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Science-Based Climate Metrics supporting engagement policies and shareholder engagement

The Shareholders Rights Directive and the X-Degree Compatibility

In May 2017 an amendment to the Directive on the encouragement of long-term engagement, (2007/36/EG) was enacted by the EU Parliament ("SRD", 2017/828/EU). Requiring institutional investors and asset managers to design engagement policies that would encourage long-term shareholder engagement and enhance transparency amongst companies and investors.

This amendment is part of a larger regulatory and political framework that the EU is displaying in order to promote support for long-term considerations of investment decisions as a key part for supporting sustainable investments on a longer time span.

Art. 3g SRD provides that Member States shall ensure that institutional investors and asset managers comply with two requirements, or publicly disclose a reasoned explanation as to why they have not complied. Institutional investors and asset managers shall (1) develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement into their investment strategy, and (2) on an annual basis, publicly disclose how their engagement policy has been implemented. The institutional investors' and asset managers' policy should describe how they monitor companies they are invested in with relevant matters such as <u>social, environmental impact and corporate governance</u>.

This directive SRD is to be implemented into German legislation on May 2019 at the latest. via the German Corporation Act (*Aktiengesetz*) and has the likelihood of impacting German institutional investors' engagement style, which has up to know not being focused considering sociopolitical (environmental, political, ethical or gender) issues.

In order to understand the role that sociopolitical issues, specifically climate change will have on long-term investment considerations, asset managers and institutional investors are looking for tools and metrics that can measure and quantify the implications of such choices. For this purpose, the X-Degree Compatibility ("XDC") offers a myriad of options to assist on this endeavor.

This directive is mainly aimed at institutional investors and asset managers, but will also put pressure on third parties:

- Direct affectations: institutional investors and asset managers are directly affected by this directive. Since it sets explicit guidelines for how to integrate shareholders engagement, reducing the discretionality as to how they justify the way they manage to engage shareholders and the quality of information they are to provide to justify their investment decisions.

- Indirect affectations: shareholders will be required to actively engage by understanding the information they are presented with, specially when it comes to the considerations of ESG factors, in order to support or reject investors´ decisions regarding mid and long-term considerations of the assets they are invested in. Investee companies will also be touched by this directive, since demands they provide and disclose useful ESG information, as part of overall investor relations programs will derive.

We see 2 main hurdles resulting from the requirements brought upon by this Directive:

1. Materiality and impact: determination of climate as a material risk factor, understanding the role and impact that climate change plays and will play in mid and long-term investment considerations.

2. Disclosure: investors will have to disclose this understanding effectively whiles simultaneously framing it in a way that leads to shareholders supporting mid and long-term investment decisions.

The XDC as a metric for facilitating investors´ and asset managers´ duties

The XDC is a science-based climate metric, which informs investors and asset managers about the level of impact and exposure of a certain asset. It does so by establishing how many degrees the earth would warm up to by 2050, should all companies/assets be as emission intensive and have the same economic output as the company/asset in question.

Example: Smiles Ltd.'s XDC is 2.9° (Utility Company) ; the sector specific average is 2.2°
Clouds Ltd.'s XDC is 1.7° (Utility Company), the sector specific average is 2.2°

In determining and construing the XDC for investment decisions, investors can clearly understand how their investments incorporate or respond to long-term considerations and if climate is a material issue for such assets.

The XDC is a metric for facilitating the understanding of how investee companies respond to climate change, allowing investors to mainstream climate considerations into investment analysis processes and choose engagement and equity strategies that incorporate this understanding. Specific functionalities of the XDC:

- The XDC can serve for engagement policy purposes (Article 3g (a))
  Specifically allowing the monitoring of investee companies when it comes to their corporate climate strategy, climate performance and risk matters. The way in which this can be done is by first calculating the XDC for a specific asset and then utilizing a scenario based XDC as the projected target to reach. The monitoring of investee companies will then be done in relation to the target set and the possibility of reaching such target to determine the appropriateness of the investments strategy.

- The XDC as a metric to measure mid and long-term performance of assets (Article 3h)
  The XDC metric is able to capture the exposure of a certain asset when using the scenario based XDCs in which variables such as ex. Price for CO_2 can be calculated, therefore allowing the determination of how investment strategies contribute to medium and long-term performance of assets.

- The XDC enables asset managers to disclose in a transparent manner (Article 3i)
  In disclosing the XDC of assets, disclosure of material mid and long-term risks can be provided.

The XDC can serve to provide a benchmark for institutional investors and asset managers who are interested in getting support for mid and long-term investment decisions, in order to make clear what type of companies they want to invest in.

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