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

12 May 2021

Response to the ESAs Joint Consultation Paper concerning Taxonomy-related sustainability disclosures – draft regulatory technical standards with regard to the content and presentation of sustainability disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088

INTRODUCTION

On behalf of the Public Affairs Executive, Invest Europe welcomes the opportunity to respond to the ESAs Joint Consultation (JC 2021 22) concerning Taxonomy-related sustainability disclosures under Regulation (EU) 2019/2088 (Regulation on sustainability-related disclosures in the financial services sector or SFDR).

- **Preliminary points: Recitals**

We refer to our letter to the European Commission (dated 23 February 2021) in which we set out our concerns regarding the recitals to the draft SFDR RTS and in particular our concerns on issues of potential overreach by the ESAs and/or divergence from the Level 1 legislation. We would like to take the opportunity to reiterate these concerns, which are of ongoing importance to our members.

- **Preliminary points: Interpretation of reporting requirement for an Article 8 SFDR product**

We refer to our email to the European Commission on this dated 26 April 2021. In this email, we noted that our reading of the joint ESA consultation paper is that financial products classified as Article 8 SFDR products will only need to report under Article 6 Taxonomy Regulation ("TR") if: (i) such products positively commit to making environmentally sustainable investments as defined by Article 2(17) SFDR; and (ii) the Article 8 SFDR product has an environmental characteristic corresponding to a Taxonomy Regulation Article 9 objective.

Accordingly, therefore, a product which makes no such commitment is not required to measure or report under Article 6 Taxonomy Regulation or the Taxonomy-related disclosure RTS. Our understanding from the ESAs joint public hearing held on 29 April 2021 was that this view is shared by the ESAs.

Please can the ESAs confirm that this is correct?

We believe that it follows from the above that, where an Article 8 SFDR product does not *commit* to making sustainable investments as defined by Article 2(17) SFDR, but then does in fact make such an investment, that product would also not be required to disclose taxonomy alignment under Article 6 of the TR. We

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understood from the ESAs public hearing that the ESAs also share that view, but reserved final judgement on the question.

Please can the ESAs confirm that our view, and the view expressed by the ESAs at the public hearing, is correct?

In addition, we further understand that, where a financial market participant manages and has marketed a product on the basis that it seeks to invest a stated percentage of the fund in "sustainable investments" as defined by Article 2(17) of SFDR, the financial market participant will be obliged to assess the taxonomy alignment of the proportion of the fund allocated to environmentally sustainable investment, but not the remainder of the fund. For instance, where an energy fund is marketed on the basis that 20% of the fund will be invested in energy investments which have a climate change mitigation objective, the manager will clearly delineate between capital invested in (a) sustainable/taxonomy-aligned investments (in accordance with the fund's objectives) and (b) non-sustainable (other) investments. Investments classified as (a) will report taxonomy alignment in accordance with the relevant KPI. The manager would *not* be required to assess the remaining 80% of the fund's investments against the Article 3 criteria in the Taxonomy Regulation. It would be open to the manager to report "zero" contribution for these investments, even if some of them do co-incidentally meet the criteria for environmentally sustainable economic activities. Alternatively, financial market participants could analyse some or all of these "other" investments to determine whether they meet the Article 3 criteria and for those which do, could obtain the Article 8 financial information for inclusion in the fund periodic disclosure. This interpretation seems both logical and consistent with the policy objectives: it would be disproportionate, given the difficulties discussed below in undertaking taxonomy-alignment assessments in many investee companies, to require such an assessment to be made in relation to investments which are not classified as "sustainable investments" by the manager of the Article 8 SFDR product.

We would be grateful for confirmation of this understanding.

Finally, based on statements made at the public hearing, it is our understanding that the ESAs consider that it is open to an entity to choose to classify an investment underlying a financial product as not aligned with the Taxonomy due to a lack of data (including where such data would be difficult or disproportionately expensive to obtain).

Please could the ESAs confirm that this is correct?

- **Preliminary points: Timing of implementation**

Currently under the draft RTS, it would appear that financial market participants must draw up periodic reports (as referred to in Article 11(2) SFDR) in accordance with their normal reporting cycle to include reporting on climate change mitigation and adaptation using the RTS template disclosure from 1 January 2022. We note that the final delegated acts relating to Article 5/6 Taxonomy Regulation may only be published in the final quarter of 2022.

More generally, we are concerned about the varying timelines for the finalisation and application of the RTS under the Taxonomy Regulation and SFDR, and how they interact with each other. We would like to ask the

ESAs to consider an alignment of all SFDR-related Level 2 application dates which should be set several months after the publication of the Delegated Acts in the Official Journal. Alternatively, the ESAs should consider adopting a phased and transitional approach during the first year to allow fund managers to adapt to the various elements of the SFDR and the Taxonomy in a coherent way. On a related note, it may also be worth re-assessing whether 1 January 2022, as proposed in the SFDR draft RTS, is a realistic deadline for the entry into application of all SFDR-related Level 2 measures.

Furthermore, we consider that the text of the Level 1 Regulation relating to the first reporting period is ambiguous. Given the detailed content and presentational requirements of the periodic disclosures and the significant resources that financial market participants will have to dedicate to preparing for reporting on taxonomy alignment we suggest that the RTS applies to reference periods starting *on or after 1 January 2022*. In practice, this would mean that the first periodic reports would be due in 2023 in respect of a reference period relating to 2022. This particular issue is quite sensitive for funds investing in SMEs, or (for the time being) large unlisted companies, which may not be subject to reporting under the NFRD (Non-Financial Reporting Directive).

- **<u>Preliminary points: Definition of Taxonomy-aligned and sustainable investment</u>**

We note that paragraph 38 of the Joint Consultation Paper states that "investments in taxonomy compliant activities are sustainable investments in accordance with Article 2(17) SFDR". We urge the ESAs to clarify this statement further and provide guidance. For instance, is it the ESAs' view that:

(a) investments in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation will be deemed to meet the definition of a "sustainable investment" in Article 2(17) SFDR; **<u>or</u>**

(b) *only* those investments that fall within Article 2(17) SFDR are capable of being taxonomy-aligned; **<u>or</u>**

(c) *only* economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation can be classified as environmentally "sustainable investments" (i.e. on the basis that they contribute to an SFDR environmental objective, as opposed to a social one) according to Article 2(17) SFDR?

- **<u>Preliminary points: Coherence</u>**

We note that the obligation to report taxonomy alignment applies to entities that may already be reporting certain non-financial information under the NFRD. These entities will be required to report at both a firm level (under NFRD) and potentially at a financial product level under SFRD/Taxonomy. We believe that it is of the utmost importance to ensure coherence and alignment between the different levels of reporting to encourage compliance and regularity of reporting. This is particularly important to our members given the recent proposed changes to the scope of NFRD under the Corporate Sustainability Reporting Directive, which will (if implemented) bring many more asset managers within the scope of firm level reporting.

We set out our detailed responses to the consultation questions below.

QUESTIONS

Question 1: Do you have any views regarding the ESAs' proposed approach to amend the existing SFDR RTS instead of drafting a new set of draft RTS?

Answer:

Yes.

We agree with the ESAs' proposed approach to amend the existing SFDR RTS and to produce a single set of RTS. We believe that it is not necessary or desirable to draft a new set of RTS. In our view, the creation of a new set of RTS would create confusion amongst stakeholders as well as imposing additional costs and burdens on market participants.

Question 2: Do you have any views on the KPI for the disclosure of the extent to which investments are aligned with the taxonomy, which is based on the share of the taxonomy-aligned turnover, capital expenditure or operational expenditure of all underlying non-financial investee companies? Do you agree with that the same approach should apply to all investments made by a given financial product?

Answer:

Yes.

In our view, it is appropriate that firms are given the choice between these metrics and we agree that it makes sense, for consistency, that all investments made by a given financial product should adopt the same metric.

We note that in some cases it may be difficult to calculate the precise share of a portfolio company's turnover, capital expenditure or operational expenditure which is taxonomy-aligned and we believe that some latitude should be given to firms to allow them to use reasonable estimates when precise information is not available despite the firm having used reasonable efforts to obtain it. Data issues are further amplified for fund-of-funds managers, who completely depend on the data provided by the underlying fund managers of venture capital or private equity funds.

Furthermore, in light of the significant costs that may be associated with assessing taxonomy alignment for investments in companies not themselves required to report their taxonomy alignment, we believe that the ESAs should introduce an element of proportionality into the reporting of taxonomy alignment by asset managers. As mentioned above (our final point under the heading "Preliminary points: Interpretation of reporting requirement for an Article 8 SFDR product"), we believe that it is open to a financial market participant who cannot obtain reliable data at reasonable cost in relation to a particular investment to classify the investment as not aligned with the Taxonomy. In addition, we suggest that it be made explicit that financial products should *not* be required to report taxonomy alignment for an underlying investment where the investment has taxonomy-aligned turnover, capital expenditure or operational expenditure (as the case may be for the product concerned) of less than 20%, nor should reporting be required for investments in companies that qualify as SMEs. In our view, although managers may *choose* to assess and report taxonomy alignment in such investments, it would be disproportionate to *require* them to do so. Such assessment may be very costly and, if the result of the assessment was that none or only a small amount of the company's activity (in absolute terms or as a proportion of the overall activity) was taxonomy-aligned, this expensive assessment would not deliver meaningful information to investors (who would nevertheless generally bear the cost).

Question 3: Do you have any views on the benefits and drawbacks of including specifically operational expenditure of underlying non-financial investee companies as one of the possible ways to calculate the KPI referred to in question 2?

Answer:

Yes.

Even though *operational expenditure* can in principle be very straightforward to calculate, and it can make sense to calculate it for some investments, we believe this is not always the case for the private equity and venture capital (PE/VC) industry. We note that the quarterly reports of PE/VC funds typically do not include figures relating to operational expenditure in the first place (in some cases PE/VC funds may not even collect this data on a quarterly basis).

Moreover, for certain investee companies, particularly SMEs, the calculation of operational expenditure is not always easy or even possible. In this context, we believe that turnover is a better indication of taxonomy alignment. Yet difficulties can also be expected in certain cases, particularly, when estimating which part of an underlying investee company's turnover can be linked to the EU Taxonomy and can be considered EU Taxonomy compliant, given the complexity of the Taxonomy and the limited resources that SMEs would have for such reporting. Therefore, as in our response to Question 2, we suggest introducing some sort of proportionality when requiring PE/VC funds to calculate the KPI.

Finally, while we believe that turnover is a better indication of taxonomy alignment in certain contexts, we do not object to the use of operational expenditure as one of the possible ways to calculate the KPI.

Question 4: The proposed KPI includes equity and debt instruments issued by financial and non-financial undertakings and real estate assets, do you agree that this could also be extended to derivatives such as contracts for differences?

Answer:

Not applicable. We do not have a particular view on this question as the extension of the proposed KPI to derivatives such as contracts for differences is not a mainstream issue for the PE/VC industry.

However, in general terms we note that the KPI should be as easy to calculate as possible. Any decision to extend the KPI to include derivatives should be based on an analysis of whether the inclusion of such instruments would make a material difference to the KPI. We would encourage the ESAs to include only those categories of equity and debt instruments that are the most pertinent to the KPI calculation in view of its ultimate goal.

Question 5: Is the use of "equities" and "debt instruments" sufficiently clear to capture relevant instruments issued by investee companies? If not, how could that be clarified? Are any specific valuation criteria necessary to ensure that the disclosures are comparable?

Answer:

No.

We believe that the scope of the terms "equities" and "debt instruments" is unclear at present. Therefore, we would welcome further clarification and ultimately recommend that the ESAs develop definitions of the instruments in each category or refer to other official definitions already established.

We also believe that loans should be included under "debt instruments" and note that the current term does not unequivocally imply this.

Question 6: Do you have any views about including all investments, including sovereign bonds and other assets that cannot be assessed for taxonomy-alignment, of the financial product in the de-nominator for the KPI?

Answer:

Yes.

First, we believe it is important to ensure that there is a level playing field. Therefore, we believe sovereign bonds should not be treated differently to other investments.

Secondly, in addition to showing the percentage of taxonomy-aligned investments over the total of all investments, we believe that, in order not to mislead investors, it should also be possible, or required, to state the following: (i) the percentage of taxonomy-aligned assets over all of those assets that can be classified (i.e. excluding assets that cannot be classified because data is not available or because Technical Screening Criteria have not been specified); and (ii) the percentage of assets that cannot be classified over the total. We believe that requiring a single percentage, where the denominator is all assets, is misleading for investors when a number of the assets are not capable of classification.

It is important to avoid double counting, and to ensure that the information provided as a result of the KPI calculation is both easily digestible and relevant for investors. We believe that differentiating between the three percentages above will assist with this assessment and give a more accurate report for investors and others.

<u>Question 7</u>: Do you have any views on the statement of taxonomy compliance of the activities the financial product invests in and whether those statements should be subject to assessment by external or third parties?

<u>Answer</u>:

Yes.

Private equity funds do not track indices. Private equity funds take several years to deploy their capital and become fully invested. These factors mean the assessment and disclosure of taxonomy alignment will be very different to traditional UCITS funds investing in listed and traded equity and debt instruments.

We believe that, for private equity and venture capital firms, many investments will not be capable of a clear classification, in part because data will not be easily obtainable. The data problems are exacerbated for investors in private equity and venture capital funds, who will depend on the information provided by their managers. Therefore, any stated level of taxonomy alignment will be a minimum - *i.e.*, there may be investments that have not been classified as taxonomy-aligned because reliable data is not available, even though the investment is, in fact, wholly or partially aligned. This fact should be made clear to users of the disclosures, who might otherwise be misled by the disclosure made.

Furthermore, any obligation to have third party verification could be very expensive, of limited utility and burdensome (and few providers may be willing to provide this service, at least in the short term). In particular, we note that such third party assessments would likely be unduly burdensome on smaller firms as they would impose additional and disproportionate costs.

<u>Question 8</u>: Do you have any views on the proposed periodic disclosures which mirror the proposals for pre-contractual amendments?

<u>Answer</u>:

Yes.

In general terms, we believe that the periodic disclosures should mirror the pre-contractual disclosures to ensure ease of compliance and the regularity of reporting. In addition, we believe that a unified approach for pre-contractual and periodic reporting could help investors' understanding.

<u>Question 9</u>: Do you have any views on the amended pre-contractual and periodic templates?

<u>Answer</u>:

Yes.

First, there is a question regarding the temporal scope of the pre-contractual templates and how the pre-contractual disclosures would apply to closed-ended private equity and venture capital funds, which generally do not make investments until after investors have been admitted to the fund. We understand from remarks made by the ESAs at the public hearing that the pre-contractual templates are intended to reflect the *intention* for the product, *not* its actual asset allocation. Therefore, in the lead-in to the pre-contractual template for Article 8 or Article 9 products, we think that it should be clear that the question relates to the investment intention, not actual investments. It will not be possible to state definitively whether a defined proportion (or even any) of the underlying portfolio will be, and will remain, "sustainable", as defined by the SFDR. An investment may be "sustainable" when acquired but may cease to be after investment. Given that most private equity and venture capital investments are considered illiquid (not readily tradeable on a fixed exchange), it would not be possible to dispose of an investment that ceased to qualify – at least not quickly without significant prejudice to investors. On the other hand, an investment may be acquired when it does not qualify as "sustainable", but it could become sustainable (most likely due to requirements imposed by the PE/VC investor) after investment[1]. We therefore think that the pre-contractual disclosure for both Article 8 and Article 9 funds should expressly refer to the "expectation" to make sustainable investments and the intention to use the Taxonomy to determine whether an investment is sustainable, rather than imply that a stated share of investments will be and will remain sustainable or taxonomy-aligned.

Similarly, in the actual reporting required in the body of the pre-contractual template, the trigger for Article 8 SFDR products to report Taxonomy alignment in their pre-contractual disclosures is for a "financial product which includes sustainable investments" (Article 13(3)(cc) RTS). For most closed-ended products, which will not yet have made any investments, it would be meaningless to report taxonomy alignment as at the date of the pre-contractual disclosure itself (zero divided by zero). We would urge the ESAs to re-consider the drafting of the pre-contractual templates to make clear that the reporting relates to the intention for the product.

Secondly, as noted at the beginning of our response and in separate correspondence with the European Commission, our reading of the amended pre-contractual templates is that financial products classified as Article 8 SFDR products will only be required to report taxonomy alignment under Article 6 Taxonomy Regulation if such products positively commit to "invest partially in sustainable investments". It is only if a product ticks this box that the template then asks whether the financial product invests in activities aligned/non-aligned with the Taxonomy. On this reading, by implication an Article 8 SFDR product that does not make such a positive commitment (but falls within Article 8 on the basis of the promotion of an enhanced ESG screen or some other form of ESG metric) is *not* required to measure or report taxonomy alignment under Article 6 Taxonomy Regulation. As noted above, we understand, based on statements by representatives of the ESAs at the public hearing, that this is also the ESAs view.

We would be grateful for confirmation of our understanding of the template and draft RTS.

[1] Please see our response to the ESAs Joint Consultation Paper concerning ESG disclosures from September 2020 for more information on a possible ESG approach carried out at the level of the PE/VC-backed company based on each step of the investment process.

Finally, we note that neither the RTS nor the templates provide any guidance as to the *frequency* with which taxonomy alignment ought to be calculated for underlying investee companies. We assume that compliance should be assessed once per annual reporting period and stated as at the reporting date.

We would be grateful for confirmation of this understanding.

Question 10: The draft RTS propose unified pre-contractual and periodic templates applicable to all Article 8 and 9 SFDR products (including Article 5 and 6 TR products which are a sub-set of Article 8 and 9 SFDR products). Do you believe it would be preferable to have separate pre-contractual and periodic templates for Article 5-6 TR products, instead of using the same template for all Article 8-9 SFDR products?

Answer:

No.

We believe that it would be preferable to use unified templates applicable to all Article 8 or 9 SFDR products (including Article 5 and 6 Taxonomy Regulation products) as proposed by the RTS. Utilising the same templates would ensure the required alignment, compliance and encourage regularity of reporting. In addition, we believe that unified templates for Article 8 and Article 9 SFDR products could help investors' understanding.

Question 11: The draft RTS propose in the amended templates to identify whether products making sustainable investments do so according to the EU taxonomy. While this is done to clearly indicate whether Article 5 and 6 TR products (that make sustainable investments with environmental objectives) use the taxonomy, arguably this would have the effect of requiring Article 8 and 9 SFDR products making sustainable investments with social objectives to indicate that too. Do you agree with this proposal?

Answer:

No.

In our view, it should be clear from the template that a product which commits to make socially sustainable investments (and not environmentally sustainable investments) is not required to use the Taxonomy and should not be required to state whether it does so. We consider that the current template is potentially misleading in this respect and may even create the impression that sustainable investments with a social objective or environmental objectives not currently covered by the Taxonomy Regulation may be somehow less worthy (an impression that is reinforced in the template by the symbol for taxonomy-aligned investments being crossed out for these types of investment).

Question 12: Do you have any views regarding the preliminary impact assessments? Can you provide more granular examples of costs associated with the policy options?

Answer:

General: Preliminary impact assessment

Our view is that the setting of a minimum standard of harmonised rules makes sense as it allows for a degree of comparability. However, it is crucial that the templates cater for the specificities of certain financial products, such as private equity or venture capital funds (which are blind pools). At present, we do not think that the templates achieve that allowance for the specificity of these financial products.

Internal reporting teams will have to allocate significant additional resources. It is estimated that the initial phase and set-up will likely be costly, but we are unable to give a general statement as to the impact as costs will be specific to each individual firm given the number and type of products managed. Thereafter, we note that the Regulation will create additional annual costs for the additional reporting, but this should be normalized within 24-36 months.

Examples of costs

As indicated above, we do not have numerical evidence of the impact yet; however, it is clear that the policy options presented will result in additional costs, at both the manager and portfolio company level (because of the need to provide information in additional formats). For the latter, costs will also vary depending on the type (listed versus unlisted companies) and the size of the company as costs for larger companies would be less burdensome (relatively speaking) than for SMEs, which constitute the majority of PE/VC portfolios. Therefore, we believe a level playing field needs to be ensured.

Moreover, to reduce unnecessary costs we believe it will be essential to ensure alignment with extant legislation such as the NFRD and proposed future developments. The higher the level of alignment with existing legislation, the lower the costs will be at both the management and portfolio company levels for companies.

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.

About Invest Europe

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

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

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