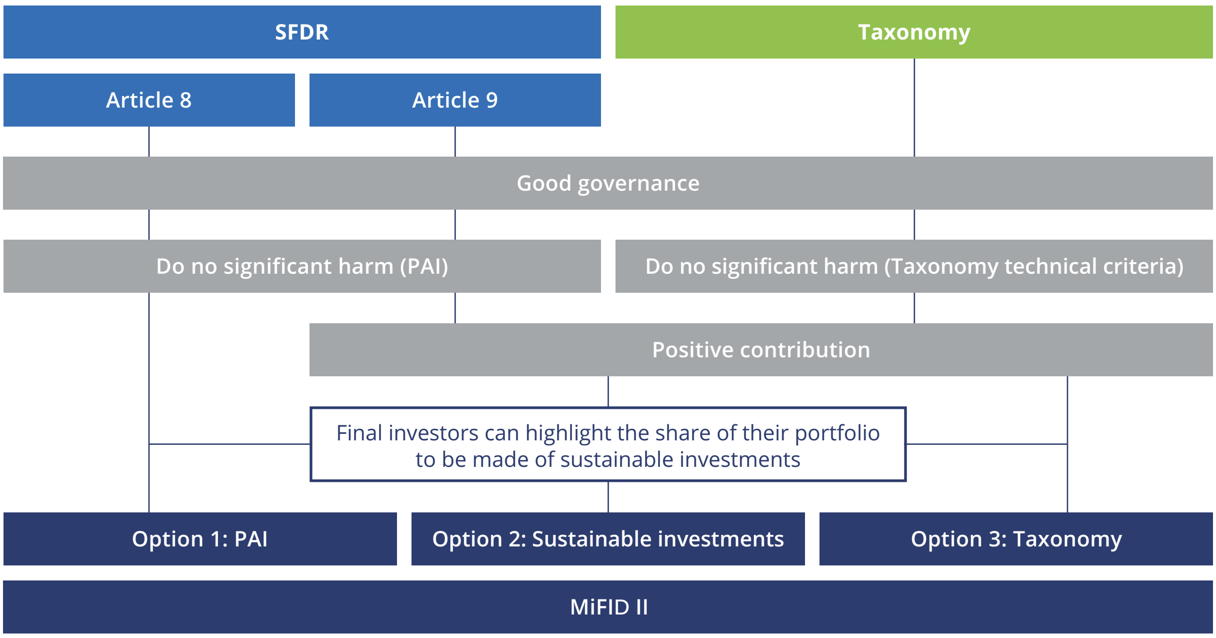
[2] List of additional SFDR queries requiring the interpretation of Union law, JC 2022 47.

2.2. A cornerstone of the EU's sustainable finance framework

Sustainable investment as defined in the SFDR is a cornerstone of the EU's sustainable finance regulatory agenda:

- It determines the eligibility of securities to be included in Article 9 products under SFDR: "A financial product to which Article 9(1), (2) or (3) of Regulation (EU) 2019/2088 applies may invest in a wide range of underlying assets, provided these underlying assets qualify as 'sustainable investments', as defined in point 17 of Article 2[3]"
- It entails a concept of good governance that is part of the exclusion base layer for Articles 8 and 9 of the SFDR
- It overlaps with the Taxonomy under development (see below; positive contribution: product and service revenues)
- It represents one of the three ways in which end investors can express their sustainability preferences under MIFID 2,[4] alongside the EU Taxonomy and the Principle Adverse Impact (PAI) indicators also provided for in the SFDR[5]

Figure 2: Common requirements under SFDR, MiFID II and the EU Taxonomy.



Source: Qontigo.

[3] Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088).

[4] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021, amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

[5] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088; Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

2.3. Overview of Qontigo's sustainable investment methodology

Qontigo used the following guiding principles when developing the sustainable investment (SI) methodology presented in this document:

Consistency with the existing reference frameworks for the EU's SI regulations:
- The DNSH screening layer should be based as far as possible on the PAIs and should be aligned with the Taxonomy's minimum safeguards.
- The assessment of any positive contribution should be based on revenue alignment with the Taxonomy and should accommodate further developments to the latter, provided that the data reported by companies permits sufficient coverage and consistent relative performance assessment.
- Since the Taxonomy's perimeter is still expanding to include more economic activities, positive contributions made by investee companies may fall outside of its scope. An alternative approach is therefore developed to account for positive contributions, such as those made to the United Nations' Sustainable Development Goals (SDG)[6],

Specificity, so as to reflect the current recommendations in the SFDR as far as possible:
- Specific metrics should be sought to account for the four dimensions of good governance – management structures, employee relations, staff remuneration and tax compliance – to the extent that data availability permits sufficient coverage.
- Since some sustainability objectives (e.g., gender equality, human rights and biodiversity) cannot be attained simply through products and services, the definition of sustainable investment used should also allow for operating performance once the European Commission has provided clear guidance on how to implement such an approach.[7]

Integrity, to avoid any risk of greenwashing:
- In line with the methodological approach used in the Taxonomy, a comparable assessment of revenue contributions to environmental and social objectives would ideally reflect the share of revenue aligned. However, the SFDR requires that Article 9 products should invest exclusively in underlying assets that qualify as sustainable investments. Such a target can only be reached if the sustainable investment classification used has a binary basis, with 100% of the activity of a company being classified as sustainable if a given threshold of revenues generating positive contributions is exceeded.
- Similarly, when accounting for operational performance a non-binary metric should be implemented to support granular assessment of investee companies.

Cohesiveness across all indices:
- Classification of securities as sustainable investments should be consistent across all Qontigo products (uniform methodology). Qualification as a sustainable investment is a reporting attribute, and must be distinguished from SI metrics that could potentially be used in index design and for which specific reporting is needed (to be supplied by the data provider for the specific index in question).

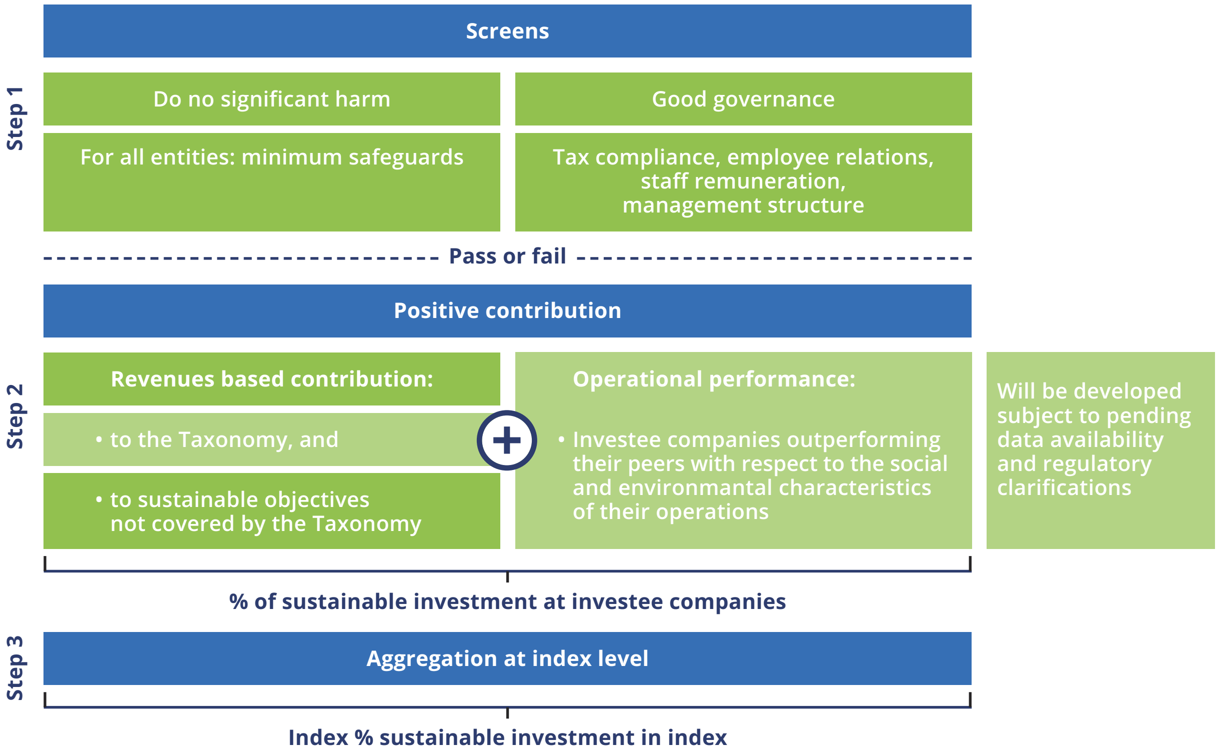
Flexibility, to account for different approaches and evolving regulation:
- Qontigo acknowledges that its clients may have different views on this issue and will make every effort to enable them to assess its products based on their own definition of sustainable investment as long as it is consistent with the SFDR spirit.
- Some indices may be designed with a specific approach to sustainable investment; for example, they might leverage sustainability data from a given provider. In addition to its measurement of sustainable investment across all its products using the same data provider for uniformity, Qontigo will facilitate specific measurement using the data embedded in these indices, if this should differ.
- Since the regulatory framework is evolving, Qontigo commits to adjusting its definition of sustainable investment in a timely manner while taking market feedback into consideration.

[6] Sustainable Development Goals – the United Nations

[7] See the requests for clarification by the ESAs to the European Commission mentioned earlier.

2.4. Framework methodology overview

Figure 3: Qontigo's sustainable investment measurement framework.



Source: Qontigo.

This methodological framework is based on the following fundamental choices, which aim to maximize robustness in an evolving context:

Implementation of a conservative approach towards interpreting the regulation and no anticipation of regulatory clarifications/developments

- With respect to regulatory confusion, a binary SI % measurement using a 20% sustainable revenue alignment threshold at the company level will be implemented while waiting for further clarification
- Similarly, measurement of the positive contribution through investee companies' social and environmental operational outperformance will only be implemented in a future version.

Adoption of an approach that is supported by the greatest data coverage currently available

- Use of the Taxonomy as the prime reference framework to measure SI % will only be implemented in an updated version, once sufficient reporting by corporations becomes available.
- The positive contribution will be measured using the Sustainable Development Goals framework until the Taxonomy is fully developed.

3. Detailed methodology

The following sections describe in detail the individual steps in Qontigo's SI % measurement methodology, as shown in the overview chart on page 7 (Figure 3).

3.1. Screening pillar: do no significant harm

Latest regulatory context[8]: the principle of "do no significant harm" (DNSH) is a key component of the SFDR. It is linked to the disclosures of the Principal Adverse Impacts (PAIs) on sustainability factors of investment decisions:

- Financial product disclosures relating to the DNSH principle should explain how the adverse impact indicators have been taken into account.
- What is more, as these disclosures are closely linked to Regulation (EU) 2020/852 of the European Parliament and of the Council, it makes sense to require additional information on the alignment of investments with the minimum safeguards set out in that regulation.
- In the case of financial products making sustainable investments, Chapter III Article 22 of the Taxonomy Regulation also lays down requirements regarding compliance with the DNSH principle set out in Article 2(17) of the SFDR. Information must be provided on whether investments are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, plus the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organization on Fundamental Principles and Rights at Work and the International Bill of Human Rights. The objective of these requirements is to bring DNSH disclosures under Article 2(17) of the SFDR into line with the minimum safeguards set out in Article 18 of the Taxonomy Regulation.

Based on these current regulatory requirements, Qontigo has adopted the following criteria and approach for the DNSH step of its methodology:

- Screening of all investee companies for involvement in the manufacture or selling of controversial weapons, in line with PAI 14,[9]. Companies which derive >0% of revenues from controversial weapons are excluded from the "sustainable investment" percentage calculation.
- Screening for PAI 10 breaches: companies in breach of UN Global Compact standards and/or involved in the highest level of controversies.
- Excluding companies that derive more than 5% of their revenue from tobacco production and distribution and thermal coal extraction and power generation.
- Monitoring evolution of data coverage for PAI 11[10] to permit its future inclusion, since data availability currently appears to be low (less than 20% of the STOXX TMI for the main data providers assessed).
- As part of its DNSH screen for SI % calculation, and in line with the vote by the European Parliament,[11] Qontigo does not exclude companies generating revenues in the nuclear and natural gas sectors. These companies are eligible under the EU Taxonomy. However, Qontigo acknowledges that some investors may have different views on this topic[12] and undertakes to support them in calculating the SI % according to their preferences.

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[8] EC Delegated Regulation (April 2022).

[9] PAI 14 is measured as exposure to controversial weapons (antipersonnel mines, cluster munitions, chemical weapons and biological weapons).

[10] PAI 11 is measured as a lack of processes and compliance mechanisms to monitor compliance with the principles of the UN Global Compact and the OECD Guidelines for Multinational Enterprises.

[11] https://ec.europa.eu/commission/presscorner/detail/en/ip_22_4349.

[12] For example, UZ 49 – the Austrian eco label – excludes companies involved in the nuclear sector.

3.2. Screening pillar: good governance

Latest regulatory context[13]: good governance is defined in Regulation (EU) 2019/2088 (the SFDR). Article 8 specifies that the assessment of good governance practices forms an integral part of financial products that promote environmental or social characteristics, or that have sustainable investment as their objective. Therefore, financial market participants that make financial products promoting environmental or social characteristics available, or that have a sustainable investment objective, must disclose information on their policies for assessing good governance practices at investee companies. Good governance practices at investee companies must be assessed across four dimensions: sound management structures, employee relations, staff remuneration and tax compliance.

Based on these current regulatory requirements, Qontigo has adopted the following criteria and approach:

- Qontigo screens all investee companies for violations of the principles of the UN Global Compact (UNGC) and the OECD Guidelines for Multinational Enterprises (MNE Guidelines), in line with PAI 10[14]. Different aspects of the UNGC and the MNE Guidelines adequately cover the four dimensions of good governance specified in the SFDR.
- Companies with no very serious controversies relating to good governance practices (topics covered include bribery, accounting, anti-competitive behavior, money laundering, child labor, forced labor, violation of union rights, workplace discrimination, workplace standards, taxes) are considered to have good governance practices.
- Qontigo will regularly monitor the evolution of the data available to qualify companies' performance in the four dimensions of good governance, so as to aid the future evolution of its methodology. Our research led to the conclusion that insufficient data is available at this stage to permit consistent implementation across our index universe.

3.3. Positive contribution: product and service revenues

Qontigo's recent research shows that only 1% of companies in its Total Market Index (STOXX TMI) have a Taxonomy alignment percentage of more than 10%. This finding is corroborated by the results of similar studies undertaken by the European Union's Platform on Sustainable Finance (0.6% out of 12,000 companies). These very low figures can be explained by the facts that (i) the Taxonomy framework is not fully available yet[15] and (ii) the number of companies fully reporting their alignment with the Taxonomy is currently still very limited.

This being the case, Qontigo has adopted the following approach to measuring the positive contribution made by investee companies:

- Qontigo defines sustainable investment companies as companies deriving at least 20% of their revenues from products and services that make a net positive contribution to the SDGs (binary approach). According to the ISS SDG Solutions Assessment, 12% of companies in the STOXX TMI have at least 20% of revenues aligned with the SDGs. The SDGs are a well-established normative framework against which investors and data providers can measure the share of revenues making a positive contribution.

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[13] EC Delegated Regulation (April 2022).

[14] PAI 10 is measured using violations of the principles of the UN Global Compact and the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

[15] Only two out of six environmental objectives and none of the social objectives are available.

– Qontigo will continue to explore the use of specific environmental and social metrics and KPIs from various data providers to complement its SFDR reporting and provide investors with additional information on individual products' sustainability performance in the context of their distinct environmental and social goals.

3.4. Aggregation methodology at index level

Qontigo uses a market value-weighted approach to aggregate the SI % (positive contribution) at portfolio level. We think this methodology is the most robust approach and properly reflects the actual aggregated positive contribution, since it is aligned with the regulatory recommendation for measuring Taxonomy alignment at portfolio level (see the formula below).

Figure 4: Aggregation formula for Taxonomy alignment at portfolio level.

Article 16b
Calcutation of the taxonomy alignment of investments

1. The taxonomy alignment of investments shall be calculated in accordance with the following formula:

$$\frac{\textit{market value of all taxonomy-aligned investments of the financial product}}{\textit{market value of all investments of the financial product}}$$

where "taxonomy-aligned investments of the financial product" shall be the sum of the market values of the following investments of the financial product:

(a) for debt securities and equities of investee companies, where a proportion of activities of those investee companies is associated with Taxonomy-aligned economic activities, the market value of that proportion of those debt securities or equities;

Source: SFDR Final Report on draft Regulatory Technical Standards, October 2021.

3.5. Future developments

Qontigo is committed to updating its methodology as the regulatory environment develops and more data becomes available, with a view to implementing the desired framework presented in the overview section above. The following additional methodological developments will be considered for implementation as soon as the required feasibility conditions are met:

3.5.1. Do no significant harm

As data coverage improves, driven by the new Corporate Sustainability Due Diligence Directive (CSDDD), adopted by EC in February 2022, Qontigo will continue to investigate additional indicators from a number of data providers to assess companies against the DNSH principle. Specifically, Qontigo will seek to add PAI 11 (which relates to due diligence processes for monitoring compliance with the UNGC and the MNE

Guidelines) to its DNSH requirements, in line with the recommendations by the Platform on Sustainable Finance. Currently, data coverage for the largest reference universe (i.e., the Total Market Index) appears to be too low for this, with only 50% of constituents being assessed by the main data providers.

3.5.2. Good governance

Qontigo will continue to investigate the use of specific ESG scores from various data providers with a view to using more granular social and governance metrics to assess investee companies' performance on the four dimensions highlighted by the regulation: tax compliance, employee relations, sound management structures and staff remuneration. Companies will be expected to meet the minimum requirements reflected in this "governance practices" score. This "governance practices" score could be based on the ISS Good Governance Practice indicator.[16]

Currently, the data coverage for the largest reference universe (i.e., the Total Market Index) appears to be too low, with only 50% of constituents being assessed by the main data providers. As data coverage improves in response to the new Corporate Sustainability Reporting Directive (CSRD) expected to apply from 2025, Qontigo will exclude companies with poor governance practices from its Article 8 and Article 9 products, and from the reporting of their sustainable investment percentage.

3.5.3. Positive contribution: product and service revenues

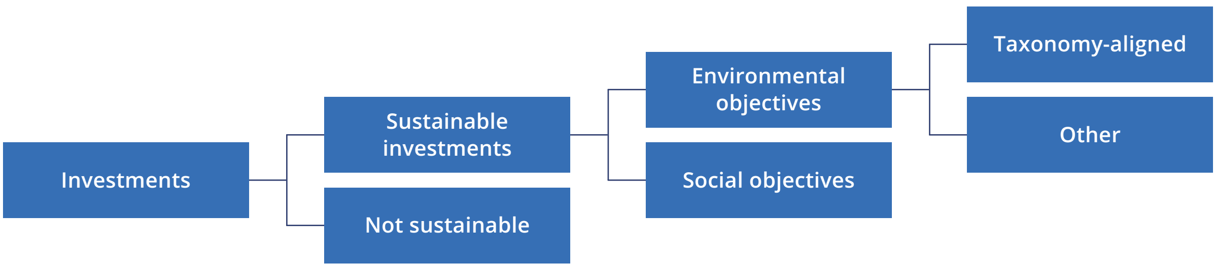
Over time, Qontigo plans to adopt a two-stage approach to measuring the revenue-based positive contribution of investee companies:

– Measurement of percentage alignment with the Taxonomy, and
– The percentage alignment with environmental and social objectives not yet covered by the Taxonomy.

In the latter case, Qontigo relies at present on revenue contribution to the SDGs. Since the Taxonomy currently covers the climate change mitigation and adaptation objectives, Qontigo would not then consider SDGs 7 ("Affordable and Clean Energy") and 13 ("Climate Action").

This recommendation is aligned with the PRI's view as set out in its document entitled "EU regulation on sustainability related disclosures in the financial services sector" (February 2022).

Figure 5: Breakdown of investments required for Article 9 disclosures.



Source: EU regulation on sustainability related disclosures in the financial services sector, February 2022

[16] ISS Good Governance Practices – Medium to Excellent Performance: This factor provides a True/False indicator to whether the issuer has received a minimum score of 1.75 or C-rating in all of the following relevant scores and topic areas: Corporate Governance Rating, Business Ethics Rating, Staff Rating; and has no direct corporate involvement in tax-related controversies assessed as amber or red.

This approach will eventually maximize consistency with the Taxonomy. Avoiding sector overlap when measuring revenue alignment under the Taxonomy and the SDGs prevents potential discrepancies. This approach also recognizes the Taxonomy as the leading framework for defining sustainable investment assets within the EU regulatory framework.

This methodology ensures additionality as much as possible, and we consider that adding the percentage revenue contribution to the Taxonomy and to complementary SDGs entails only a limited risk of overlap. The latter is expected to disappear as the Taxonomy progressively becomes the sole reference framework.

3.5.4. Positive contribution: operational performance

The inclusion of a complementary criterion focusing on top sustainability operational performance acknowledges the fact that some sustainability objectives cannot be pursued through commercial activities alone (gender equality, biodiversity, human rights), but can be significantly impacted by how companies run their businesses.

Whereas the SFDR's Principle Adverse Impact indicators (PAIs) could serve to measure operational performance, we feel they are better suited to use in an exclusion/screening process. Some environmental, social and governance scores are the most developed and available sustainability metrics for qualifying companies' operational performance. It therefore seems appropriate to eventually rely on the aggregated ESG score to qualify the extent to which companies are delivering a positive contribution to broad environmental and social objectives through their operations (e.g., overall environ-mental footprint, diversity and inclusion, local communities and broader stakeholder engagement).

Qontigo awaits further clarification from the ESAs on how to account for operational performance when calculating sustainable investment percentages.

4. Research process overview

Qontigo conducted research on the STOXX Total Market index universe when developing this methodology.

4.1. Ongoing monitoring and update cycle

Qontigo regularly updates the indices in its index governance framework. Given the highly evolving context of the SFDR and the fact that European sustainable finance regulation is still at an early stage overall, Qontigo expects to see both new regulatory guidelines and evolving market practice in the short term. It will therefore review this methodology twice a year until January 2024, and to adjust it as necessary.

4.2. Data sources

Qontigo uses an open data architecture that allows best-of-breed sustainability data providers to be selected in specific use cases across index design and reporting. As a consequence, Qontigo will regularly assess what data providers offer the best solutions for each step in the sustainable investment classification: DNSH, good governance, revenue-based positive contributions and operations-based positive contributions.

Figure 6: At the time of publication, the data providers used are as follows:

SI % Step	Do no significant harm	Good governance	Revenue-based positive contribution
Data provider	ISS Norms-Based Research score and exposure and product involvement research (controversial weapons, tobacco and thermal coal)	ISS Norms-Based Research score	ISS SDG Solution score
Data provider	Sustainalytics Global Standards Screening Research and product involvement research (controversial weapons, tobacco and thermal coal)	Sustainalytics Global Standards Screening Research	Sustainalytics' Impact Metrics (Sustainable Development Goals score)

Source: Qontigo.

The choice of the ESG data provider is related to the index construction. Additionally, as a customer-centric organization Qontigo will make every effort to facilitate the reporting of SI % for clients wishing to implement a different methodology and/or leverage other data providers.

Lastly, in the case of specific indices whose design is based on positive contribution datasets that are different to those used in its generic SI % reporting, Qontigo will complement its reporting by a specific measurement based on the data in question.

5. Contacts and further information

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