THE VOICE OF PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

European Commission
DG FISMA
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Dear Lukas and Christina,

Many thanks for taking the time to speak to us on Friday 29 January. In this letter and its annexes, we are following up as promised.

As we explained, our members have been thinking deeply about SFDR and Taxonomy implementation issues for several months. We have been developing positions, notably through meetings of our specially-convened "SFDR Known Unknowns" working group. This group has brought together a significant number of financial market participants (FMPs, known in our industry colloquially as "general partners", who are the "AIFMs"), investors ("limited partners") and advisors, including representatives of our Responsible Investment Roundtable (mostly ESG professionals) and Financial Services and Regulatory Working Group (mostly regulatory lawyers).

The discussions of this group have extended beyond the priority questions identified by the ESAs in their letter to Mr Berrigan. Whilst, in this letter, we have confined ourselves to such priority issues, please let us know should you wish to discuss other SFDR or Taxonomy Regulation topics in due course.

Article 8 scope

Our key concern is the threshold for a product to be subject to Article 8. Our members look forward with enthusiasm to the Commission's guidance on this topic, for two reasons.

First, our industry has for a long time been at the forefront of responsible investment and a number of our members positively wish to fall within Article 8. Although we appreciate that you do not view Article 8 as a "labelling regime" (and we are sympathetic to your view), we do believe that some investors will regard it in this way. Some of our members will wish to receive acknowledgement for their efforts to promote environmental or social characteristics and use this as a competitive advantage.

Second, because others of our members (notably smaller firms and larger firms for certain of their products) will not wish to fall within Article 8 inadvertently, since they would not be able to justify the costs of compliance with Taxonomy Regulation reporting (under Article 6 Taxonomy Regulation) which is required of an Article 8 product which promotes environmental characteristics. Such costs would likely be passed onto investors and diminish returns, when Taxonomy reporting is likely to be zero, on the basis that the fund is not meaningfully promoting environmental or social characteristics. In addition, firms will want to ensure that they do not

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mislead their investors by having to categorise a product as an Article 8 product (therefore implying that the product has meaningful social and environmental features) when in fact their strategy is to maximise risk adjusted returns for investors, including through the proactive monitoring and management of sustainability risks.

On our call, we were therefore very encouraged to find that you and we agree on the fundamental principle that disclosures made by a financial market participant concerning its approach to the consideration of ESG or sustainability risks (as mandatorily required by Article 6 SFDR) should not be muddled up with the "promotion" of environmental or social characteristics for the purposes of determining the threshold of Article 8; and that therefore any discussion of ESG, or references to core ESG integration, by an FMP to a prospective investor is not enough, by itself, to bring a product within Article 8.

Accordingly, Article 6 will allow private equity, venture capital and infrastructure fund managers to disclose on a range of approaches to the consideration of sustainability risks, from adoption of minimum standards to robust consideration of ESG factors in the investment decision-making process and portfolio management phase (i.e. during the period of their ownership of a particular portfolio company). You described these approaches as having "outside-in" financial impacts.

In Annex 1, we set out our suggestion of how the threshold for Article 8 should be determined. In summary, we think the test is whether the product promotes environmental or social characteristics in a way which suggests that certain investments would not be made by the product on environmental or social grounds, even if those investments otherwise met the product's risk and return objectives. These would be "inside-out" effects, as you described them.

<u>Article 8: exclusion screens</u>

However, we are somewhat concerned that you were not able immediately to agree with our suggestion that Article 8 should *not* be triggered merely because a product incorporates a norms-based or other exclusion screen (for example, a screen for thermal coal, tobacco or pornography). We suggested that treating these products as Article 8 products would lead to undesirable outcomes (which others have labelled "reverse greenwashing") because this characteristic alone does not render them "more sustainable" products at all. In Annex 1, we give some hypothetical examples of our concern.

You commented that, in your experience, some products which have exclusion screens *<u>do</u>* sell themselves on the basis of these green credentials alone, and that these ought to be Article 8 products. Having reflected on what you said, we agree that this is a risk in some contexts, for example in the retail fund context. In Annex 1, we give a retail fund example, but contrast it with a different, typical private equity situation.

In light of our conversation, we now suggest that an institutional Article 8 product (such as an AIF) should not trigger Article 8 merely because the product incorporates a norms-based or other exclusion screen, <u>provided that the existence of such screen is not actively promoted as a</u>

positive feature as part of an attempt to "badge" or "sell" the product as sustainable. In Annex 1, we explain how, in the private equity, venture capital and infrastructure fund industry (and, in our experience, in the alternative fund industry more broadly) such screens are put in place not as a result of any active marketing by the financial market participant but rather because sophisticated, institutional investors with considerable market power demand their inclusion, often in investor's standardised "side letters" imposed on all of their appointed managers, irrespective of strategy or mandate. To categorise all such products as Article 8 products would, in effect, render almost all private equity and venture capital funds as Article 8 products, even though most do not actively promote their exclusion screens as a core part of their product and cannot therefore be said to "promote" environmental or social characteristics by virture of having this screen. We do not think this can have been the legislator's intention, nor do we think that it would be appropriate given the potential to mislead investors (who, incidentally, once they have invested in a closed-ended product are not able to exit from it easily because they do not like the investment strategy).

Other ESA questions

In case helpful, we set out in Annex 2 our thoughts on some other of the ESAs' questions to Mr Berrigan. Of these, the topic which concerns us most is the last question, relating to public disclosures pursuant to Article 10 SFDR by private funds. In our view, specific public disclosures of information relating to private products (i.e. those not available to retail investors) would be both novel and inappropriate. We would be very grateful if you could consider addressing this concern explicitly or (if that is not possible) by implication in any guidance you publish.

We are at your disposal to discuss these matters further.

Yours sincerely,

Martin Bresson
Director of Public Affairs

ANNEX 1

Meaning of "promotion" in the context of products promoting environmental or social characteristics

This is our key concern, as illustrated by the emphasis which we put on it in our telephone call.

In raising this concern, we are acutely conscious that firms managing Article 8 products which promote (specifically) environmental characteristics will need to make detailed reports to investors (and potentially the wider public – see below) pursuant to the detailed requirements to be included in the RTS and Article 6 of the Taxonomy Regulation from 2022, and some may need to make a considerable investment in systems in order to gather data for that purpose. In many cases, these costs are likely to be passed onto investors. Either way, the costs may be beyond some of our members and not proportionate or relevant to their investment strategies, which are not marketed on the basis of their specific sustainability characteristics.

The threshold

In our view, Article 8 should only be engaged if the product *promotes* environmental and/or social characteristics in a way that suggests that certain investments would not be made by the product even if those investments would otherwise meet the fund's risk and return objectives. Therefore, in order for a product to meet the Article 8 threshold, the manager would apply two conditions before a prospective investment could be approved for the fund: (1) that the investment satisfies the fund's risk and return objectives (which, in our industry, will in most cases be at least market-level returns); and (2) meets a pre-defined environmental or social standard. Such a standard could cover: (a) investments that would be avoided for certain negative externalities; and/or (b) investments that have certain positive environmental and/or social characteristics. Such a two-pronged approach would help differentiate an Article 8 product from other funds, and help define its scope. **We would be delighted if you would consider reflecting this concept in your guidance please.**

It would follow from reaching this position that, absent other active promotion of environmental or social characteristics, the following could form part of Article 6 disclosures but none would be sufficient to engage Article 8:

- Firm or fund-level sustainability-related disclosures regarding investment processes if they are made only to comply with a legal obligation (e.g. a sustainability risk disclosure per Article 6 SFDR).

- Firm or fund-level sustainability-related disclosures explicitly or implicitly related to the firm's obligations to maximise risk-adjusted investment returns and not constraining investment decisions by reference to environmental or social considerations (i.e. no dual conditionality).

- The sponsoring firm's subscription to certain sustainability frameworks or standards, in particular where those frameworks focus on management of financially material sustainability risks and explicitly recognise that fiduciary risk-and-return related obligations to investors are paramount (for example, the Principles for Responsible Investment[1]), or mandate reporting.

Negative screens: our view

Furthermore, in our view, Article 8 should *not* be triggered merely because a product incorporates a norms-based or other exclusion screen (for example, a screen for thermal coal, tobacco or pornography) and [this proviso has been added in light of our recent conversation] <u>provided that the existence of such screen is not actively promoted as a positive feature as part of an attempt to "badge" or "sell" the product as sustainable</u>. A product may be considered to be actively promoting a screen, for example if this was the core proposition to investors.

Similarly, a merely confirmatory response to one or more investors' request or enquiry – i.e. where a financial market participant confirms to a particular investor, when asked, that its product is not going to do [X] - should not push the product into Article 8, provided that [X] has not previously been identified as part of the product's strategy. This is particularly relevant in the context of side letter assurances (see below) which may be given on a 'for-avoidance-of-doubt' basis rather than as substantive commercial concessions.

Negative screens: context

It is important to understand the particular circumstances in which negative screens arise in our industry (and, in our experience, in the alternative asset management industry for the most part).

Private funds are typically structured as limited partnerships (such as Luxembourg *société en commandite spéciale*, SCSps). These are inherently flexible legal structures.

The principal legal document governing the fund is its limited partnership agreement, which will typically cross-refer to a formal "private placement memorandum" (PPM) or "issuing document". The PPM or issuing document will typically be the main vehicle for the manager's proactive marketing statements, including any environmental or social characteristics it chooses to promote, but this may be supplemented by other documents made available to prospective investors in an electronic data room.

Investors in these products will almost always be large, sophisticated, insitutional investors, who are either themselves extremely knowledgeable, or who are well-advised by specialists, or both. Such investors will include insurance companies, pension scheme trustees, and specialist fund-of-fund managers. Such investors have considerable buying-power and negotiating-power.

[1] The Principles for Responsible Investment are explicitly subject to a firm's "fiduciary" duties. As stated in the signatory declaration: "In signing the Principles, we as investors publicly commit to adopt and implement them, *where consistent with our fiduciary responsibilities.*"

The limited partnership will be heavily negotiated between (at least the cornerstone) investors and the general partner (FMP or AIFM), and their respective lawyers. In addition, it is global market practice for the general partner (typically an affiliate of the AIFM, the financial market participant for the purposes of SFDR) to be entitled to negotiate “side letters” between individual investors and the general partner. These can range in scope from administrative matters, to special reporting frameworks and additional rights, such as excuse rights in relation to particular investments. Any matter which affects all limited partners is generally considered to be more suitable to be included in the limited partnership agreement. Limited partnership agreements typically include a most-favoured-nation (MFN) clause, under which limited partners making commitments to the fund of the same amount are shown all side letter provisions granted to other investors and are given the right to elect to have the benefit of such provisions.

Very many limited partners, and all of those making the largest commitments, will maintain their own standard side letter provisions, which they impose on all managers, typically on a take-it-or-leave-it, non-negotiable basis.

It is in such standardised investor side letters that ESG screens are typically found. They are not an active part of the FMP’s design or promotion of the fund, nor part of the core investment proposition. Of course, over time, a particular FMP may learn from experience and in subsequent products pursuing the same strategy offer first to apply norms-based or standardised screens, for example against tobacco, pornography, child labour or thermal coal extraction. But, even in these cases, this is not a positive feature of the product actively promoted in an attempt to “badge” or “sell” the fund as sustainable.

Example 1

Please consider this hypothetical example, which illustrates the risk of reverse greenwashing.

A large private equity technology fund invests in EU technology growth opportunities. Typically, the sustainability risks in these types of investments are low and few to none investments would satisfy proposed Taxonomy Regulation technical screening criteria. The manager knows that a key prospective investor wants to invest in a ‘sustainable manner’.

Today, and if the Article 8 threshold is as we advocate: The manager would explain its ESG capabilities and how it addresses (limited) financial sustainability risks in its investment process.

In future under SFDR if a negative screen is sufficient by itself to constitute a fund an Article 8 product: The fund realizes it could be commercially interesting to position itself as more sustainable. It therefore commits that it will “not invest in tobacco products”, although the manager wouldn’t have considered these anyway as these are not technology investments. This brings the fund into the scope of Article 8. The investor likes the ‘light green’ status and decides to commit. Reporting requirements for the fund would likely be manageable: the FMP can report pursuant to Article 11(1)(a) that 100% of their assets are aligned with the ESG objective and likely none of the investments in their strategy would be Taxonomy aligned so, whilst they will bear Taxonomy measurement and reporting costs under Article 6 Taxonomy Regulation, these may be limited.

Example 2

Please consider this hypothetical example, which illustrates the risk of disproportionate reporting burden.

A small private equity fund with a defined product strategy of investing in EU manufacturing businesses. Certain of its investments could potentially fall to be assessed against proposed Taxonomy technical screening criteria. One large investor only wants to make a commitment if the fund will confirm it will not invest in thermal coal extraction – even if this is outside of the stated investment strategy.

Today, and if the Article 8 threshold is as we advocate: The manager would typically accept this as doing so will allow them to secure a sizeable investment in the fund and have no impact on the strategy or operations of the fund nor on any of the other investors.

In future under SFDR if a negative screen is sufficient by itself to constitute a fund an Article 8 product: Accepting the thermal coal exclusion would require disclosure and reporting under Article 8 and trigger Taxonomy reporting under Article 6 of the Taxonomy Regulation. Before accepting a potentially attractive investor, the manager first needs to consider whether it would be able to meet the additional reporting obligations and the costs associated with that, and whether it will bear those costs itself or pass them onto investors (and, typically, reporting costs would be borne by the investors).

Example 3

Please consider these comparators, based on real life examples, which illustrate that you are right to be concerned that certain products could in some circumstances be sold by reference to their exclusions or screens, but demonstrates how our revised test would solve this problem.

A retail ESG fund is called a Sustainable Investment Fund and emphasises its exclusions in its fund factsheet as a core part of its investment proposition. In this case of a retail fund investing predominantly in minority positions in cash equities, exclusion screens are the main way in which the fund manager differentiates this fund from its non-ESG offerings.

On the other hand, a typical large European private equity fund will have an exclusion policy, but that is not widely advertised to investors, even though it is included in the detailed information about the product that is made available to prospective investors.

In general, the fund’s factsheet or key information document will not mention the exclusions, even though its responsible investment policy does in fact have an extensive exclusion list and a comprehensive ESG policy (the latter aimed at addressing sustainability risk). These are important to the firm, but are not a core part of the manager’s proposition to investors.

ANNEX 2

OUR THOUGHTS ON OTHER OF THE ESAS' QUESTIONS

Application of SFDR to non-EU AIFMs

This is a question which we have considered at length. In our view, only fund level obligations (i.e. Article 6 and, as applicable, 8 and/or 9) apply in the context of a non-EU AIFM marketing a fund into the EU pursuant to Article 42 AIFMD. It would be disproportionate and very hard to enforce firm-level obligations on these managers.

Application of SFDR to small registered AIFMs

This is also a question which we have considered at some length. In our view, the question of how SFDR applies to a sub-threshold AIFM should be a question determined by the law of the (home) Member State of that AIFM.

Financial market participants under SFDR include 'AIFMs' as defined in point (b) of Article 4(1) of AIFMD.

This is a broad, activities-based definition which includes all "legal persons whose regular business is managing one of more AIFs" regardless of whether, or the extent to which, they are caught by AIFMD.

Sub-threshold AIFMs (within the exemption in Article 3 AIFMD) are AIFMs within that definition. On this basis, some argue that they will be financial market participants for the purposes of SFDR.

However, the pre-contractual disclosure requirements in Article 6 SFDR and the periodic report disclosure requirements in Article 11 SFDR set out an exhaustive list of ways in which SFDR-required disclosures should be made. This does not include any method relevant to sub-threshold AIFMs. Specifically, they are not obliged by EU law to prepare disclosures to investors "referred to in Article 23(1)" of AIFMD (Article 6(3)(a) SFDR).

The regulation of sub-threshold AIFMs is left to the policy determinations of Member States. For this reason, we believe that the question of the application to them of SFDR should be determined by the Member States.

Application of the 500-employee threshold for principal adverse impact reporting at entity level to parent undertakings of a large group

Our working group has not considered this topic at length. However, we believe that the position is reasonably clear that this threshold applies to an FMP which has 500 employees either: (a) itself on a solo basis; or (b) together with any subsidiaries of the FMP with whom it prepares consolidated accounts – see Article 4(3) and 4(4) SFDR and the cross-reference to the Company Law Directive.

Application of Article 9 SFDR

We believe that the scope of Article 9 is very clear. Article 9 applies to a product which has sustainable investment (a term defined in Article 2(17) SFDR) as an objective. In our industry, this will generally be identified readily in the fund's constitutional documents, for example in a summary of the principal legal terms, under the heading "investment objective". This sustainable investment objective could be (and often will be) accompanied by a binding obligation to target market rate returns (a so-called "double bottom line").

As you noted on our call, an Article 9 product cannot exist without data. It must have "relevant sustainability indicators" – see Article 11(b)(i) – which will be explicit or implicit in its investment objective.

The ESAs ask, "*Must a product to which Article 9(1), (2) or (3) SFDR applies only invest in sustainable investments as defined in Article 2(17) SFDR?*" We think it is clear that an Article 9 product need not invest exclusively in sustainable investments. However, it would need to specifically target investments (at least for a material proportion of the fund) which make a measurable "contribution to" an environmental and/or social objective.

The ESAs go on to ask, "*If not, is a minimum share of sustainable investments required (or would there be a maximum limit to the share of "other" investments)?*" We do not see any basis to support the imposition of a minimum share, beyond a material proportion, which must be implicit from having sustainable investment as an objective.

Application of SFDR product rules to MiFID portfolios and other tailored products

The ESAs ask, "*If the disclosure requirements of SFDR apply at the portfolio level, how is it possible to maintain confidentiality obligations to the client in view of the disclosures required, especially the website disclosures required by Article 10 SFDR?*"

Invest Europe does not represent many members running MiFID portfolios and other tailored products, so we have not engaged on this question directly.

However, under this broad heading, we do have a point of concern, which we raised briefly at the end of our telephone call.

Article 10 of the SFDR requires certain financial market participants to make website disclosures in relation to Article 8 and Article 9 products. We think it is important for the Commission to confirm that this obligation does not apply in relation to products <u>where information is not otherwise made available to the public</u>.

Most private funds are not made available to retail investors; indeed, European and international marketing and securities law are generally clear that private funds may not be marketed to such investors except in certain clearly defined circumstances. These requirements are particularly stringent in certain countries, including the United States, and making information about specific products available to the public could have very serious consequences for the manager. Most private equity, venture capital and infrastrcture funds are only marketed to professional investors and, in practice, great care is taken to ensure that information about these products is not included in publicly available materials.

Invest Europe members believe that it would be inappropriate to make product-specific information available to the public generally, even with appropriate disclaimers, as this would seem contrary to the general policy objective of ensuring that only investors for whom a product is suitable are given information about that product. We also think it is not necessary because retail investors cannot typically invest in the products. The number of investors in private equity, venture capital and infrastructure funds are limited, and investor disclosures, as required by Articles 8, 9 and 11, will ensure that they have the information that they need.

We therefore think that the Commission could helpfully clarify that product-specific website disclosures are only required where there is other information available about the product on a website. In this regard, we note that Article 33 of the draft RTS published last year by the ESAs said: *"Financial market participants shall publish the information on their websites in accordance with Article 10(1) of Regulation (EU) 2019/2088 and this Chapter in a section titled 'Sustainability-related disclosures' in the same part of the website as the other information relating to the financial product, including marketing communications."* By implication, if there is no other information about the financial product on the website, we would suggest that there would be no requirement to include it.