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

1 September 2020

Response to the ESAs Joint Consultation Paper concerning ESG disclosures - Draft regulatory technical standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a, Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088

INTRODUCTION

On behalf of the Public Affairs Executive, Invest Europe welcomes the opportunity to respond to the ESAs consultation on the draft RTS relating to certain disclosure requirements under Regulation (EU) 2019/2088 (Regulation on sustainability-related disclosures in the financial services sector or SFDR).

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors. Private equity and venture capital (PE/VC) fund managers take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but also dynamism, innovation and expertise. It is the combination of patient capital and active ownership that characterises the PE/VC business model and sets it apart from most other sources of funding. This commitment also 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.

PE/VC fund managers routinely consider sustainability risks and, indeed, opportunities when making investment decisions and when acting as stewards of their portfolio companies. A significant proportion of firms also consider sustainability issues more broadly, and report on their processes and performance against metrics agreed with investors. Several hundred PE/VC firms are signatories to UNPRI and many more have a written ESG policy and/or are committed to certain SDGs.

The following image sets out the possible ESG approach adopted by fund managers at the level of the PE/VC-backed company based on each stage of the investment process: from the phase of purchasing the undertaking over the holding period to the divestment phase of the undertaking.

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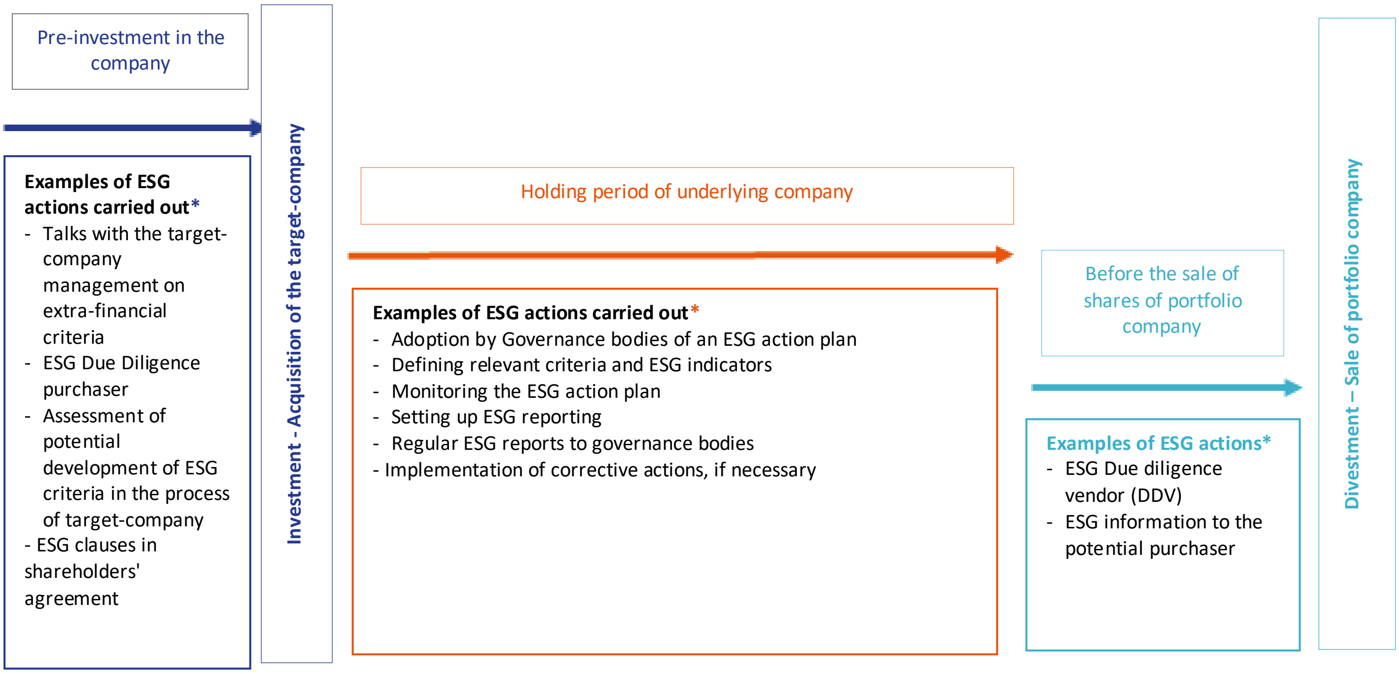
Possible ESG approach carried out at the level of the PE/VC-backed company based on each step of the investment process



* These are examples illustrating the *scope* of actions that can be implemented by a PE/VC fund as part of the ESG approach at the portfolio company level.

Depending on the approach, a first view on the indicators can be taken before the investment with the ESG DDQ purchaser. The impact of the investment process can be demonstrated before the sale of the underlying portfolio company with the ESG DDQ vendor. During the holding period, the PE/VC fund manager ("PE/VC Firm") can develop and monitor the ESG action plan with the prior agreement of other shareholders and managers of the underlying portfolio company.

Invest Europe, along with other private equity and venture capital industry associations, has produced a number of tailored resources[1] for private equity fund managers to assist them in their evaluation of the sustainability risks and opportunities within their prospective and existing portfolio companies. These resources have been developed by investors (pension funds and other institutional investors) and private fund managers to accommodate the specificities of investing into private companies. That **tailoring and proportionality** is critical for private equity firms, because the vast majority[2] of portfolio companies that are private equity and venture capital

[1] For example, the Invest Europe "Guide to ESG Due Diligence for Private Equity GPs and their Portfolio Companies" (March 2019) and the France Invest "Commission ESG: Recommandation pour faciliter le dialogue entre GPs et LPs" (October 2019).
[2] In 2019, 7,902 companies received private equity and venture capital investment. 84% of those were SMEs. In the case of venture capital alone, this percentage even amounted to 98% in 2019.

backed are Small and Medium-sized Enterprises (SMEs[3]), so detailed information on sustainability indicators is often **not available** before an investment is made and, for some sustainability indicators, would be **disproportionately expensive** for the underlying SME to produce on an ongoing basis given the nature and scale of its activities.

As an industry, we welcome proportionate and effective measures that respond to the urgent climate crisis and fully support the transition to a sustainable economy. As such, we would like to recall that the mandate given to the ESAs was founded on a proportionate approach, as mentioned in Recital 18 and Article 4(1)(a) SFDR "*taking due account of the size [of financial market participants], the nature and scale of their activities and the types of financial products they make available*".

With these points in mind, we have the following key comments on the draft RTS:

1. The list of "mandatory" indicators at Table 1 should be subject to **materiality** and **proportionality** considerations, to take account of firms' size (and therefore their available resources), the nature and scale of their activities (and, in particular, that of their portfolio companies) and the specific financial products offered (as contemplated by the SFDR). Concretely, we suggest that Table 1 be made optional or, at the very least, that the list of indicators be reduced to a more manageable number (from 32 + 2 to, for example, 10 + 2 or even 5 or 6). A management company's choice should be limited to a small number of **relevant** indicators (preferably, a low single digit number) in line with the activity of the underlying SME.

   For many of the currently proposed indicators, data for private companies will be **impossible to obtain** (examples include cases where mandatory principal adverse impact data simply cannot be obtained, such as Scope 3 data which the investee company does not track); for others, it would be **difficult and disproportionately expensive** (for example, venture capital firms with limited resources facing considerable challenges to obtain principal adverse impact data). In addition, certain types of fund managers, including funds-of-funds, minority and mezzanine investors, will find it difficult or impossible to report on certain of the indicators, given the lack of information available to them. For example, a fund-of-funds investor with indirect holdings in private equity companies through primary and secondary fund investments and minority co-investment holdings often will have no means to ensure they can receive those detailed indicators. See also our response to Question 10.

   Given the binary nature of the choice presented to them, we would expect many PE/VC Firms that do in fact take sustainability extremely seriously and would prefer to comply, to be left with no choice but to explain non-compliance (where eligible to do so). This would

[3] SMEs are to be understood as defined in the EU Recommendation 2003/361. The main factors determining whether an enterprise is an SME are: (i) staff headcount (<250 employees) and (ii) either turnover (≤ €50m) or balance sheet total (≤ €43m). Article 3 of the Annex to the SME Recommendation should not be considered for businesses that are owned by private equity and venture capital managers.

result in less (and potentially misleading) information being made available to investors who, as a result, will be less able to compare sustainability performance between investment funds. Requiring mandatory disclosure of non-material indicators would inflict disproportionate cost on managers (and, indeed, the investors themselves, where they bear the cost) without any material benefit to investors or wider stakeholders.

Fund-of-funds groups like the above (e.g. an indirect fund-of-funds investor and co-investor with minority holdings) should not be obliged to report information they are unable and not in a position to obtain and/or to report on indicators where they are not provided with the underlying data by fund managers/the lead sponsor. One way to solve this structural problem is to introduce a minimum holding requirement below which the obligations do not apply. Concretely, we believe that such reporting should only be required where the financial market participant, in this case the fund-of-funds manager, holds a greater than 10% holding in a portfolio company, whether indirectly through a fund or directly as a co-investor.

2. A firm that can explain and not comply with the entity adverse impact disclosures is required to include on its website a "prominent statement that the financial market participant does not consider the adverse impacts of its investment decisions/advice on sustainability factors" (Articles 11 and 13 of the draft RTS). For that statement to be clear and not misleading to readers, we think it critical to clarify that the sustainability factors referred to are <u>the set of factors in Annex I</u>, and to allow firms to clarify that they consider sustainability risks (as will be required under the proposed revisions to AIFMD and MiFID) and also (if it is the case) consider other material sustainability impacts but do not actively consider *all* of the sustainability adverse impacts specified in Annex I. It would clearly be wrong and misleading to investors for a firm to say that it "does not consider sustainability impacts" when in fact it does do so, even if only to some extent.

3. Investors and managers need further clarification as to what constitutes an Article 8 SFDR product and we do not believe that Recital 21 of the draft RTS is sufficiently clear in that regard. It appears that the ESAs intend to take a broad interpretation of Article 8, which we do not believe to be required by the SFDR. We think it important that an investment fund or related product should not be brought within the scope of Article 8 by: (i) disclosure of a firm's consideration of sustainability risks under the revisions to AIFMD and MiFID, (ii) compliance with principal adverse impact requirements as contemplated by Article 4 SFDR, and (iii) non-material investment exclusions. Unless these three types of activity are excluded, most private equity investment funds would be Article 8 products which seems wide of the intention of the SFDR. It is also important that the disclosures that are required for an Article 8 product are clear and relate specifically to the "characteristic(s)" that are promoted in relation to that product and do not require disclosure in relation to characteristics that are not. We are concerned that, given the wide variety of funds that could fall within Article 8, overly prescriptive disclosure requirements will mean that information provided to investors will be at best uninformative, and possibly misleading. We also believe that it is important to clarify which Article 8 funds will be obliged to make

disclosures under Article 6 of the Taxonomy Regulation because we are concerned that this could again lead to misleading investor disclosures and/or excessive burdens for funds with an ESG screen or exclusion policy.

4. The obligation under Article 7.2 of the draft RTS to disclose the best efforts taken to obtain information for indicators imposes an indirect best efforts obligation on firms. That level of obligation seems disproportionate, is absent from the SFDR, and is contrary to the principle of taking due account of firms' size, the nature and scale of their activities. We think that the efforts taken should be **proportionate** to the materiality of the indicator to the firm or the financial product.

In short, a "one-size-fits-all" approach with extensive mandatory indicators will require a disproportionate effort from firms, and in any case may not be the optimum means of achieving sustainability objectives. Meaningful disclosures risk becoming "lost" amongst a series of less relevant ones; more information is not necessarily better information. Adding additional administrative compliance burden in areas that do not move the needle for the company involved in sustainability should be avoided. Materiality, proportionality, flexibility and relevance are key terms in this context. One size should **not** fit all.

Finally, we would like to stress that, given the massive data gathering endeavour, the set timeframes, e.g. between the publishing of the final rules and those coming into force, are **extremely compressed** leading to a considerable risk of non-intended non-compliance, which would be detrimental or contrary to the purpose of the rules. In light of this, we would argue in favour of a postponement of the 30 June 2021 date for removal of the option to explain for large firms. If it is not delayed, we are concerned that there will be insufficient time for certain sponsors to collate the information and prepare the disclosures.

Time is of the essence for the proper and meaningful collection of data, particularly in the context of private equity and venture capital investments which are long term by nature. This is a reflection of the actual time which is needed between investment and divestment to implement an ESG process in an underlying portfolio company (most often an SME).

One of the specificities of PE/VC funds consists in supporting the portfolio company throughout a holding period, which is on average five or even seven years. It is during this holding period that ESG actions can be carried out and monitored. This support on ESG criteria is all the more impactful when the PE/VC fund has a majority stake in the capital of the company.

QUESTIONS

Question 1: Do you agree with the approach proposed in Chapter II and Annex I – where the indicators in Table 1 always lead to principal adverse impacts irrespective of the value of the metrics, requiring consistent disclosure, and the indicators in Table 2 and 3 are subject to an "opt-in" regime for disclosure?

Answer:

General

The ESAs' intention to pursue a part mandatory, part optional approach (i.e. its policy option 2) in relation to adverse impact disclosure is not reflected in a significant mandatory component of 32 + 2 mandatory indicators (some with multiple data items, each requiring further disclosure of methodology). We would welcome the following:

1. an opt-in regime for Table 1 (i.e. Table 1 to serve as an optional toolbox) or, at the very least, a reduced Table 1 that covers a more limited set of indicators, for example 10 + 2 or even 5 or 6;

2. the Table 1 indicators should in any case be subject to **materiality**. Firms should be permitted to explain where an indicator is not material to their portfolio in sufficient detail to allow a firm's determination to be policed, and not expend finite time and resource on non-material indicators; and

3. the obligation to obtain data on indicators should be subject to **proportionality**. If underlying data relating to an indicator is not available, or would only be available at disproportionate cost, then firms should be able to explain that. This would apply particularly in relation to investments in SMEs, developing countries, minority investments, and other types of investment with limited rights in respect of underlying investments in portfolio companies such as mezzanine or funds-of-funds. The issue of **access to data** for SMEs is not only related to cost; it is just as much linked to the absence of any process inside SMEs to collect the data. One of the goals of PE/VC Firms when investing in SMEs is exactly to improve the governance and build the right frameworks. PE/VC Firms are at the forefront of the ESG approach adopted by SMEs. During the holding period, PE/VC Firms have to identify the relevant ESG indicators and build the ESG process. Again, where a firm determines that obtaining data would not be proportionate, it should disclose that in sufficient detail to allow its determination to be policed.

The indicators outlined in the tables are very extensive and complying with them would result in **considerable and disproportionate costs** to PE/VC Firms both in terms of internal resource and the use of external consultants. We agree with the general principle, as required by the SFDR, of requiring firms to disclose the effect of their investment decisions on material ***principal*** adverse impacts; however, the number of data items and extent of Annex I and the mandatory nature of Table 1 is likely to result in the majority of PE/VC Firms electing to explain (where they can) and few firms complying due to the practical barriers, reporting cost and the additional due diligence burden associated with obtaining information on those indicators in respect of target portfolio companies. The result of this will be:

1. less sustainability-related information for investors than if a more progressive approach were taken to apply materiality and proportionality to those disclosure obligations (which would increase the number of firms electing to disclose principal adverse impacts, and the effectiveness of the market force of investor pressure on firms to do so); and

2. the increased costs of raising and managing sustainability-focussed products will favour large, well-resourced incumbents, raising the cost barrier to entry for new entrants, limiting (possibly stifling) innovation in sustainability-focussed products and services.

The cost assumptions made at page 74 of the Consultation document seem to derive mostly from public markets firms, where data disclosure is more readily available and can be purchased. Those considerations do not apply to investments in private companies and it should be expected that the costs would be significantly higher. We are not aware of any reliable estimates of the actual cost for a private equity or venture capital fund manager that have been made available to the European Commission or the ESAs and our members estimate that the costs of compliance would be significantly higher (and disproportionate) than mentioned in the Commission's impact assessment as illustrated below.

Even if we use the EUR 80 – 200,000 range of cost of implementation for small firms that is mentioned at page 74 of the Consultation, that would amount to a significant barrier to entry for a venture capital fund manager, for example, that is raising its first EUR 30 million fund, likely to receive a gross management fee in the region of EUR 700,000 a year, with a cost base of at least EUR 500,000 a year plus significant start-up costs. It is likely that, in some cases, the cost of complying with entity-level reporting and in some cases product-specific reporting, would have to be met by the firm from limited resources. So, retaining the option to explain (rather than comply) for smaller firms is and will remain of considerable importance.

Even for a larger venture capital or private equity fund manager, with (for example) EUR 500 million under management, a EUR 200,000 cost would imply an additional cost of 0.04% of AUM, which is a significant additional expense. A considerable proportion of those firms have existing sustainability teams, who focus on due diligence, portfolio company onboarding, implementing sustainability best practice and enhancing investee companies' sustainability capability, and supporting portfolio companies' provision of sustainability management information. Many of those firms are concerned about the resourcing requirements and cost of the proposed principal adverse impact obligations on pre-investment due diligence and ongoing reporting for non-listed investments; many of the proposed indicators are not currently reported on by private companies, public data is not available nor likely to be provided by data providers, pre-investment due diligence is a manual process that is hard to scale without hiring additional staff or third party advisers, ongoing information rights will have to be negotiated (and skilfully so to avoid disadvantaging a bid from an EU fund manager against an otherwise comparable bid from a non-EU fund manager with lesser ongoing information demands). There is therefore a concern that cost constraints will require firms to divert ESG resource away from maximising ESG opportunities and working with portfolio companies on material sustainability issues to spend more time on gathering non-material data. That would have a negative impact on the ESG efforts of such firms.

Funds-of-funds could be responsible for two levels of fees (at the fund-of-funds and underlying fund levels), depending on the type of funds and how costs are paid.

Our expectation is that the costs will be significantly higher for PE/VC Firms operating in the non-listed sector than those estimated in the impact assessment as PE/VC Firms would need to establish (1) processes, systems and controls in every investment and (2) processes and tools at the manager level, including third party consultants for specialist industries.

Table 1

We see strong arguments to apply **materiality** and **proportionality** principles to the obligation to report the Annex I data items, which would take into account firms' size, the nature and scale of their activities and the financial products that they make available, as set out in the SFDR.

1. It is likely that disproportionate cost and management time will be expended on reporting. Even large PE/VC Firms with existing and fully integrated ESG teams that have considerable resources available to them have informed us that data for certain items in Annex I Table 1 will be impossible, and, for others, difficult and very expensive to obtain. This resourcing and cost issue will be more pronounced for smaller start-up PE/VC Firms with limited financial resources and management time. That finite cost and time could be focussed on material reporting of value to investors, and on improving the sustainability performance of the portfolio companies in which funds are invested (and not on what risks becoming a box-ticking exercise reporting on indicators of no relevance or use for investors). It is likely that the implementation costs of firm-level principal adverse indicators will be met by managers. Many of those firms have limited internal resources and balance sheets to meet those costs, and additionally the early stage portfolio companies in which many invest will be less able to provide the data required to report many of the Annex I indicators. Many firms would prefer to opt in to compliance and to provide more balanced and useful data to investors, but as Annex I is currently proposed, they would have no choice but to opt out (and some international investors may pressure them to opt out if they see the costs as delivering insufficient value).

2. Sufficiently meaningful data for many indicators is unlikely to be available for non-listed companies, without – or even with - considerable expenditure. Because of this lack of

available data, firms may be required to rely on industry estimates by external consultants to report on certain data items, which would be of questionable value. The issue is further pronounced for funds (and for funds-of-funds, who may have exposure to funds) that invest in non-listed portfolio companies in developing countries with lesser sustainability reporting obligations and norms to those in the EU. See response to Question 4 for further information.

3. Some of the data items may not be relevant to a particular strategy. For example, for a fund manager focussed on early venture artificial intelligence companies, the mandatory obligation to report on water, biodiversity and waste would be of little relevance and of limited value to investors, and could detract from more important indicators relating to energy usage.

   It is clear that not all indicators will be (equally) relevant for each portfolio company / sector. This is particularly true taking into account that PE/VC Firms invest in a large diversity of economic and activity sectors, ranging from ICT and business products over consumer goods and services to biotech and healthcare. For example, for a group of nursing homes for elderly people, indicators related to biodiversity are not relevant at all. For a provider specialised in cybersecurity, the implementation of a deforestation policy will make no sense. Bearing in mind that some sectors will typically have a bigger impact on certain areas within the sustainability framework, requirements should be tailored to the sector characteristics. That is also important because otherwise the proposed indicators could be misleading for investors: for a fund specialising in cybersecurity investments, a report showing that no companies have a deforestation policy may lead to some negative conclusions, even though there would be no “adverse impact” on sustainability associated with that indicator.

   In light of the above, the management time and cost on both the PE/VC Firm and also on the portfolio companies to accurately report non-material indicators on a best efforts basis (and explain those efforts and why the indicator is not material) seems disproportionate to the benefit to investors or even misleading. The disproportionate effect applies to both resource-constrained small early stage venture capital funds, and also to large fund managers that manage a range of funds with 100+ portfolio companies in multiple sectors, particularly where many of the indicators being reported on are not material to the manager or fund product (as applicable). See also detail on indicators in the response to Question 5.

4. The aggregation for PE/VC Firms of data across all portfolio companies of their funds (which may include Article 8, Article 9 funds and non-Article 8/9 funds) is likely to be misleading, given that funds have a typical lifespan of ten to twelve years, and the typical portfolio company holding period is three to seven years and often more for a venture capital fund, and may mask improvements in sustainability practice in more recent funds. Private equity and venture capital fund managers do not hold liquid investments and are not able to trade out of positions, except over a long time period.

We understand that this requirement is part of the SFDR, but we think that retaining firms' ability to explain the reported indicators is of importance.

This explanation option is also important taking into account there may be situations in which indicators deteriorate. After special events, such as a crisis, a build-up or any other events, there can be a deterioration of the indicators. This would be due to external events, and not necessarily to the portfolio company.

5. For a newly formed PE/VC Firm that manages a single fund with one or a few portfolio companies as at the reporting date, the entity level public reporting could result in public disclosure of identifiable **(commercially) sensitive or confidential** information relating to that single portfolio company, or could permit reverse engineering of data for a small pool of portfolio companies to identify portfolio-company specific information, which could put the PE/VC Firm in a conflict between its reporting obligation and disclosure requirements. Therefore, we think firms should not be required to disclose firm level information that can be identified as relating to a single underlying portfolio company investment, provided firms disclose why such disclosure is not being made.

Tables 2 and 3

We agree that Tables 2 and 3 should be subject to an "opt-in" regime. We think it is important that firms should only be required to report indicators that are **material** to their businesses, and to be able to explain where an indicator is material but the underlying data is not available or is only available at disproportionate costs. This would be consistent with the SFDR objective to take into account firms' size, the nature and scale of their activities and the financial products that they make available.

With reference to Table 2, we note that it is in a species-genus relation to Table 1, representing a more detailed survey and a division into subcategories of the aspects addressed in the latter. This structure seems in principle to be applied consistently throughout the tables. Nevertheless, we note potential issues in the way some concepts have been defined. With respect to the mandatory requirements, the concepts of "*carbon emission reduction initiatives*" (point 4), "*water management initiatives*" (point 6), "*sustainable land/forestry/agriculture practices polices*" (point 9) and "*sustainable oceans/seas practices polices*" (point 10) are used. In general terms, we note that the use of such expressions does not allow a precise quantification/ measurement of the scale of the relevant policies and their suitability to meet the relevant objectives. It is therefore necessary to highlight how the lack of definition of said expressions results in a vagueness of the requirements. This may lead to a contradiction wherein, despite the initial structure, some mandatory disclosures would be actually too specific and difficult to make, while some "opt-in regime" indicators would introduce criteria that would apparently serve to measure certain factors, but in reality would have a very wide scope.

Best efforts obligation – Article 7.2 of the draft RTS

The current draft RTS imposes an indirect best efforts obligation on firms to obtain information on all principal adverse impact indicators from all investee companies. That best efforts obligation is absent from the SFDR, contrary to the principle of taking due account of firms' size, the nature and scale of their activities and the types of financial products that they make available, and is in excess of the current draft obligations on firms to take into account sustainability risks and principal adverse impacts (see for example Article 1(2) of the draft Delegated Regulation to amend the Delegated Regulation EU 231/2013 made under Directive 2011/61/EU or AIFMD). A uniform obligation to expend best efforts on obtaining data for indicators could require firms to incur disproportionate costs; we think that the obligation to disclose should be **proportionate to the materiality** of the indicator to the firm or the financial product, the investment and the underlying portfolio company. Certain types of investment may not provide the level of control or influence to obtain information on indicators – for example, a minority (perhaps 3%) investor is unlikely on its own to require an investee company to provide data on all indicators, a mezzanine debt holder may not be in a position to require information that is not required by equity or senior debt holders, a fund-of-funds that purchases a secondary interest in a non-EU fund is unlikely to be able to require the underlying manager to widen data reporting for all of its underlying portfolio companies, and an infrastructure fund manager that is invested in state-managed infrastructure may not be able to obtain data on the indicators from that state. Certain types of portfolio company may not be able to provide data on all relevant indicators, particularly earlier stage companies and those located in developing countries.

On a related note, Article 7(1)(c) of the RTS requires financial market participants to disclose (emphasis added) "*a description of the methodologies to assess each principal adverse impact and, in particular, how those methodologies take into account the probability of occurrence and severity of adverse impacts, including their potentially irremediable character*". The disclosure of such information in relation to 32+2 indicators seems likely to result in a large amount of text, making the adverse sustainability impacts statement less manageable. It is difficult to envisage how information regarding "*the probability of occurrence and severity of adverse impacts*" and their "*potentially irremediable character*" can be provided for the 32+2 principal adverse impact metrics reported at the financial market participant's entity level. This is particularly important bearing in mind that each of these metrics covers many different activities, sectors and companies in which the financial market participant might have invested. In addition, such extensive disclosure is unlikely to be helpful for the (end) investor and might even undermine the objective of producing user-friendly and comparable documentation. We would therefore suggest limiting the amount of detail being requested by amending Article 7(1)(c) as follows: "(c) a **brief** description of the methodologies to assess each principal adverse impact ~~and, in particular, how those methodologies take into account the probability of occurrence and severity of adverse impacts, including their potentially irremediable character~~;".

__No consideration of sustainability adverse impacts__

A firm to which Article 4(1)(b) SFDR applies (i.e. that is not required to comply with the entity adverse impact disclosures) is required to include on its website a "*prominent statement that the financial market participant does not consider the adverse impacts of its investment decisions/advice on sustainability factors*" (Articles 11 and 13 of the draft RTS). For that statement to be clear and not misleading to readers, we think it is critical to clarify that the sustainability factors referred to are the set of factors in Annex I, and to allow firms to clarify that they consider sustainability risks (as will be required under the proposed revisions to AIFMD and MiFID) and also (if it is the case) consider other material sustainability impacts but do not actively consider *all* of the sustainability adverse impacts specified in Annex I. It would be misleading to investors for a firm to say that it "does not consider sustainability impacts" when in fact it does do so, even if only to some extent. The Article 11 / 13 wording could be revised to "*the financial market participant does not consider* __*all of*__ *the adverse impacts of its investment decisions/advice on sustainability factors* __as set out in Annex I to [the RTS]__". A firm should be expressly permitted to explain its approach to sustainability, or link to such an explanation elsewhere on the website.

__**Question 2**__**:** Does the approach laid out in Chapter II and Annex I, take sufficiently into account the size, nature, and scale of financial market participants activities and the type of products they make available?

__Answer__:

The mandatory nature of Annex I does __**not**__ take into account the size, nature, and scale of financial market participants' activities and the type of products they make available. A one-size-fits-all and all-or-nothing approach is likely to:

- inflict disproportionate costs on reporting firms, including in reporting data items that are not relevant to their portfolio companies or the sectors in which they invest;
- dissuade firms from complying, thereby reducing the available sustainability information;
- potentially mislead investors by leaving firms with no option but to state that they do not take into account adverse sustainability impacts when in fact they devote considerable resource and costs in doing so; and
- require investors to expend time and resources in reviewing information that is not material.

Therefore, firms should only report against the Annex I items that they consider are __**material to their portfolio**__ (or the specific product and companies in which they invest), and to do so __**on a proportionate basis**__. Firms would not be under an obligation to report data items that would result in disproportionate cost in relation to the utility of the data item to investors. Such an approach would also enable firms to make more meaningful, targeted information requests to their portfolio companies and, in turn, this would result in more meaningful, actionable information being available for investors relating to adverse sustainability impacts.

Question 3: If you do not agree with the approach in Chapter II and Annex I, is there another way to ensure sufficiently comparable disclosure against key indicators?

Answer:

See response to Question 2 above.

Reporting under existing global standards for sustainability-related information, such as GRI or SASB, would (a) assist in developing a more synchronised end-to-end reporting system through the capital markets - from portfolio companies to fund manager to institutional investor to its shareholders etc., and (b) reduce the duplication of sustainability reporting for products with a global investor base.

Question 4: Do you have any views on the reporting template provided in Table 1 of Annex I?

Answer:

The reporting template provided in Table 1 of Annex I is very comprehensive. Such a comprehensive approach will lead to information overload for investors and stakeholders, substantially reducing the value and usability of the information.

The 32 data items are extensive and many of them will require disproportionate efforts from PE/VC Firms and portfolio companies to collect the data, where they can. Whereas certain indicators may be available in relation to companies listed on EU regulated markets, that data is not readily available for private companies that are not listed and **the availability of such data and the ease with which it may be obtained is generally inversely correlated to the size and development stage of portfolio companies** and the stage of development of the country in which they are located. As a result, a considerable burden is likely to be imposed on firms that invest in early stage companies (venture capital and SMEs) as well as in larger private companies, especially those not subject to EU reporting requirements. Whereas data solutions may be developed in the public markets to respond to demands of public markets investors including large institutions, those are unlikely for most private markets and non-listed companies. As a result, large institutional investors that are subject to the SFDR may be dissuaded from investing into early stage and SME-focussed funds, reducing the availability of capital to that important sector and, potentially, reducing their incentives and available resources to address sustainability-related objectives.

Retention of the explanation section in Article I Table 1 (and the inclusion of an explanation section for Tables 2 and 3) to allow firms to explain any data anomalies both in relation to specific data items and long-term trends, and clarification that firms may do so, are important to allow firms to avert the risk of misrepresentations (which may result from companies that are expanding by acquiring new businesses or disposing of part of their existing operations, or where a portfolio is early stage and developing).

The disclosure items that relate to policies should provide a useful overview; however, firms should be permitted (but not required) to provide performance information in the explanation sections in respect of those data items they consider material, which may be of greater importance to certain investors.

Question 5: Do you agree with the indicators? Would you recommend any other indicators? Do you see merit in including forward-looking indicators such as emission reduction pathways, or scope 4 emissions (saving other companies' GHG emissions)?

Answer:

General

We would not recommend including any other indicators in Annex I, which we think is already **overly prescriptive** (see response to Question 2).

We would welcome *permitting* (but not requiring) firms to include information relating to emission reduction targets where firms consider them material; *requiring* forward-looking indicators would add **disproportionate cost and complexity** to the reporting.

Certain data items are ahead of available data in relation to EU-based companies, and far ahead of available data in respect of portfolio companies in non-EU (especially developing) countries. We think that a **more progressive approach** would be more appropriate and would welcome including **materiality and proportionality** and/or reducing the mandatory indicators to a more proportionate number - see our response to Question 1. That approach could then be reviewed after the second entity level reporting cycle, i.e. after 30 June 2023.

Annex I Table 1 indicators

For financial market participants who are not investing in publicly listed companies, emissions reporting (whether scope 1 or higher) would be **extremely difficult** to provide. Currently we see no merit or use in including scope 4 emissions indicators. Only some of the most advanced large European private equity firms with large dedicated ESG teams are currently able to provide scope 1 and 2 emissions reporting for their portfolio companies; some are seeking scope 3 emissions from their larger portfolio companies but it is very hard to obtain from many companies. Under the Greenhouse Gas Protocol, listed companies are only required to report on scope 1 and 2. This will go further *and* extend the requirements to private companies that are typically smaller.

Feedback from member firms is that the following indicators in Annex I Table 1 are impossible or extremely difficult to obtain across a portfolio and should not be mandatory:

- 1, 2 and 3 – Carbon emissions (including scope 1, 2 and 3): Scope 3 data, in particular, will be difficult or impossible to obtain for SMEs. It is hard to measure precisely and consistently as there are subjective elements.

- 9 – Biodiversity and eco-system preservation practices: Few portfolio companies monitor this information. It will be hard to obtain and also be irrelevant for many service companies. In addition, this is very specific information connected to relatively vague concepts ("*pressure corresponding to the indirect and direct drivers of biodiversity and ecosystem change*"), that a company does not normally have. The information required seems to go beyond the purview to which all companies, large or small, are held by law, by virtue of the data that ordinary environmental compliance requirements allow or require to be collected. The same goes for indicator 11 – Deforestation.

- 10 – Natural species and protected areas: This may be very relevant for logging or extractive portfolio companies, but will be irrelevant for most service companies and difficult to obtain.

- 12 – Water emissions: While this is likely to be material for certain types of manufacturing companies, for many service companies this will not be relevant and difficult to measure unless located in a country and area where water is metered.

- 14 – Untreated discharged water: This would only seem relevant for certain types of manufacturing companies, and would not be relevant for most service companies.

- 16 – Non-recycled waste ratio: This may be relevant for certain types of manufacturing companies that produce material levels of waste. However, some companies do not, and may have difficulty, tracking this indicator. The companies that do might not track all types of waste, or have no information on how waste is handled if waste management is outsourced. For most service companies whose office and any other recyclable and non-recyclable waste is removed by state waste removal services where a fixed fee not by-weight charging applies, weighing the two types of waste and identifying whether recyclable waste has been recycled seems disproportionate.

- 19 – Excessive CEO pay ratio: It may be difficult to collect this information as it goes beyond current legal requirements for private companies and there could be concerns under local data protection laws.

- 28 - Number and nature of identified cases of severe human rights issues and incidents: The scope of "connected" to the company could be extremely wide in the context of global supply chains, and clarification that the obligation is limited to "direct" supply chain (and is not infinite) would be of benefit to reporting firms.

<u>Question 6</u>: In addition to the proposed indicators on carbon emissions in Annex I, do you see merit in also requesting a) a relative measure of carbon emissions relative to the EU 2030 climate and energy framework target and b) a relative measure of carbon emissions relative to the prevailing carbon price?

<u>Answer</u>:

We consider that requiring those data items would be **<u>overly complex and costly</u>**, may only be obtainable by financial market participants that invest in EU listed companies, and so would be overly ambitious to include as mandatory items now. It would be appropriate to consider these in the European Commission's evaluation due on 30 December 2022 or after two entity level annual reporting cycles have completed.

<u>Question 7</u>: The ESAs saw merit in requiring measurement of both (1) the share of the investments in companies without a particular issue required by the indicator and (2) the share of all companies in the investments without that issue. Do you have any feedback on this proposal?

<u>Answer</u>:

Feedback from our investor members supports the approach taken in Annex I, which is to include both metrics (i.e. both by number of companies and by size of investment). While it may be more important for many investors to see data by number of companies, some prefer to also see data by size of investment. The two allow for a better understanding of what may otherwise be overly crude and possibly misleading information.

<u>Question 8</u>: Would you see merit in including more advanced indicators or metrics to allow financial market participants to capture activities by investee companies to reduce GHG emissions? If yes, how would such advanced metrics capture adverse impacts?

<u>Answer</u>:

We would welcome clarification that firms can include (a) more advanced indicators in addition to the metrics in the tables in Annex I, and (b) forward-looking information in relation to activities to reduce GHG and other indicators in the explanation section of the tables in Annex I.

Question 9: Do you agree with the goal of trying to deliver indicators for social and employee matters, respect for human rights, anti-corruption and anti-bribery matters at the same time as the environmental indicators?

Answer:

We agree that the indicators should include *both* material Social and Governance indicators *as well as* Environmental indicators. We believe this makes sense in order to cover all areas of sustainability. Sustainability disclosure is more than just environmental disclosures; the environmental and social aspects of sustainable finance have to be treated together.

Some of our member firms thought that a **more progressive implementation** focussing on Environmental indicators first would reflect the urgent climate crisis and need to support the transition to an environmentally sustainable economy, and would allow firms to focus on those indicators and result in more actionable environmental information for investors.

On a related note, we would like to highlight that the Regulation on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation) is only focussed on environmentally sustainable objectives. The list of proposed indicators in the RTS contains not only climate and other environment-related indicators but also social-related indicators. Over time, it will be important to make sure that the social-related indicators in the RTS are aligned with or even are the same as those identified by the future Social Taxonomy, which as yet does not exist.

Question 10: Do you agree with the proposal that financial market participants should provide a historical comparison of principal adverse impact disclosures up to ten years? If not, what timespan would you suggest?

Answer:

While we think that many investors may only consider a shorter period of perhaps five to seven years, the cost to firms of retaining ten years of historic reports appears to be marginal.

An important issue that arises for many of our members is that they will not be in a position to require existing investee companies or funds to comply with their requests for data. As an example, we would like to focus on a fund-of-funds business, for instance holding over one thousand indirect positions. Such a fund-of-funds is very unlikely to be able to go back on a retroactive basis (post-investment) to the lead sponsors and require them to provide the information required to be disclosed. As the industry adopts the Regulation, funds-of-funds expect to be able to negotiate side letter positions with sponsors requiring them to provide the information required to be reported on and disclosed in relation to future investments, however that will not be the case retrospectively. Also, lead fund managers in Europe who are familiar with these regulations are expected to be more collaborative and receptive to these requests than those in North America or Asia, hence this would have to be done on a "best efforts" basis, even prospectively. There should therefore be consideration of the nature/profile of the financial market participant because a direct asset manager is in a different position to an indirect fund-of-funds investor or a passive minority co-investor as it relates to the ability to collate and prepare the contemplated metrics.

We would welcome clarification that the obligation to make available 10 years of historic entity level reporting under Article 6.2 is **not retrospective**[4], i.e. it would not, for example, require a firm that has elected to explain (and not comply) in relation to the principal adverse impact disclosures until 2024, but elects to comply in 2024, to publish four years of data. We understand that this is not the intention of Article 6(2)(b), and would welcome the clarification as the precise meaning of "*the date on which the financial market participant first considered principal adverse impacts of its investment decisions on sustainability factors*" is open to interpretation. Clarification is required that this sentence is intended to refer to consideration of principal adverse impacts as contemplated by Article 4 of the SFDR and not more generally, because many firms do indeed already consider sustainability impacts when making decisions.

In addition, for a private equity or venture capital fund manager, particularly one that invests across many different sectors, or uses a buy-and-build strategy (using bolt-on investments to its portfolio companies), inter-year comparisons and trends are likely to be misleading; therefore, firms should be able to clarify in the "Explanation" section if the historical comparison is misleading (see response to Question 4) and why.

Indeed, while it can be insightful to show how principal adverse impacts develop over time, this only makes sense if it can be presented on a like-for-like basis. This requires that the indicators can be reported for the vast majority of investments in a portfolio. As long as this is not the case, the comparisons will not make sense.

In addition, a number of more technical questions ought to be considered: How does the data reflect changes in a company, e.g. if it doubles in size organically, acquires another business, disposes of part of its operations, starts up a new business line, etc.? How do the comparables take account of this?

[4] In any case, pre-contractual information in case of private equity and venture capital funds is only relevant in the fundraising period, and periodic reports can only be provided for **new** private equity and venture capital products, not for the legacy ones which did not have such requirements in their pre-contractual documents.

Question 11: Are there any ways to discourage potential "window dressing" techniques in the principal adverse impact reporting? Should the ESAs consider harmonising the methodology and timing of reporting across the reference period, e.g. on what dates the composition of investments must be taken into account? If not, what alternative would you suggest to curtail window dressing techniques?

Answer:

Requiring firms to report under Article 4 annually on 31 December seems effective in the context of private funds and would make it difficult to cherry-pick data or "greenwash". Reporting across a period is likely to be challenging and could be misleading, and reporting by time weighted average would seem to be unnecessarily complex – in the context of investment activity with a holding period of three to eight years.

Providing firms the option of reporting as at their annual reporting date (which could be aligned with product annual reporting dates) would avoid duplication of reporting at different times at firm and product levels, which would reduce costs to firms.

Imposing more frequent reporting obligations (for example, quarterly) on entity or product level disclosure obligations seems disproportionate and is misaligned with other regulatory reporting (for example, annual reports under Article 22 AIFMD and under the NFRD).

Requiring product-level periodic reports to be in line with Article 22 AIFMD as at the end of the product's financial year seems to adequately discourage window dressing techniques.

We would welcome clear guidance from the ESAs on the timing of firm level reporting, and product level reporting.

Question 12: Do you agree with the approach to have mandatory (1) pre-contractual and (2) periodic templates for financial products?

Answer:

No, we do not agree.

We agree with the approach in the RTS of including pre-contractual and periodic reporting in existing reporting requirements (for example, AIFMD Articles 22 and 23 for alternative investment funds) in line with the SFDR. However, we think it should be sufficient to specify the items that need to be included in the pre-contractual and periodic reporting and that, given the range of types of product that such disclosure items will apply to, a one-size-fits-all template that is effective for all types of product would be difficult to specify and is likely to be overly prescriptive, giving rise to misleading information for investors.

To avoid disproportionate costs, the pre-contractual and periodic reporting obligations should be subject to **materiality and proportionality**, and take due account of the size, nature, scale and type of the financial product, and allow firms to focus on material data items.

We would be grateful for confirmation that the obligation to provide periodic reports – which for AIFMs is in the annual report under Article 22 AIFMD – would not also require the periodic reports themselves to be audited. If that is not the case, such external assurance would add very considerably to timing, resource and cost burdens, with no pursuant tangible benefits. In addition, we would welcome confirmation that periodic reporting would not be required for products that are **not** marketed after 10 March 2021.

Question 13: If the ESAs develop such pre-contractual and periodic templates, what elements should the ESAs include and how should they be formatted?

Answer:

If, contrary to our view, the ESAs do develop mandatory templates, we would suggest a template which allows firms enough **flexibility** in its application to ensure that information provided is fair and not misleading. We would suggest that any template for principal adverse impact disclosure is less comprehensive compared to the indicators in Table 1 and is a mix between environmental and social questions. In our view, it needs to be **material** to the type of business, which is why it would be good to tailor it depending on company size and sector.

Only elements that are directly relevant for particular products should be included, taking account of their structure (open-ended or closed-ended) and whether they are offered to retail or institutional investors.

Question 14: If you do not agree with harmonised reporting templates for financial products, please suggest what other approach you would propose that would ensure comparability between products.

Answer:

We think useful comparability between financial products across asset classes will be very difficult to achieve if a one-size-fits-all approach is used. Applying **materiality and proportionality principles** to reporting indicators would simplify drawing actionable conclusions within asset classes (i.e. between particular investment funds) and so would seem appropriate.

Question 15: Do you agree with the balance of information between pre-contractual and website information requirements? Apart from the items listed under Questions 25 and 26, is there anything you would add or subtract from these proposals?

Answer:

Agree. Nothing to add or subtract.

Question 16: Do you think the differences between Article 8 and Article 9 products are sufficiently well captured by the proposed provisions? If not, please suggest how the disclosures could be further distinguished.

Answer:

We understand the tension regarding Article 8 as between:

(a) a kitemark, with a narrower scope that reflects the SFDR requirement that a product "*promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics*" (and in line with recitals 18 and 19 of the draft RTS); or

(b) an anti-greenwashing measure, to be interpreted as widely as possible to ensure that a product is not marketed as having ESG characteristics that have no consequences for the product (and in line with recital 21 of the draft RTS).

We understand that the ESAs intend to adopt a wide interpretation of Article 8 - i.e. approach (b) above – and would like to flag three points in relation to that:

1. Firms will be required to consider sustainability criteria in their investment or advisory processes under the amendments to AIFMD and to MiFID, and the marketing material for a financial product or service is required to be clear, fair and not misleading, and so would reflect that obligation to consider sustainability criteria. Therefore, it seems important to distinguish between (i) disclosure of the required processes for an investment product reflecting firms' sustainability obligations in respect of their investment processes, and (ii) active promotion of environmental and/or social characteristics that form a qualification to an obligation to maximise risk-adjusted returns. Absent that distinction, most financial products would fall within Article 8 which seems contrary to the SFDR intention.

2. The current recital (18) of the draft RTS infers that "*best-in-class* [and] *specific sectoral exclusions*" would be Article 8 products. We think it is important to distinguish between (A) negative screening that is sufficiently material to amount to promoting environmental and/or social characteristics, and (B) limited exclusions that would not be material. In private equity or venture capital fundraising, it is common for investors to

negotiate certain excluded investments, which may be implemented either through bilateral side letters, or as exclusions in the investment policy of the fund. These are often required by investors on principle (or to back-to-back an investor's own obligations to its investors) even where they are not material to the particular investment fund – for example, a prohibition on a fund that is focussed on artificial intelligence from investing in companies that extract coal or oil. Common examples include investments in companies that manufacture pornography, depleted uranium munitions, or that operate casinos. We would welcome clarification that limited or non-material investment exclusions would not on their own bring a financial product within Article 8. Otherwise, investor-specific ethical requirements would cause the majority of private equity and venture capital funds to be Article 8 funds, resulting in inappropriate and excessive disclosure on sustainability.

3. Many of our members have subscribed to UNPRI, SASB, certain SDGs or other sustainability frameworks or standards – we would welcome clarification that a firm that refers in its marketing material to that framework or standard would not automatically be promoting an environmental or social characteristic, and would not automatically fall within Article 8.

We would be grateful for clear guidance that the Article 8 test is distinct from the EU Taxonomy; that an Article 8 product would not automatically be subject to Taxonomy obligations solely by becoming an Article 8 product. In particular, we believe that Article 6 of the Taxonomy Regulation only requires Article 8 products to report taxonomy compliance if they have, as part of their promoted objective, as intention to make "sustainable investments" as defined in Article 2(17) of the SFDR (and not only because part of their approach to ESG considers environmental factors in a more generic sense), but we would welcome clarification on that point.

The perimeter of what constitutes an Article 9 product seems sufficiently clear.

Please also see response to Question 21 in relation to good governance practices.

<u>Question 17</u>: Do the graphical and narrative descriptions of investment proportions capture indirect investments sufficiently?

<u>Answer</u>:

The graphical and narrative descriptions of investment proportions set out at Articles 15(2) and 24(2) of the SFDR seem to capture indirect investments sufficiently. See also response to Question 18 and to Question 1 in relation to efforts.

Question 18: The draft RTS require in Article 15(2) that for Article 8 products graphical representations illustrate the proportion of investments screened against the environmental or social characteristics of the financial product. However, as characteristics can widely vary from product to product do you think using the same graphical representation for very different types of products could be misleading to end-investors? If yes, how should such graphic representation be adapted?

Answer:

In the private equity and venture capital context, if the ESAs continue with their (in our view, overly expansive) interpretation of Article 8, it is likely that most products will qualify as Article 8 products (see response to Question 16). That is because many firms apply an ESG screen to their investments, disclose that screen in their marketing material or actively promote that screen to their investors, and will be required to take proper account of sustainability risks by proposed changes to AIFMD. In addition, most firms also include certain exclusions (for example, they are often not permitted to invest in companies that are engaged in the manufacture of arms or derive significant revenues from pornography). It is also important to note that these products are typically marketed to investors before any investments have been made (or, in some cases, when a small proportion of the total investments have been made) meaning that the pre-contractual disclosures will focus on planned, not actual, activity. Therefore, the disclosure in Article 15.1(b) would be based on expected rather than actual investments.

If those products are Article 8 products, as the ESAs appear to contemplate, then any graphical representation in pre-contractual documents required by Article 15(2) will show that *all* investments will be screened using the firm's ESG screening (and therefore "contribute to the environmental and social characteristics promoted") and *none* are planned to be "sustainable investments". This does not seem to be information which needs to be represented graphically. We therefore suggest that graphical representations should not be required at all, or at least only when they can reasonably be regarded as helpful in enhancing a reader's understanding of the information presented in narrative form.

Similarly, the narrative disclosures contemplated by Article 15.2(b) would not seem suitable for a product such as that described above, when all investments will be screened using specified ESG criteria and no "planned" investments will not be subject to the screen or exclusion. It will also be very hard for most funds to predict the proportion of investments in different sectors or sub-sectors, since their investment strategy may be sector agnostic and be based on where investment opportunities arise.

In addition, it is very unlikely that any reference benchmark would be used for private equity or venture capital funds. We would welcome clarification that Article 21 only applies where an index has been designated as a reference benchmark.

It is our understanding that Article 8 funds will not only be promoted by firms that have complied with Article 4 of the SFDR and disclose PAIs (and, indeed, unless the proposals in the draft RTS

Annex 1 are modified, we would expect most PE/VC Firms to be forced to opt out of Article 4 of the SFDR, as mentioned above). If that is correct, Article 15.1(c) should be revised as follows (new text underlined): "*a reference to the webpage where the information referred to in Article 4 or Article 11 is published.*"

The application of a one-size-fits-all disclosure obligation between products and asset classes may, by its nature, be misleading. Given the range of potential products and greater number of combinations of products that investors may choose to compare, any meaningful adaptation of the graphic representation appears challenging.

Question 19: Do you agree with always disclosing exposure to solid fossil-fuel sectors? Are there other sectors that should be captured in such a way, such as nuclear energy?

Answer:

Disclosing exposure to coal, oil and gas (under Article 24.2(b)(iii)) in respect of Article 9 SFDR products seems advisable, given the pressing urgency of the need to transition to a low carbon economy and their adverse impact on carbon emissions.

We do not think nuclear energy or other sectors are as material to that transition and under some analyses, nuclear is important to achieve that transition.

Extraction of geological materials (i.e. mining) could also be included, as poorly managed mining can result in considerable negative externalities.

Question 20: Do the product disclosure rules take sufficient account of the differences between products, such as multi-option products or portfolio management products?

Answer:

To a certain extent.

Where two or more vehicles invest in the same underlying asset class, for example a series of parallel funds that invest alongside each other, or where a segregated mandate invests alongside a main fund, in the same (or substantially the same) investments, it would seem proportionate to treat them as the same product and to provide a single product disclosure, and where the differences are immaterial to the underlying assets (for example, a leveraged or non-leveraged option, or the option of investing through a partnership that is fiscally transparent or a company that is opaque for tax purposes) to not treat them as separate products.

Question 21: While Article 8 SFDR suggests investee companies should have "good governance practices", Article 2(17) SFDR includes specific details for good governance practices for sustainable investment investee companies including "sound management structures, employee relations, remuneration of staff and tax compliance". Should the requirements in the RTS for good governance practices for Article 8 products also capture these elements, bearing in mind Article 8 products may not be undertaking sustainable investments?

Answer:

The SFDR seems unclear to us in this regard, because it could be read to suggest that good governance is a mandatory pre-requisite for any investment by a product that is an Article 8 SFDR product, even if its Article 8 status is derived from a specific social or environmental characteristic that has been promoted or a commitment to engage with an investee company post-investment to improve its governance. Such an approach would be highly problematic for private equity and venture capital funds, especially funds that invest in early stage, high growth businesses or those in developing countries with less advanced social and governance legislation. In practice, private equity and venture capital funds often invest in companies and then immediately seek to improve their governance. We do not believe that it is intended by the SFDR that PE/VC Firms that are within Article 8 should be precluded from making such investments - that would seem to be contrary to the policy objectives of the SFDR. Funds-of-funds, with indirect holdings in investee companies, will also find it difficult to meet this pre-requisite. Therefore, it is important to clarify that the good governance obligation: (a) is not a mandatory requirement pre-investment; (b) allows firms to invest in companies without "good governance" if they intend to improve governance of a portfolio company after investment; and (c) includes where firms seek to improve governance of an investee company, where the size of the holding and associated rights do not permit the investor sufficient control to effect improvement itself.

In any event, we do not believe that any further specification of the Article 8 requirement for "good governance", other than as mentioned above, would be helpful.

Furthermore, we are concerned that the requirement in Article 17(c) would seem to reinforce the suggestion that "good governance" is a pre-requisite and we would suggest that it be made clear that any such processes to assess "good governance" should also extend to policies to improve governance when the existing governance is not regarded as sufficiently "good".

Question 22: What are your views on the preliminary proposals on "do not significantly harm" principle disclosures in line with the new empowerment under the taxonomy regulation, which can be found in Recital (33), Articles 16(2), 25, 34(3), 35(3), 38 and 45 in the draft RTS?

Answer:

While we agree with the "do not significantly harm" (DNSH) principle, we are concerned that it has been applied too widely. For example, for an Article 8 SFDR product that promotes environmental characteristics and subsequently invests in one or more "sustainable investments", it would be reasonable for it to disclose under Article 16(2) of the draft RTS how ***that*** (or those) specific investment(s) do(es) not significantly harm the sustainable investment objectives that have been promoted, and how the adverse indicators in Annex I have been taken into account where they are material to the environmental characteristics that have been promoted. This would protect investors against greenwashing and provide relevant information on related negative externalities. It seems disproportionate to apply the obligation to take into account all Annex I indicators when the Article 8 product has not promoted to investors that it have sustainable investment as its objective (and, indeed, has specifically told investors that it does not, as required by Article 16(1)).

Furthermore, we believe that it would be reasonable to require a renewable energy fund that invests in onshore wind and solar and that is an Article 9 SFDR product to report on indicators relating to carbon footprint, weighted average carbon intensity, solid fossil fuel sector exposure, and non-renewable energy consumption. However, trafficking in human beings, child labour or controversial weapons, for example, would not seem relevant or related to the environmental aim of the renewables fund as promoted to investors and we do not believe that it should be necessary to report on them.

In addition, where an Article 8 fund does not promote "sustainable investments" (as defined in Level 1 Article 2(17)), we do not believe it would be appropriate to require any reference to DNSH. We do not believe that the ESAs intend this but we would appreciate clarification.

Question 23: Do you see merit in the ESAs defining widely used ESG investment strategies (such as best-in-class, best-in-universe, exclusions, etc.) and giving financial market participants an opportunity to disclose the use of such strategies, where relevant? If yes, how would you define such widely used strategies?

Answer:

To a certain extent.

We see some merit in the application of such strategies (which are more commonly used by public markets participants) to products that invest in publicly listed securities, for which existing definitions already exist (for example, Eurosif or Morningstar). This could help to provide clarity, and it should be considered that a product can pursue multiple strategies (e.g. exclusions can be layered over other strategies).

<u>Question 24</u>: Do you agree with the approach on the disclosure of financial products' top investments in periodic disclosures as currently set out in Articles 39 and 46 of the draft RTS?

<u>Answer</u>:

The obligation at Articles 39 and 46 of the draft RTS on Article 8 SFDR and Article 9 SFDR products to disclose the top 25 investments seems to reflect common practice for UCITS funds and the number of investments of index tracker funds. In the context of private equity funds, where it is common to have 10-20 portfolio companies, the clarification that firms need to disclose the top 50% of fund holdings is proportionate, should not be increased and could be decreased.

<u>Question 25</u>: For each of the following four elements, please indicate whether you believe it is better to include the item in the pre-contractual or the website disclosures for financial products? Please explain your reasoning.

a) an indication of any commitment of a minimum reduction rate of the investments (sometimes referred to as the "investable universe") considered prior to the application of the investment strategy - in the draft RTS below it is in the pre-contractual disclosure Articles 17(b) and 26(b);
b) a short description of the policy to assess good governance practices of the investee companies - in the draft RTS below it is in pre-contractual disclosure Articles 17(c) and 26(c);
c) a description of the limitations to (1) methodologies and (2) data sources and how such limitations do not affect the attainment of any environmental or social characteristics or sustainable investment objective of the financial product - in the draft RTS below it is in the website disclosure under Article 34(1)(k) and Article 35(1)(k); and
d) a reference to whether data sources are external or internal and in what proportions - not currently reflected in the draft RTS but could complement the pre-contractual disclosures under Article 17?

<u>Answer</u>:

a) *an indication of any commitment of a minimum reduction rate of the investments (sometimes referred to as the "investable universe") considered prior to the application of the investment strategy* = **<u>pre-contractual</u>**; in line with the draft RTS.

b) *a short description of the policy to assess good governance practices of the investee companies* = **<u>pre-contractual</u>**; in line with the draft RTS (see also response to Question 21 in relation to the application of good governance to Article 8).

c) *a description of the limitations to (1) methodologies and (2) data sources and how such limitations do not affect the attainment of any environmental or social characteristics or sustainable investment objective of the financial product* = **<u>pre-contractual</u>**; while the draft RTS indicates this should be a website disclosure item (in line with Article 10.1(b) SFDR), detailed information would only be relevant to potential investors, whereas a general website disclosure could be in summary high-level form.

d) *a reference to whether data sources are external or internal and in what proportions* = **pre-contractual**; we think it preferable for the general website disclosure obligation at Article 10.1(b) SFDR to be in summary form, and to the extent that any additional information is deemed necessary including between external and internal sources, we think those would be more appropriately included in product-specific pre-contractual information.

We support the current position to include the additional pre-contractual disclosures within the existing applicable disclosure framework (for example, Article 23 AIFMD for AIFMs, Article 69 of the UCITS Directive for UCITS managers), for simplicity and clarity from the point of view of a prospective investor.

Question 26: Is it better to include a separate section on information on how the use of derivatives meets each of the environmental or social characteristics or sustainable investment objectives promoted by the financial product, as in the below draft RTS under Article 19 and Article 28, or would it be better to integrate this section with the graphical and narrative explanation of the investment proportions under Article 15(2) and 24(2)?

Answer:

In Articles 19 and 28 of the draft RTS that apply to Articles 8 and 9 SFDR, we think it is important to distinguish between (a) the use of derivatives as an investment – for example, hedge fund activity seeking to bet against market movements, and (b) the limited use of derivatives to mitigate investment-specific risks (for example, a forex derivative where a fund denominated in Euro invests in a Norwegian SME in NOK that seeks to balance the EUR / NOK exchange rate that could adversely affect the fund's investment) which would not seem to require the same level of express disclosure. It would seem preferable for risk mitigation derivatives to be reported on alongside the primary investments giving rise to the risk(s) being mitigated, and not as a separate class of investment, in relation to Articles 19, 28, 15(2) and 24(2).

Question 27: Do you have any views regarding the preliminary impact assessments? Can you provide more granular examples of costs associated with the policy options?

Answer:

It appears that the cost assumptions underlying the preliminary impact assessments are based primarily or indeed solely on publicly listed investments and firms with considerable AUM. As such, the costs of complying with the additional reporting requirements for smaller PE/VC Firms and for the SMEs in which they typically invest appears to have been biasedly ignored. These costs will be **disproportionately much higher**.

The same goes for funds-of-funds, where investors already bear a high expenses ratio.

Such increased costs significantly **reduce returns** and will potentially defeat the objective of the SFDR being to increase sustainable investment.

Contact

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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.

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