DANISH FSA

Sustainable investments – requirements and practices

July 2025

1. Introduction

In recent years, the Danish FSA has conducted several thematic reviews on financial products with sustainable investments made available by financial market participants, including fund managers, life insurance companies and pension funds. This paper describes the main legal requirements for sustainable investments, as well as some of the observations made by the Danish FSA during the completed thematic reviews. It also describes the most central aspects of the Danish FSA's expectations to financial market participants' methodology when classifying an investment as sustainable in accordance with the Disclosure Regulation (SFDR)[1].

The paper focuses on investments in equity shares but may also be relevant for other asset classes such as corporate bonds and alternative investments, cf. section 5.

Sustainable investments can be assessed at either activity level or company level[2], meaning that either a part of an investee company's activities are classified as sustainable, or the investee company as a whole is classified as a sustainable investment.

A sustainable investment is an investment in a company or activity that:

- contributes to one or several environmental or social objectives
- does not significantly harm any environmental or social objectives
- is only invested in companies that follow good governance practices

This means that the investee company must contribute to at least one environmental or social objective and that the contribution should be measurable. This can, inter alia, be ensured if a part of the company's turnover contributes to one of the UN's 17 Sustainable Development Goals ("SDGs").

Furthermore, the investee company must not significantly harm any environmental or social objectives. Financial market participants must assess and ensure this based on a number of sustainability factors, including greenhouse gas emissions and compliance with international standards. Financial market participants must set thresholds or criteria for when an investee company has

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

[2] Classifications made at the company level are intended for cases where a financial market participant invests in equity shares and the investment does not finance a specific activity. Activity level classifications is intended for cases where the proceeds from an investment are allocated to a specific type of activity/project, e.g. an investment in shares in a company that has only one type of activity or in green bonds where the proceeds are used to finance specific green projects. In practice, however, the Danish FSA also observes cases where financial market participants only recognise as sustainable investments those activities of the company that contribute to an environmental or social objective, regardless that the investment also finances other activities.

a “significant” negative impact on each sustainability factor and therefore cannot constitute a sustainable investment.

The requirement to only invest in companies that follow good governance practices mainly concerns the investee company's sound management structures, employee relations, remuneration of staff and tax compliance

Financial market participants must ensure that the requirements are met at any time, i.e. both at the time of the investment and as long as the investment is a part of the portfolio and classified as a sustainable investment.

2. Positive contribution to environmental or social objectives

Legal requirements and observed practices
As previously mentioned, sustainable investments shall contribute to an environmental or social objective, e.g. a contribution to one or more of the SDGs or the environmental objectives of the Taxonomy Regulation[3,4].

Financial market participants have developed different approaches to measuring and ensuring this contribution in practice. The Danish FSA has observed that most financial market participants measure this contribution against the SDGs by using two parameters:

- One that measures the proportion of the investee company's turnover deriving from activities contributing to at least one SDG or
- One that measures the “operational” contribution of the investee company, i.e. the extent to which the company's activities are carried out in a sustainable manner (e.g. use of renewable energy, diversity in management, etc.).

Some financial market participants use - and set a threshold value for - only one of the two parameters (typically “turnover”), while others set threshold values for both parameters separately or use an overall score (SDG score).

Several financial market participants make their threshold values for the two parameters mutually dependent. This means that the threshold for one parameter can be lowered if the other parameter reaches a sufficiently high score - and vice versa (see figure 1).

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[3] Regulation (EU) 2020/852 of the European Parliament and the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[4] The six environmental objectives under the Taxonomy Regulation (EU 2020/852) are climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection of biodiversity and ecosystems.

Figure 1. Observed method for determining when there is a contribution to an environmental or social objective based on the SDGs.

Metric	*Products & Services Contribution (turnover)*					
	Threshold values	*Negative*	*Neutral*	*Moderately positive*	*Positive*	*Very positive*
Operational contribution	*Very positive*					
	Positive					
	Neutral					
	Negative					
	Significantly negative					

Some financial market participants set additional requirements for when an investment can be considered to contribute to an environmental or social objective, besides requiring that the individual investment contributes to one or multiple SDGs. For example, that the individual investment must also provide solutions for climate change mitigation or adaptation, or that the investee company must have low greenhouse gas emissions compared to other companies in its sector.

Some financial market participants also measure contributions without using the SDGs. For example, by calculating contributions through the criteria set out in the Taxonomy Regulation, or through more generic wording, such as at least “x per cent” of the turnover of the investee company must be within “predefined sustainable economic activities” (setting out more specifically, which activities can be included).

Finally, there is a frequent use of a so-called “net approach” to calculate the contribution. Here, the negative impact of the investee company on environmental or social objectives is subtracted from the positive contributions. The threshold for a sufficient contribution is thus determined based on the company's net contribution.

A few examples have also been observed where financial market participants assess contribution solely based on whether the investee company has committed to setting reduction targets in line with the Paris Agreement, e.g. within two years.

The Danish FSA’s supervisory expectations

When it comes to measuring the contribution of sustainable investments, the Danish FSA expects financial market participants to select specific metrics for measuring and to have set out clear and meaningful thresholds or criteria for when a contribution is sufficient.

As there is some methodological flexibility in how to measure a contribution, financial market participants must be extra cautious and transparent when setting these thresholds or criteria[5]. The Danish FSA expects financial market participants to have a methodology for measuring the contribution that ensures that there is an actual contribution, and that the contribution is not only marginal.

To ensure that an activity truly contributes to a sustainable objective, it is also important that financial market participants do not adapt too broad a definition of whether an activity constitutes a contribution.

According to the Danish FSA, a commitment from an investee company to set reduction targets for its greenhouse gas emissions is not sufficient to ensure that there is a contribution to an environmental objective. A contribution can only be included if there is an actual emission reduction. Alternatively, the company's plan to set target reductions must be supplemented by other contribution criteria, e.g. through contributions to specific SDGs or environmental objectives of the Taxonomy.

Moreover, it is important that the total contribution from an investment is not exaggerated. For example, if the value of the entire investee company or if the share of the company's turnover that may contribute to several objectives is counted as contributing to several objectives. To avoid this, the share of turnover that may contribute to multiple objectives could be split out and allocated between these objectives, thus preventing “double counting”.

Finally, the Danish FSA notes that the “net approach” can help ensure that there is an actual contribution. However, the method does not necessarily ensure that there is no significant harm on any environmental or social objectives. For that reason, it is important that the assessment of contribution - also when the net approach is used - is supplemented by a separate check that there is no significant harm on environmental or social objectives (see also next section).

Ensuring a contribution

It is considered good practice, if the financial market participant has a methodology that:

- contains clear thresholds or criteria for when there is an actual and sufficient contribution to an environmental or social objective
- does not adapt too broad a definition of activities that can contribute to an environmental or social objective
- does not exaggerate the total contribution from an investment

[5] This also follows from the Commission's Q&A of 6 April 2023 in relation to the calculation of contributions. See p. 8 in JC 2023 18 - Consolidated JC SFDR QAs

3. No significant harm to any environmental or social objectives (DNSH-test)

Legal requirements and observed practices

Legal requirements

Sustainable investments must not significantly harm any environmental or social objectives. This assessment shall be made either at the activity level or company level, depending on how the financial market participant measures its sustainable investments[6].

This requirement shall be ensured by using a set of mandatory indicators for the company or activity's principal adverse impacts on sustainability factors ("PAI indicators"), i.e. indicators of whether investments can be considered to have negative environmental, social and governance impacts[7]. Examples of mandatory PAI indicators are indicators for greenhouse gas emissions, impact on biodiversity-sensitive areas and violations of the UN Global Compact principles and OECD Guidelines for Multinational Enterprises[8].

Besides the mandatory PAI indicators, there are additional PAI indicators that shall be included in the assessment where relevant[9]. This includes, for example, the indicator for emissions of inorganic pollutants.

Financial market participants shall set thresholds or criteria for each of the mandatory and other relevant PAI indicators, i.e. a limit for when an investment can be considered to cause significant harm to the relevant environmental or social matter. Thresholds and criteria shall be set based on available data for each PAI indicator. The financial market participants shall use data reported by the investee companies as far as possible. Estimated data shall only be used in cases where reported data is not available.

Observed practice

The Danish FSA has observed different approaches to ensuring that sustainable investments do not significantly harm environmental or social objectives. The following section includes practical examples for the PAI indicators that are considered particularly significant.

[6] If a financial market participant invests in shares of a company with multiple activities but only counts as sustainable investments those activities that contribute to an environmental or social objective, the assessment of whether significant harm occurs harm must be made on the entire company.

[7] Table 1 in Annex 1 to SFDR DA.

[8] In addition to ensuring that the investment does not cause significant harm through the use of the PAI-indicators, the financial market participant must pre-contractually and periodically account for alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

[9] Table 2-3 in Annex 1 to SFDR DA

Greenhouse gas emissions

For the first three mandatory PAI indicators, related to greenhouse gas emissions, carbon footprint and greenhouse gas intensity in the investee company, financial market participants usually use thresholds to assess whether there is any significant harm[10].

Several financial market participants have set absolute thresholds for both the company's absolute greenhouse gas emissions (scope 1, 2 and 3) and for emissions relatively set according to the size of the company (carbon footprint and greenhouse gas intensity).

The Danish FSA has observed a few financial market participants stating that it is not possible to set absolute thresholds for greenhouse gas emissions of investee companies. Others have set a criterion based on whether investee companies report – or does not report – on greenhouse gas emissions (or estimates thereof). Under this approach, investee companies that have not disclosed this information will not fulfil the no significant harm requirement. For those companies that report data, the level of emissions will be assessed under the following PAI-indicators for carbon footprint and greenhouse gas intensity.

As for carbon footprint and greenhouse gas intensity, most financial market participants have set an overall threshold for significant harm. Typically, the level is set relative to the investee company's turnover, with the same threshold across sectors and asset classes.

Few financial market participants instead assess the company's greenhouse gas intensity relative to other companies within the same sector, combined with a requirement that the company has committed to a science-based reduction target.

Several financial market participants supplement the thresholds for individual indicators with additional activity or sector-specific exclusion criteria. Inter alia, thresholds for how much of the turnover from a company can be related to fossil fuels or tobacco, etc.

There are also financial market participants that make two or more factors interdependent in determining whether significant harm is being done. For example, an investment is automatically considered to cause significant harm on biodiversity if the company has significant activity in the fossil fuel sector.

[10] The greenhouse gas emissions indicator is categorised into scope 1, 2, 3 and total emissions. It relates to the total, absolute emissions level of the investee company. The carbon footprint and greenhouse gas intensity indicators, on the other hand, relate to the investee company's relative emissions in relation to its total investments and turnover.

<u>International standards etc.</u>
As for the mandatory PAI indicators for international standards, including social matters, the Danish FSA has observed frequent use of qualitative criteria rather than quantitative thresholds.

This includes for the indicator *violations* of the UN Global Compact principles and the OECD Guidelines for Multinational Enterprises. Some financial market participants assess a potential violation e.g. based on whether the company is directly involved in an ongoing - or partially closed - case, determined to be serious by an external data provider based on the nature and extent of the harm. The assessment may include how the company has handled the incident or whether there are other aggravating or mitigating circumstances. For some financial market participants, it is left unclear how they assess whether there is a violation.

Furthermore, there is a separate indicator for lack of *processes and mechanisms* to monitor compliance with the UN Global Compact Principles and the OECD Guidelines for Multinational Enterprises. Some financial market participants considers that a company causes significant harm if (i) it has not adopted a policy covering the topics included in both of the standards, (ii) does not have a system to monitor and evaluate compliance with this policy, (iii) does not have a complaint mechanism, or (iv) if the company is on a watch list for non-compliance with either of the standards.

The Danish FSA has also observed that several financial market participants merge the two indicators. This means that the investee company is only deemed to cause significant harm if it has both been involved in violations of the UN Global Compact Principles/OECD Guidelines for Multinational Enterprises and lacks monitoring mechanisms for this.

<u>Subtracting positive contributions</u>
Finally, in a few cases the Danish FSA has observed financial market participants that take into account any positive impacts by the company when assessing whether the company does significant harm. This is done by subtracting positive impacts from negative impacts in their assessment.

The Danish FSA's supervisory expectations
The Danish FSA expects financial market participants to have established clear and meaningful thresholds or criteria for when an investee company can be considered to cause significant harm. This should be set for each of the mandatory PAI indicators and other relevant indicators.

<u>Greenhouse gas emissions</u>
Financial market participants must set a cap for the level of greenhouse gas emissions they will tolerate. Thresholds for the investee company's absolute greenhouse gas emissions do not take into account the size of the company.

For this indicator, it may therefore be relevant to only check whether there is data on the company's greenhouse gas emissions.

Data on the investee company's absolute greenhouse gas emissions can then be used to set thresholds for emissions relative to the size of the company, i.e. where emissions are, for example, assessed in relation to the turnover of the company.

The Danish FSA does not find that relative thresholds, where an investee company is assessed relative to the sector in which it is active, are sufficient to ensure that the investment does not cause significant harm in relation to greenhouse gas emissions. For example, in a sector where greenhouse gas emissions are generally at a level that causes significant harm to the environment, a company could still do significant harm even if its emissions are lower than those of other companies in the relevant sector[11]. Similarly, reference to a transition plan will not in itself be sufficient to ensure that no significant harm is caused[12].

Activity or sector-specific exclusion criteria can be used to complement thresholds or criteria for individual PAI indicators. However, as exclusion criteria typically focus on specific sectors, e.g. the utility sector, these can usually not stand alone as they do not ensure that companies in other sectors are not causing significant harm.

Using qualitative criteria

In cases where the financial market participant has set qualitative criteria for selected indicators, the Danish FSA expects that, as a starting point, the criteria are set in a way where it can be determined binary whether the criteria is fulfilled. Where the criteria require a qualitative assessment, it is important that financial market participants have established a clear methodology for this and can document that the criterion is met for each investment.

International standards

The UN Global Compact Principles and the OECD Guidelines for Multinational Enterprises cover several of the same topics, which financial market participants may take into account when setting criteria or thresholds for the relevant PAI indicators.

In this regard, the financial market participant must be able to explain how all topics under both standards have been included in the assessment of significant harm on the PAI indicators. If there are material topics that are not

[11] For other indicators that do not relate to greenhouse gas emissions, the Danish FSA cannot exclude that relative thresholds may be relevant to use in combination with other criteria/assessments.

[12] This also follows from the European Commission's Q&A of 6. april 2023 in relation to calculation of contribution. See page 8 in "JC 2023 18 - Consolidated JC SFDR QAs".

included in the assessment for these specific PAI indicators, e.g. tax issues, the financial market participant must be able to explain how the topic is ensured in other ways, e.g. through the financial market participants other policies or processes, such as tax policies, that all investee companies must comply with.

Lack of processes and compliance mechanisms can be monitored together with violations. However, it is not sufficient if the financial market participant only ensures that the investee company complies with one of the two indicators when considering them together.

Data gaps

When setting criteria and thresholds, financial market participants must take into account the available data for the specific indicator. Similarly, an assessment of a company's significant harm must take into account the data that is available on the specific company.

A company cannot be assessed as a sustainable investment if data is missing for a significant number of indicators or for indicators that are material to the sector in which the company operates[13]. Conversely, there may be indicators lacking data but where the indicator is less material for the specific company[14]. When lacking data, the financial market participant should make an effort to obtain the necessary data and provide a detailed and specific explanation of the data quality and data coverage as well as any potential data gaps. However, estimates can be used where reported data is not available.

Subtracting positive contributions

The Danish FSA does not assess it to be possible to subtract positive impacts from negative impacts when determining whether an investment does significant harm to any environmental or social objectives.

[13] For example, it should not be possible to conclude that an investee company is not doing significant harm if the company operates in the utility sector and has no carbon footprint data, as the utility sector is characterized by a high level of carbon emissions

[14] For example, the Danish FSA remarks that it can often be challenging to obtain data on the indicator for pollution to water (PAI 8). For this reason, many financial market participants have not set any thresholds or criteria for this indicator.

No significant harm

<u>It is considered good practice, if the financial market participant:</u>

- has a methodology that includes clear and meaningful thresholds or criteria for each of the mandatory and any relevant PAI indicators
- uses thresholds and criteria for greenhouse gas emissions that are not set in relation to other companies in the specific sector (i.e. uses absolute thresholds)
- take into account data for each PAI indicator where available
- can document how the individual PAI indicators are included in cases where multiple indicators are considered together
- in case of data gaps, make efforts to obtain the necessary data and ensure a better data basis, and provide a concrete explanation for poor data coverage, data gaps and data quality (estimates can be used where reported data is not available)
- do not subtract positive impacts from negative impacts in their calculation

4. Good governance practices

Legal requirements and observed practices

The final requirement for an investment to be considered sustainable is that the investee company follows good governance practices. This relates to solid management structures, labour relations, staff remuneration and compliance with tax regulations[15].

The Danish FSA has observed that financial market participants typically ensure the requirement through a test covering the four parameters mentioned above. Within each of these parameters, the financial market participant has defined more specific indicators (e.g. an indicator for “child labour” in relation to “labour conditions”) with relevant thresholds or criteria. Then followed by a score that shows how the company performs on the parameters next to the set thresholds. If a company is below the set threshold, it will not fulfil the requirement for good governance practices.

The Danish FSA has also observed the use of ESG-ratings from external providers. Under this method, a company must achieve a certain ESG rating before it fulfils the requirement for good governance.

In cases where a financial market participant has decided that a company does not fulfil good governance practices, the consequence will typically be

[15] The requirement applies to both sustainable investments and to all investments within a product disclosing according to article 8 of the SFDR (i.e., products that promote environmental or social characteristics), regardless of whether the investment is classified as sustainable.

that the company is not included in - or is excluded from - the portfolio of sustainable investments.

However, the Danish FSA has also observed cases where financial market participants - despite identified breaches - decide to keep a company in the portfolio, for example if it considers that there is a potential for improvement. Through active ownership the financial market participant will thus try to influence the company in a more sustainable direction. However, in the identified cases, there were no pre-established criteria for when the breaches - or the duration of such - lead to divestment due to a breach of the requirement for good governance practices.

Similarly, the Danish FSA has observed a few market participants addressing good governance solely through active ownership. In these cases, no criteria have been set for - or monitoring - when certain conditions mean that an investment does not fulfil the requirement of good governance practice.

The Danish FSA's supervisory expectations

The Danish FSA expects financial market participants to have a methodology in place to ensure that investee companies fulfil the requirement of good governance practices. It must be clear which parameters are included in the assessment, and the criteria must be set based on frameworks that relate specifically to good governance practices.

The Danish FSA expects it to be clear when an identified breach of good governance means that a company can no longer be included in - or remain in - the portfolio, and when it is instead assessed that ongoing active ownership can be applied. Here it should be clear what elements the top management focus on when deciding to exclude a company, such as the severity and duration of the breach/controversy.

There should be some room for companies to adapt or improve their practices. There may also be grounds for retaining investments, for example when identified controversies relate to extraordinary circumstances that temporarily complicate dialogue or divestment, or if the circumstances do not in fact pertain to good governance practices or are not sufficiently ascertainable and objective. If this is the case, the Danish FSA expects there to be clear criteria or principles for assessing whether a company has shown sufficient progress or has a credible plan to ensure compliance with the requirements for good governance, including a specific timeframe for how long the investment can continue in the portfolio of sustainable investments.

When using ESG-ratings from external providers, the Danish FSA expects financial market participants to independently consider - and be able to explain - how the given rating ensures compliance with good governance practices. Financial market participants should also be aware that ESG-ratings typically focus on sustainability risks and consist of a wide range of factors, including compliance with good governance practices. This means that a company can achieve a certain score in an ESG assessment without ensuring actual compliance with the requirement for good governance practices if the rating is driven by other parameters than the company's governance practices.

Good governance

<u>It is considered good practice, if the financial market participant:</u>

- has a method that includes clear criteria or thresholds for assessing whether a company adheres to good governance practices
- has policies that, in addition to active ownership, sets out clear criteria when the nature or duration of the identified issue means that the investment cannot be classified as a sustainable investment
- when using ESG ratings, independently determines – and can account for – how the rating ensures compliance with the good governance requirement

5. Additional remarks

Other asset classes than equity shares

In this report, the Danish FSA has chosen to focus on investments in equity shares. The Danish FSA expects that financial market participants apply a consistent methodology for ensuring compliance with the requirements for sustainable investments across asset classes. This means using the same parameters, criteria or thresholds. However, the practical implementation of the methodology may vary depending on the asset class. For example, for alternative investments, the requirements related to the principle of no significant harm are typically outlined in a side letter, and compliance with the requirements for sustainable investments are monitored on an ongoing basis, e.g. through use of questionnaires for the manager or the investee company to complete. Similarly, there may be other processes for investments in green bonds where the proceeds are used to finance specific green projects and where the contribution therefore can be calculated based on the specific project rather than the issuer.

Interaction between the SFDR and Taxonomy Regulation

The determination of whether an investment is sustainable can be based on the reporting on environmentally sustainable economic activities according to the Taxonomy Regulation, i.e. reporting on whether an activity or part of a company's activities is aligned with the taxonomy.

Where a financial market participant invests in a specific activity that fulfils the requirements to be an environmentally sustainable economic activity under the taxonomy, the activity will automatically meet the requirements to constitute a sustainable investment under the SFDR.

However, for equity shares that does not finance a specific activity but finance the company as a whole, there are some additional requirements that the financial participant must be aware of. In such cases, financial market participants must (i) assess whether a sufficiently large proportion of the investee company's activities contributes to an environmental objective, for the investment as a whole to qualify as a sustainable investment; and (ii) ensure that the other economic activities of the company do not significantly harm any environmental or social objectives[16].

Sustainable investment objectives on product level

In addition to the methodology used to determine whether an individual investment qualifies as sustainable, several investment products also have sustainable investment objectives at the product level, i.e. for the product's overall investment portfolio.

These product-level objectives may correspond to the methodology used by financial market participants to assess the contribution of the individual sustainable investments. However, it is common for there to be separate objectives at the product level and for each underlying sustainable investment.

A frequent example of a sustainable investment objective at the product level is a target for annual reduction in the product's total greenhouse gas emissions in line with the long-term goals of the Paris Agreement. In such cases, the emissions are, for example, measured against specific EU climate benchmarks[17] to ensure that the reduction is achieved and aligned with the long-term goals of the Paris Agreement.

The Danish FSA remarks that an overall reduction target for the product, or actual reductions at product level, is not sufficient to ensure that all the underlying investments contribute to an environmental or social objective. This means that, in addition to the product target, financial market participants

[16] This follow from the European Commission's FAQ "Do Taxonomy-aligned investments qualify as 'sustainable investments.'", See page 5 in 2023/C 211/01.

[17] The requirements for EU climate benchmarks are set out in Regulation (EU) 2020/1818. The abbreviations for the two EU climate benchmarks are CTB and PAB, referring to respectively the Climate Transition Benchmark and the Paris-Aligned Benchmark. Common for these two EU climate benchmarks is that they must follow a reduction path for greenhouse gas emission of 7 pct. per year and must exclude companies that engage in certain activities. In addition, CTB must initially have at least 30 pct. lower GHG intensity or absolute GHG emissions compared to the investment universe, while PAB must be 50 pct. lower.

must ensure that each investee company contributes to at least one environmental or social objective for the individual investments to qualify as sustainable.

Passively managed products
In the case of a passively managed product tracking an EU Climate Benchmark, financial market participants are not required to have set out a methodology to ensure that each investee company contributes to at least one environmental or social objective.

The reason for this is that investments in passively managed products that follow an EU Climate Benchmark can automatically be classified as sustainable investments[18].

Potential review of the regulation
The Danish FSA expects the European Commission to put forward a proposal for the revision of the SFDR, which is the central regulation for the definition of sustainable investments. This paper is based on current regulation and guidance from the European Commission as well as the thematic reviews performed by the Danish FSA under this regulation.

[18] This follows from the European Commission's Q&A of 6 April 2023 regarding products that track a reference benchmark. See page 36 in JC 2023 18 - Consolidated JC SFDR QAs