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PRIVATE CAPITAL  
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PRIVATE EQUITY  
INFRASTRUCTURE  
LONG TERM INVESTORS

19 February 2019

*On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY*

## **Response to the ESMA Consultation Paper on Integrating sustainability risks and factors in the UCITS Directive and AIFMD**

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## 1. INTRODUCTION

Invest Europe, on behalf of the Public Affairs Executive (PAE), welcomes the opportunity to respond to this consultation on how to integrate sustainability risks and factors in the UCITS Directive and the AIFMD.

The European private equity<sup>1</sup> industry supports the EU's work on Financing Sustainable Growth and appreciates the EU's efforts to ensure that institutional investors and asset managers assess, incorporate, act upon and disclose material sustainability risks and factors in their due diligence processes and investment portfolios. We agree it is critical that sustainability and ESG (environmental, social and governance) considerations become an integral part of investing principles.

The concept of ESG is not new to the private equity industry. Private equity firms have a specific business model focused on identifying and managing key opportunities and risks, including those related to ESG factors, in their investment portfolios. Through their model of active ownership of their portfolio companies and ability to influence management through their shareholding (which may be a majority or minority position), private equity firms are well positioned when it comes to integrating, mitigating and managing ESG matters in investment decision-making and operational value creation. Even the formal incorporation of these long-standing ESG principles into industry practice is now almost a decade old.

In fact, the asset class's active stewardship and long-term investment horizons mean many private equity fund managers already focus on ESG matters. They do so both in their due diligence before choosing to invest and during the investment management process through their focus on value creation and risk management (through for example sound corporate governance, including attending regular board meetings, active involvement in setting direction and strategy and proper management oversight and controls, including regular and detailed reporting procedures). In this way, these managers contribute to the on-going development and resilience of the company across its investment horizon/during the ownership lifecycle.

Invest Europe has been keen to ensure that best practice is spread across the industry and to that aim, has produced two documents that include more information on the kinds of (general and specific) ESG issues private equity fund managers could/should take into account in relation to the management of the fund's portfolio companies:

- [the Invest Europe 2018 Professional Standards Handbook](#) - The Handbook includes concrete information on responsible investment and ESG risks and opportunities that should be considered and reflected in the different stages of a private equity fund's life, from early-stage planning and fund management to making investments and portfolio management. It addresses ESG in the context of the fund manager's interactions with the companies in which funds invest and the manager's relationship with the investors in the fund.
- the Invest Europe [ESG Due Diligence Questionnaire for Private Equity Investors and their Portfolio Companies](#) - This covers a range of questions in relation to ESG factors that can impact the performance of a portfolio company and/or an investment, including the private equity fund

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<sup>1</sup> For the purpose of this consultation response, "private equity" is used as a generic term to refer to and to encompass both private equity and venture capital.

manager itself.

Private equity managers' expertise lies in analysing information to identify attractive, long-term investment opportunities and then, once invested, in their focused execution of a plan to increase the value of those assets. The assessment of these companies' ESG policies for compliance with the investor's own expectations is a part of the decision process for many. Reporting how value has been protected and enhanced through consideration and, as appropriate, through the management of ESG issues is increasingly also being included in the due diligence material that potential investors receive from private equity fund managers.

However, it is important to recognise that ultimately the ability to impact the ESG agenda of portfolio companies depends on the governance rights. The model of private equity ownership also includes minority participations (with reduced governance rights); this is even more so for venture or growth capital. Nonetheless, over the last decade, it is clear that the increasing focus on ESG considerations by both investors and fund managers does have consequences for the companies, which receive investment from the private equity industry.

Against the above background, Invest Europe recognizes the (fiduciary) duty of asset managers (and institutional investors) to incorporate material sustainability factors in their investment decisions and monitoring. This is particularly so where such factors may have a long-term impact on value creation or destruction, performance, and/or where the investors, acting in the best interests of their beneficiaries, have determined a specific policy on ESG to be taken into account by the managers in their assets.

Nevertheless, while the consideration and management of material sustainability factors should be consistent with the exercise of fiduciary duty, in the same way that any other risk or opportunity impacting financial performance is addressed, it is essential to ensure that:

- (i) the final legislation is fit for purpose, practical and workable for all parties and financial market participants, irrespective of the size of either the fund managers or the companies and other assets into which they are investing, and their level of experience in dealing with sustainability factors; and
- (ii) there is sufficient flexibility for financial market participants to design a programme, which best aligns with their business needs and supports the needs of their individual portfolio companies.

In light of that, we welcome and agree with

- (i) ESMA's recommendation to move towards the integration of sustainability risks within the AIFMD (and UCITS) framework(s) through a high-level principles-based approach, similar to that already followed for a number of other relevant risks, which aims to "strike a good balance between the need for harmonisation on the one hand and the need to maintaining flexibility in some aspects" and "achieve the intended objective of fulfilling the Commission's mandate without imposing unnecessary burden on the relevant entities";
- (ii) ESMA's assessment that "detailed prescriptions at this stage could enhance the risks of regulatory arbitrage by authorised entities and create regulatory errors, especially considering that there are still several ongoing legislative procedures"; and

- (iii) ESMA's recognition that any rules on how to integrate sustainability risks in the due diligence process and risk management systems need to be appropriate to the size, nature, scope and complexity of the entity's activities and the relevant investment strategies pursued.

In line with the above, Invest Europe would like to ask regulators to bear this proportionality principle in mind and to avoid that these new requirements pose unnecessary additional regulatory burden. The need to keep the level of regulatory burden under control is particularly acute for small and mid-market firms with lower income and ability to absorb additional analysis and reporting costs. The back office workload resulting from regulatory requirements has grown multiple fold in recent years, both for private equity fund managers and portfolio companies. In the long run, this will (and has already) drive(n) up costs for the industry and has distracted the attention away from issues that actually matter in creating sustainable value. Such factors may actually contribute negatively to the attractiveness of the ESG concept as such and therefore be counterproductive for private equity firms' ability to promote ESG internally in the investment team and to portfolio companies.

Rather than imposing strict regulatory requirements, it may be worth pondering a "comply or explain" approach, particularly where managers are bound by promises to investors, invest in assets with limited ESG risks, etc. It is important to take care not to push for what turns out to be the "not so good" solution and to consider that:

- (i) it would be far too early/premature, at this stage, to provide a granular amount of detail. The world is still learning about and trying to get a better understanding of climate change (and other) effects on sustainability, both short term and long term. In addition, several legislative initiatives are still underway (e.g. the EU's Taxonomy still needs to fall in place). Before all implications, complexities and inter-dependencies or "domino-effects" have been fully understood, there needs to be flexibility and more narrative;
- (ii) it risks distorting competition if the EU one-sidedly becomes very granular. The markets are global and the EU needs to be careful not to disrupt competition; and
- (iii) there is already a degree of coalescence around the UN Sustainable Development Goals and engagement on a global level across investors and fund managers on how best to effect these in practice. The EU would seem better served to work with the efforts that are already being made to find some sort of global impact matrix, rather than a rigid set of ESG criteria, in order to achieve its goals.

Finally, we would ask that ESMA keep in mind that the effective implementation of ESG considerations has to support the right sort of mind-set across all participants (investors, fund managers and company executives), as well as identifying the means by which the consideration of ESG factors in the investment process can be demonstrated. Participant-led incorporation of ESG within an agreed framework/impact matrix to their investment processes will lead to more effective adoption. It is also crucial that throughout the process of finding the right way to frame the regulation, ESMA remains open to the consideration of any highlighted potential unintended consequences of what is proposed.

## 2. OVERVIEW

Question 1 - How do you understand or how would you define the notion of “sustainability risks” for the purposes of the delegated acts adopted under the UCITS Directive and AIFMD?

Answer:

### ***Materiality***

Before getting into the details of the notion of “sustainability risks”, it is important to emphasise that sustainability more generally should always be considered in light of materiality. There are two important aspects to this:

1. Materiality would encompass material *business risks* (which could be either of a physical (e.g. flooding) or of a transitional nature (e.g. companies within the construction or transportation sectors switching to non-carbon emission production or fuel), as well as material *opportunities* (e.g. new or disruptive sustainability services or technologies) taking a holistic value chain perspective and understanding the interdependencies and relationships that exist.
2. The determination of materiality is issuer/investment entity and situation-specific: materiality may differ/vary considerably depending on the ESG issue in question, the timeframe, the investment practice and strategy, market/sector/industry, country/geography, supply chain, company and exposure to natural resources.

Therefore, materiality should be considered in each specific case and each investment needs to be assessed qualitatively on its merits. Not all factors will likely have the same impact for the concerned stakeholders. While a given sustainability issue or ESG factor may be material for one investment/company/investment entity, it may be immaterial (or less material) for another. A strong governance function for example will facilitate the identification and management of other sustainability factors that are relevant for a certain investment.

We are pleased to see that ESMA acknowledged this concept of materiality on different occasions in the consultation paper.

### ***ESMA’s proposed definition***

ESMA proposes to define “sustainability risk” as “the risk of fluctuation in the value of positions in the fund’s portfolio due to ESG factors”.

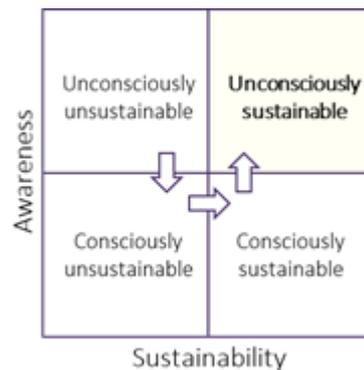
As a starting point, we like that the proposed definition makes a direct connection to portfolio valuations and welcome ESMA’s (initial) approach to present sustainability risk as a risk that could impact the value of the portfolio, i.e. a direct business risk.

As such, we agree that sustainability risk should be part of the overall risk management function of an organisation and should not and cannot be treated as a standalone topic.

We are pleased to see that ESMA confirms that approach in paragraph 13 (on page 6) of the consultation paper (emphasis added):

“(…) all authorised fund managers subject to the UCITS and AIFMD regimes need to incorporate sustainability risks in their due diligence processes and assess and manage the sustainability risks stemming from their investments along with all other relevant risks such as market, interest or credit risk.”

The below matrix gives a good representation of what the desirable state should be: to become ‘unconsciously sustainable’. The best way to get there is by integrating ESG into existing processes, teams and resources.



In addition, it is important to take into account that ESG factors will vary in intensity depending on whether managers apply a negative screening approach, as a minimum ESG review standard, whereas others will engage and/or seek an impact. Considering ESMA’s proposed definition, it seems that the risk management approach towards ESG is the smallest common denominator, which works for all situations.

However, while we generally agree with the direction ESMA has followed, we believe it is important to recognise that ‘fluctuations’ in the value of positions are not necessarily the problem. Positions will fluctuate constantly due to market volatility. There will be fluctuations, due to short-term factors, which may not really impact in the longer term. In any event, these considerations are considerably less relevant for privately held investments that are not traded on a public market.

The problem is when a material and identifiable ESG risk has been missed and through being left unaddressed could lead to a significant decrease in the future value and sustainability of the business. For this reason, we would propose an amended definition as follows:

“‘Sustainability risk’ is understood as the risk of ~~fluctuation~~ a significant decrease in the value of positions in the fund’s portfolio due to unaddressed material ESG factors~~risks~~.”

An alternative could be to say:

“‘Sustainability risk’ is understood as the risk of ~~fluctuation~~ longer-term negative change in the value of positions in the fund’s portfolio due to unaddressed material ESG factors~~risks~~”.

### 3. ORGANISATIONAL REQUIREMENTS

Question 2 - Do you agree with the proposed amendments relating to organisational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Answer:

Invest Europe generally feels comfortable with the high-level and principles-based approach that ESMA has followed in proposing amendments to the European Commission’s AIFMD Delegated Regulation (EU) 231/2013, stating explicitly in paragraph 21 (on page 9) of the consultation paper that such an approach

“would seek to ensure that authorised entities are explicitly required to incorporate sustainability risks and factors within their internal organisational procedures, systems and controls in a way and to the extent that is appropriate to the size, nature, scope and complexity of their activities and the relevant investment strategies pursued.” (emphasis added)

Within every industry and asset class, including private equity, there will be diversity among market practitioners. Not only in relation to their experience in explicitly integrating ESG factors (in decision-making, investment management and disclosure) but also to the type of asset invested into and the material relevance of ESG factors to such assets [their portfolio companies], as well as to the size of the actual (private equity) firms and their portfolio companies. Dealing with all ESG aspects can be very resource intensive and the day-to-day operational consequences will not be the same depending on the size of the firm. Resources need to be allocated to where the biggest impact can be expected.

In light of that, Invest Europe in principle considers the proposed amendments to the AIFMD Delegated Regulation to be acceptable and workable from a private equity perspective. However:

- (1) We are concerned by ESMA singling out sustainability risks and factors in its drafting and adding them as a specific consideration to be taken. As explained elsewhere in this response, sustainability risks and factors should be part of the investment decision-making process (and the investee company’s operations) as such. They need to go hand-in-hand with the risk and return (and impact where relevant) considerations that also need to be taken.

One example includes ESMA’s proposed amendments to Article 57.1(e) “General requirements” of the AIFMD Delegated Regulation on page 13 of the consultation paper:

“AIFMs shall take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business. AIFMs shall take into account sustainability risks and factors when complying with the requirements laid down in the first subparagraph.”

ESMA should consider rephrasing this as follows:

“AIFMs shall take into account the nature, scale and complexity of their business and the nature and

range of services and activities undertaken in the course of that business, including, but not limited to, sustainability risks and factors. ~~AIFMs shall take into account sustainability risks and factors when complying with the requirements laid down in the first subparagraph.~~”

Similarly, on page 14 Article 60.2(b) of the AIFMD Delegated Regulation should be amended as follows:

“(b) oversees the approval of the investment strategies for each managed AIF, including the integration of sustainability risks and factors in effecting the investment strategy;”

The suggestion to add a new point (i) to the Delegated Regulation should then be removed:

~~(i) is responsible for the integration of sustainability risks and factors.~~

A similar approach could be adopted for the amendments suggested to the other AIFMD areas.

- (2) We would like to express concerns about the detailed analyses that precede ESMA’s proposed amendments. We believe that these go too far and therefore it will be crucial to ensure that they do not serve as an inspiration or guide to impose much more detailed requirements on AIFMs. Such a move would particularly impact those with limited resources that are less able to absorb related costs and for whom additional costs would have a greater relative impact.

The most problematic explanatory text is underlined in the extract below:

- Paragraph 22: “Authorised entities should in particular carefully consider whether they have sufficient human and technical resources for the assessment of sustainability risks within their organisation and governance structure. It is important that authorised entities employ individual(s) that possess the relevant skills, knowledge and expertise in sustainability risks.” (emphasis added)

We are also concerned about the underlined text in the following extracts:

- Paragraph 23: “In order to ensure appropriate consideration of environmental, social and governance risks and factors, internal control mechanisms should be instituted by senior management and systematic processes should be put in place. Thereby ensuring continued consideration of sustainability risks and factors throughout the decision-making process.” (emphasis added)
- Paragraph 24: “Moreover, ESMA would like to emphasize that, through the inclusion of a reference to sustainability risks and factors in Article 4 of the Commission Directive 2010/43/EU and Article 57 in the Commission Delegated Regulation (EU) 231/2013, it would also be expected that both the Compliance function and Internal Audit incorporate in their control programs issues related to the integration of sustainability risks and factors, as both functions are responsible for the monitoring of internal policies and procedures and their compliance with regulatory requirements.” (emphasis added)

ESMA seems to be suggesting quite strongly that management companies should consider employing dedicated “in-house” sustainability experts. We think this is going too far. Whilst some private equity firms have gone down this route, it is impractical to require it for all firms. This would lead to a potentially unhelpful ‘compartmentalisation’ of sustainability risk where sustainability is seen within

the firm as a “special” type of risk for which the in-house specialist is responsible, rather than the investment team itself.

In addition, requiring firms to employ dedicated sustainability expertise would actually discourage the investment teams from “adopting” sustainability as a commercial, business risk and recognising that sustainability is one of a number of risks that they, as investors, are responsible for managing. The presence of in-house sustainability resource might potentially risk the investment teams effectively “off-loading” responsibility for sustainability on to the dedicated expert resource and not viewing it as their responsibility.

Sustainability is one of a number of risks that form part of the overall investment risk matrix both for the acquisition of new assets and for the management of existing portfolio assets (e.g. bribery risk, sanctions risk, modern slavery risk, cyber risk). The answer lies in ensuring that the firm has integrated the identification and management of these risks into its internal procedures, systems and controls (both governance procedures and investment/portfolio management procedures) rather than employing dedicated expertise to address each risk independently. Most private equity firms do not, for example, employ dedicated cyber security expertise to support the investment and portfolio management functions. Instead, the need to consider and address cyber risks (for example) is integrated into the firm’s investment process and its governance procedures are designed to ensure that the appropriate investment committee / CIO checks that the investment processes have been followed in respect of each new investment.

To treat sustainability as a “special” risk which warrants the need for a specialist in-house resource would risk alienating responsibility away from the investment teams and would risk having the very opposite effect of what ESMA is intending. A number of private equity firms do employ in-house sustainability expertise to support the investment process but their role is mainly advisory - ultimate responsibility for sustainability remains with the investment team.

ESG is here to stay. There is no doubt about that. However, just as it was the case when the AIFMD was introduced, risk management was always part of the portfolio management process, only it was not specifically segregated as it is today. Many managers are applying ESG in their portfolio management process already. Some may have taken a risk management approach; others may have taken a portfolio management approach. This will ultimately depend on the ESG method adopted by the relevant manager.

It is important that ESG does not translate into a requirement to add a person dedicated to all ESG aspects of the business (see also our response to Question 3). Instead, ESG should be integrated into the existing processes run by the existing staff without necessarily triggering the need to hire a dedicated ESG resource. Depending on the asset class and size of the investment management team, it will not be possible to clearly segregate and single out an ESG person within a small to mid-sized organisation. Instead, more emphasis should be put on training existing staff and adapting existing processes while always following the proposed principles-based approach.

ESMA’s proposed amendments and accompanying explanatory text, as currently drafted, read too much as adding (burdensome) processes and (additional) sustainability capacity onto organisations, rather than enhancing existing resources (e.g. through training) and processes. As a result, ESMA’s approach could be both disproportionately burdensome, specifically for smaller entities, and may not be serving the ultimate purpose as sustainability is then still seen to be a separate function/analysis instead of incorporated in the

core processes.

**Question 3 - Do you see merit in expressly requiring or elaborating on the designation of a qualified person within the authorised entity responsible for the integration of sustainability risks and factors (e.g. under Article 5 of the Commission Directive 2010/43/EU and Article 22 of the Commission Delegated Regulation (EU) 231/2013)?**

Answer:

No (see also our response to Question 2). As explained above:

- (i) ESG should be integrated into the investment process and not be treated as a standalone or overriding risk category in the deal process. Treating sustainability risk as one single risk overriding all the other risk considerations when making an investment offers the danger of ESG becoming a box ticking exercise and de-integrated from the investment process; and
- (ii) such a requirement risks giving rise to a situation where responsibility for identifying and managing sustainability risks is unclear - does it reside with the “Sustainability Officer” or with the investment team? Sustainability is one of a number of risks that need to be integrated into the investment and portfolio management process (e.g. cyber risk) and it should not be treated as a “special” risk with “special” resource, which risks diluting the investment business’ feeling of responsibility and ‘ownership’ of sustainability.

While there is clearly a role for ESG and Risk Management teams to play in the diligence and ownership process, the underlying ESG risks must be owned by the investment teams and management teams to be effectively managed.

As a category of business risks, sustainability risks should be incorporated in existing functions/processes with ultimate and explicit responsibility at the top level of an organisation. In our view, this is crucial to get them truly embedded in organisations. Regulation should not be prescriptive on how this can best be achieved, though organisations should be transparent about how they (seek to) achieve this.

Specifically, market participants ought to be transparent about:

- (i) their approach towards their investors and how they link their ESG policies/programmes to economic/financial return and potentially other investment objectives; and
- (ii) the materiality assessment processes and approaches taken to assess and manage ESG risks/opportunities and integrate materiality based sustainability risk assessments.

**Question 4 - Would you propose any other amendments to the provisions on organisational requirements in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?**

Answer:

No. Invest Europe would like to encourage ESMA to follow as much as possible an approach that is:

- efficient, cost-effective and proportionate, taking into account the size and characteristics of the AIFM and their investment strategy; and
- non-prescriptive, providing a general framework only. Especially at a time where the common taxonomy does not yet exist and a principles-based approach is recommended, AIFMs, including private equity fund managers, should be given sufficient flexibility to develop their own ESG standards within their organisations and to implement the rules in a tailored way, adapted to their business's own model and processes. For example, managers should have the choice to develop internal resources and/or to retain outside advice and counsel on these issues.

Any regulatory intervention should allow for flexible implementation and leave a certain level of discretion with the AIFM. Firms invest in a wide variety of sectors and assets, and their approach to ESG has to be shaped by their specific circumstances (e.g. the relevant investment policy of the given fund/specific nature of the type of financial product or industry) and the requirements agreed by them with their investors.

In light of that, AIFMs should be able to decide and agree on *how* they consider and integrate material sustainability factors given that they might have different (responsible) investment approaches (practices, policies and processes), investors (retail and institutional) and beneficiaries, invest in a wide range of industries and operate under different (national) legislative frameworks.

The integration of sustainability risks in the investment decision-making process will possibly lead to (very) different results depending on which segment of the market and area of investment the AIFM operates (in).

## 4. OPERATING CONDITIONS

Question 5 - Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Answer:

Invest Europe is supportive of the high-level and principles-based approach that ESMA has followed in proposing amendments to the European Commission’s AIFMD Delegated Regulation (EU) 231/2013. In particular, we welcome ESMA’s explicit recognition in paragraph 31 (on page 17) of the consultation paper that:

“As a general note, ESMA considers that changes proposed in this Consultation Paper should all be applied by authorised entities with the principle of proportionality in mind, taking into account the size, nature, scale and complexity of their activities and relevant investment strategies pursued.” (emphasis added)

Within every industry and asset class, including private equity, there will be diversity among market practitioners. Not only in relation to their experience in explicitly integrating ESG factors (in decision-making, investment management and disclosure) but also to the type of asset invested into and the material relevance of ESG factors to such assets [their portfolio companies], as well as to the size of the actual (private equity) firms and their portfolio companies. Dealing with all ESG aspects can be very resource intensive and the day-to-day operational consequences will not be the same depending on the size of the firm. Resources need to be allocated to where the biggest impact can be expected.

In light of that, Invest Europe in principle considers the proposed amendments to the AIFMD Delegated Regulation to be acceptable and workable from a private equity perspective.

However, we would like to express concerns about the detailed analyses that precede those amendments. We believe that these go too far and therefore it will be crucial to ensure that they are not used as an inspiration or guide to impose much more detailed requirements on AIFMs. Such a move would particularly impact those with limited resources that are less able to absorb related costs and for whom additional costs would have a greater relative impact.

The most problematic explanatory text is underlined in the extracts below:

- Paragraph 27: “Authorised entities should consider sustainability risks associated with their investments and detail their consideration in their investment analysis. Where those risks are considered as material for the financial return of investments, authorised entities should identify the factors that are relevant for each type of risk and the relevant indicator(s) to monitor that factor. For example, when analysing the investment in an industrial company, the social risks could be considered as material for the valuation of investments. One factor materialising this risk could be the security of the employees working on site. One indicator that could be used to monitor that factor is the number of accidents. An increase in the number of accidents should be monitored if it leads to a decrease in the valuation of the investments.” (emphasis added)

- Paragraph 28: “In this context, authorised entities should pay particular attention to the information used to perform the above analysis and assess the quality of it. Where sustainability risks have a material impact on the financial return of investments, they should perform the investment analysis based on data adequately reflecting sustainability risks. They should describe how the information is sourced and whether the data is internally processed to perform the investment analysis. Authorised entities should develop specific methodologies to process the data sourced on sustainability risks. They should detail the characteristics of these methodologies and the assumptions used to perform the analysis and explain to which extent the methodology is relevant to the factors analysed.” (emphasis added)
- Paragraph 29: “Authorised entities should implement effective arrangements for ensuring the investment decisions on behalf of the UCITS or the AIF are carried out in compliance with the analysis performed above on sustainability risks. They should be able to explain the changes implemented in the portfolio as regards to the integration of sustainability risks.” (emphasis added)

The specific ESG issues to be considered and the extent to which they are materially relevant to be considered, will vary from company to company (in the case of a fund investing in private companies). Therefore, it would be inappropriate and unhelpful to be too prescriptive about how fund managers report on how they incorporate ESG considerations in their due diligence on a company-by-company basis. While the increased obligations may make sense where the manager of the fund is investing directly in companies, in the context of a fund of funds, this detailed wording makes less sense as the approach for those managers is that of an investor in a fund rather than an investor in a company.

In addition, as regards the explanatory text set out in paragraph 27, it is important to recognise that it will often be very difficult, if not impossible, to demonstrate the direct relationship between valuation and single ESG KPIs, let alone quantifying the impact. It would defeat the purpose if this paragraph meant that risks only need to be identified if they have a quantifiable value impact.

As outlined above, as a category of business risks, sustainability risks should be incorporated in existing functions/processes with ultimate and explicit responsibility at the top level of an organisation. In our view, this is crucial to get them truly embedded in organisations. Regulation should not be prescriptive on how this can best be achieved, though organisations should be transparent about how they (seek to) achieve this. See also our response to Question 3.

**Question 6 - Do you see merit in further elaborating in the provisions above on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments?**

Answer:

No.

Invest Europe would like to encourage ESMA to follow as much as possible an approach that is both efficient, cost-effective and proportionate, as well as non-prescriptive. Firms should be allowed to develop their own approaches in the first instance, which could be reviewed later as needed by the regulator.

Regulation should not be prescriptive on how sustainability should be addressed and integrated, though

organisations should be transparent about how they (seek to) achieve this.

See also our response to Question 4.

**Question 7 - Do you agree with the proposed inclusion of recitals relating to conflicts of interest? Should the technical advice cover specific examples? If so, what would be specific examples of conflicts of interests that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?**

Answer:

Invest Europe generally feels comfortable with the proposed inclusion of a recital dealing with conflicts of interest and does not think it is necessary for the technical advice to cover specific examples.

That said, it is important to be clear about:

- (1) What type of conflict is to be addressed, why and how? Where does ESMA see potential conflicts of interest that were not there before or that would not have to be taken into account up to now?
- (2) What happens if in the shorter run considering ESG matters and taking costs for these conflicts with the manager's financial return requirements as set out in their agreement with their investors? It should be clear that AIFMs primarily have to look after their investors' interests in priority to that of other stakeholders.

**Question 8 - Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?**

Answer:

No.

## 5. RISK MANAGEMENT

Question 9 - Do you agree with the proposed amendments to provisions relating to risk management included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

Answer:

Invest Europe is supportive of the high-level and principles-based approach that ESMA has followed in proposing amendments to the Commission’s AIFMD Delegation Regulation (EU) 231/2013. In particular, we welcome ESMA’s explicit recognition in paragraphs 35 and 36 (on pages 20-21) of the consultation paper that:

- Paragraph 35: “The Commission is currently developing a unified classification system (‘taxonomy’) on what can be considered an environmentally sustainable economic activity. By identifying activities that, in the Commission’s view, qualify as sustainable, businesses and investors will be provided with a common language to identify to what degree economic activities can be considered environmentally-sustainable. ESMA is aware that the finalisation of this taxonomy will be finalised in the upcoming years and that, at least initially, will not cover social and governance issues. While the Commission is developing the taxonomy, authorised entities shall take a broad approach to assessing potential sustainability risks.

Considering the high search costs that are currently attached to sourcing reliable and useful sustainability-related information, the approach shall be proportionate to the relevance and materiality of these risks for the authorised entities, based on the type and complexity of their activities. Considering on-going regulatory efforts on disclosure and transparency in the area of sustainable finance, search costs can be expected to decrease over time, and authorised entities should be able to improve in parallel their internal policies and procedures to manage sustainability risks.” (emphasis added)

- Paragraph 36: “ESMA considers that the suggested high-level and principles-based approach in this section meets the objectives set out in the Commission’s request for advice with regard to the integration of sustainability risks in the investment and risk management processes. Introducing more prescriptive rules on the integration of sustainability risks at this stage (while not doing so for various other risks that are relevant for UCITS and AIFs) appears disproportionate and could create the risk of regulatory imbalances. However, this approach does not preclude the possibility for ESMA to provide authorised entities with further guidance in the future if need be (for example, through new Q&As).” (emphasis added)

Within every industry and asset class, including private equity and venture capital, there will be diversity among market practitioners. Not only in relation to their experience in explicitly integrating ESG factors (in decision-making, investment management and disclosure) but also to the type of asset invested into and the material relevance of ESG factors to such assets [their portfolio companies], as well as to the size of the actual (private equity) firms and their portfolio companies. Dealing with all ESG aspects can be very resource intensive and the day-to-day operational consequences will not be the same depending on the size

of the firm. Resources need to be allocated to where the biggest impact can be expected.

In light of that, Invest Europe in principle considers the proposed amendments to the AIFMD Delegated Regulation to be acceptable and workable from a private equity perspective.

However, we would like to express concerns about the detailed analyses that precede those amendments. We believe that those explanations go too far and therefore they should not serve as an inspiration or basis to impose much more detailed requirements on AIFMs. Such a move would particularly impact those with limited resources that are less able to absorb related costs and for whom additional costs would have a greater relative impact.

The most problematic explanatory text is underlined in the extracts below:

- Paragraph 33: “Sustainability risks are subject to different approaches across the market, notably due to divergence of criteria and methodologies that might be fairly new and subject to further evolution. Furthermore, the availability and quality of the data on sustainability risks and factors poses additional challenges at this stage. Authorised entities should perform a formalised assessment on sustainability risks and their materiality, taking into account several aspects such as the identification of sustainability factors linked to the positions managed, the probability of occurrence and time horizon of sustainability risks with regards to the expected time of holding of the positions bearing the risks, and the quality of the underlying data and methodologies used in order to perform the assessment.” (emphasis added)
- Paragraph 34: “Bearing in mind that the methodologies used to monitor sustainability risks are often fairly new and the aforementioned challenges with regard to the availability and quality of data, authorised entities should perform regular reviews of their methodologies and data in order to highlight the potential limits of the risks monitoring and adopt dedicated measures where required.” (emphasis added)

As explained elsewhere in this response, if ESMA is to achieve its aims, it is critical that the topic of sustainability risk is not treated ‘separately’ and is incorporated in a more holistic (integrated) approach to risk management by building knowledge, awareness and capability through existing processes, teams and resources. While taking a more “separate” approach may have some relevance in the context of listed investing, where ESG may be used as a mechanism to filter the universe of stocks in an index, it is not at all appropriate for investing in private companies, where the fund manager is actively managing the investment and working alongside the company’s management team to address ESG issues in the business during the period of ownership. Organisations need to be able to calibrate better based on their size, market, risks and challenges faced, etc.

**Question 10 - Do you see merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks (e.g. techniques, tools and arrangements enabling the assessment of sustainability risks, probability of occurrence and time horizon of sustainability risks with regard to the expected time of holding of the positions bearing the risks, quality of underlying data and methodologies etc.)?**

Answer:

No. Invest Europe supports the proposed changes regarding risk management and sees no merit in further specifying the content of the risk management policy with respect to sustainability risks.

That said, given that different companies are at different stages of ESG awareness and integration, expressly listing key elements for effective integration might be useful to a certain extent as it would accelerate market learning. However, rather than listing key elements for effective integration in a prescriptive fashion, this should be done as examples of the kinds of techniques and tools to be used.

As mentioned above, Invest Europe would like to encourage ESMA to follow as much as possible an approach that is both efficient, cost-effective and proportionate, as well as non-prescriptive.

AIFMs should be able to decide and agree on *how* they consider and integrate material sustainability factors given that they might have different (responsible) investment approaches (practices, policies and processes), investors (retail and institutional) and beneficiaries, invest in a wide range of industries and operate under different (national) legislative frameworks. That said, market participants should be transparent about how they (try to) achieve this. See our response to Question 4 for more information.

**Question 11 - Do you see merit in amending risk management provisions relating to the regular review of risk management policies and systems in order to more specifically refer to elements related to sustainability risks (e.g. quality of the arrangements, processes, techniques and data used, need for authorised entities to highlight the limitations, and demonstrate the absence of available alternatives)?**

Answer:

No. Please see our response to Question 10.

In particular, we would like to stress the importance of (transparent) disclosure. Activities should be reported on to ensure accountability. There would also be value in regular internal audits, as well as - in due course - audit and reporting on how these functions are undertaken so as to enhance transparency and accountability in the market.

**Question 12 - Would you propose any other amendment to the provisions on risk management in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risk and factors?**

Answer:

No.

## 6. COST-BENEFIT ANALYSIS

**Question 13 - What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk management arrangements, market researches and analyses, organisational costs, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.**

Answer:

Invest Europe represents over 600 members that vary largely in terms of size and other characteristics. As such, we are not in a position to fill out the form.

Generally, it is fair to assume that there will be additional costs, but hopefully also benefits of incorporating sustainability (e.g. better risk management and additional value creation).

The overall balance is difficult to estimate. To a large extent this will depend on ESMA's/local regulators' views on whether incorporating sustainability requires many additional resources/policies or whether these can be included in existing risk management policies and can be picked up by existing resources. In the latter case, there will probably only be incremental training/IT/staff costs. In the former case, the costs can be significantly more substantial.

In light of that, we would like to ask ESMA to stick to its proposed high-level, principles-based approach and to avoid imposing strict and overly prescriptive regulatory requirements. As explained in more detail above, ESG should be part of the overall approach of investing, not a separate consideration.

Information requested	Firm response
Firm size (annual turnover in euro)	N/A
Number of employees	N/A
Firm complexity (low/medium/high)	N/A
Expected costs from market research related to ESG factors (in euro)	N/A
Expected IT costs related to ESG factors, (in euro)	Initial: N/A
	On-going: N/A
Expected training costs related to ESG factors (in euro)	Initial: N/A
	On-going: N/A
Other expected organisational costs related to ESG factors (in euro) - <i>please describe</i>	Initial: N/A
	On-going: N/A



### Contact

Thank you in advance for taking account of our feedback as part of the consultation process. We would be delighted to discuss any of the comments made in this paper in further detail.

For further information, please contact Erika Blanckaert ([erika.blanckaert@investeurope.eu](mailto:erika.blanckaert@investeurope.eu)) at Invest Europe.



## About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

## About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit [www.investeurope.eu](http://www.investeurope.eu).

