INVEST EUROPE

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24 January 2022

Dear Sirs,

We understand that the European Supervisory Authorities (ESAs) will shortly be preparing Questions and Answers (Q&A) on the Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation. We appreciate that some of these Q&A will be posed to the European Commission to supplement those published on 26 July 2021, and that others will be answered by the ESAs themselves.

We set out in the Annex certain suggested Q&A, which are inspired by questions posed by our members. We should be delighted to discuss them with you.

We wanted also to brief you on discussions which we have had recently with some European policymakers and which may inform your or the European Commission's approach to the forthcoming Q&A.

Interaction between SFDR and the Taxonomy Regulation

In our view, the Level 1 text of Article 6 of the Taxonomy Regulation (TR) only requires a financial market participant (FMP) to report on the level of Taxonomy alignment of a particular product (and other related information set out in TR Article 6) in its pre-contractual and periodic reports <u>if</u> it is an SFDR Article 8 product which <u>both</u> (i) promoted an environmental characteristic; <u>and</u> (ii) had made a commitment (or indicated an intention) to make some environmentally "sustainable investments" (as defined in SFDR Article 2(17)). That interpretation is based on the cross-reference in TR Article 6 to TR Article 5, pursuant to which Article 5 shall apply *mutatis mutandis* when a financial product promotes environmental characteristics. We read this cross-reference with a reference to a "*mutatis mutandis*" application to mean that only where the financial product promotes environmental characteristics ***and*** promotes that it makes, or will make, sustainable investments, Article 5 – which itself explicitly only relates to products that make sustainable investments – shall apply. Such a reading would also be consistent with the ESAs' October 2022 SFDR RTS final report and the draft templates (Article 61a of the draft RTS states for example (our emphasis): "*For financial products referred to in Article 6 of Regulation (EU) 2020/852, <u>where the financial product included a commitment to make sustainable investments</u>, the section referred to in point (c) of Article 58(2) shall also contain the following information:[…]*") and we believe that it is also consistent with the policy intent – it does not seem necessary for a product which has made no commitment to make sustainable investments to report on how many (Taxonomy-aligned) sustainable investments it has made. This topic was discussed at the ESAs' public hearing on 29 April 2021 and we had understood then that the ESAs agreed.

However, we understand that this may not be in line with the expectation or interpretation of other policymakers. Subject to the final form of the Regulatory Technical Standards (which we understand are likely to be published in early 2022), in their view any and all environmental SFDR Article 8 products are required to comply with TR Article 6 and to report their level of Taxonomy alignment (while such level could also be zero – see below). We continue to believe that this imposes an unnecessary burden on firms that have promoted an environmental characteristic (for example, an exclusion of oil and gas investments) but made no positive commitment to make environmentally sustainable investments.

In that context, we have been told that the obligation to disclose Taxonomy alignment, which presumably has to be a quantitative disclosure, does not imply an obligation to be Taxonomy aligned and to build systems to determine actual levels of Taxonomy alignment in the portfolio. We understood from the discussions that, if an FMP does not have the information required in relation to any particular investment – for example, because the investee company is not an entity that is reporting its Taxonomy alignment under the EU's NFRD – there is no obligation on the FMP to undertake its own Taxonomy alignment assessment for that investment and it would be open to the FMP simply to report it as "0%" aligned. If, as might well be the case for a venture capital or private equity investor, none of the companies in the portfolio report their levels of Taxonomy alignment, it is possible that an FMP may need to report their Taxonomy alignment as 0% for the entire portfolio, even though that might well understate the actual level of alignment that would be evident if data were available. Reporting 0% alignment is not ideal as it implies that an actual assessment of Taxonomy alignment has taken place and that the result was 0%. For that reason, to avoid misleading investors, we assume that FMPs will be able to include a note in the disclosure templates to indicate that the report is based (wholly or partly) on a lack of available data, rather than the result of an actual assessment. This clarification is very important to our members, and will be equally important to investors to understand the entire context in which the disclosure is made.

In private, illiquid, markets, it is likely to be significantly costly to build systems to measure Taxonomy alignment (since there will be no public disclosures or third-party service provider data on which to draw). Such costs would be likely to be passed onto investors. We remain strongly supportive of the Taxonomy Regulation as a key tool to tackle the climate emergency and other pressing environmental concerns. However, we understand that the framework is one of disclosure and market choice and it may be that – at least in the early years – some of our members choose not to develop Taxonomy measurement systems for private assets, recognising that they may be at a competitive disadvantage to those who do, for example where asset owners / investors themselves require Taxonomy data on a look-through basis.

SFDR Article 8 products which do not target sustainable investments

In our discussions with policymakers, we briefly touched on the fact that an SFDR Article 8 product which does not commit to make any SFDR sustainable investments is under no obligation to report the proportions of SFDR "sustainable investments". We consider that this is clear from the final draft ESA template and RTS, which says that certain sections of the template only need to be completed by an Article 8 product that "made sustainable investments" or "includes sustainable investments", and we assume that this accords with your understanding. We would be grateful if you could confirm this in your Q&A. This is important for reasons both of cost and feasibility. It may be costly in particular to develop systems to measure whether particular investments do not significantly harm environmental or social objectives (by reference to the Principal Adverse Impact indicators) and whether the underlying investments follow good governance practices in accordance with the definition in SFDR Article 2(17). Again, some of our members may choose not to develop such systems, recognising that they may be at a competitive disadvantage to those who do.

However, while costs might be one consideration, for many products it will also often not be possible for a firm to collect the data required to undertake the analysis. For a fund-of-funds, for example, it will not be possible to collect the required data directly from the portfolio companies and they will be dependent on the underlying fund managers - many of whom may not be in the EU – to provide such data. If the fund managers do not collect the data, it will not be possible to undertake the reporting.

SFDR Article 8 products which do target sustainable investments

Finally, we also have some concerns about the final draft ESA pre-contractual templates as they relate to SFDR Article 8 products which do commit to make SFDR sustainable investments. For a blind pool fund, the levels of investment in "sustainable investments" will generally be zero at the time that the templates are issued (because the product will have made no investments at all at that stage). Similarly, it will not be possible to guarantee a particular allocation to such investments because: (a) suitable investment opportunities in investments that qualify as "sustainable investments" may not be available to the FMP; and (b) as the portfolio changes over time, the proportion of investments which qualify as "sustainable investments" will vary significantly.

For example, assume that a blind pool financial product targets 50% sustainable investments and intends to split its capital equally between two investments, one of which is "sustainable" and the other is not. At the time of its pre-contractual disclosures, its actual sustainable investments will be 0 (as will its level of non-sustainable investments), but it could state that its target is 50%. If the product then makes its first investment in the non-sustainable investment, its sustainable investments will still be 0, and will remain so unless and until it is able to identify a suitable sustainable investment, at which point it will be 50% (subject to changes in the valuations of the two investments, which will lead to fluctuations). Then, when it realises one of the investments, the sustainable investment proportion will either be 0 or 100%, depending upon which of the two investments is realised first. The investments in a private equity or venture capital fund are generally illiquid, so it will not be possible to re-balance the portfolio in the short term.

For these reasons, our view is that the "minimum proportion" to be included in the pre-contractual template should be read to require disclosure of the targeted minimum proportion of sustainable investments over the life of the product (rather than at any given point in time). This then carries with it an ongoing obligation to report in the periodic reports the actual level of such sustainable investments, so that the investors can see whether the target has been achieved.

We understand that it may not be possible, at this stage, to amend the actual templates to clarify that this is the intention, so it would be very helpful if this point could also be covered in the ESAs' Q&A.

Finally, we would be grateful if the ESAs could confirm the date that we might have sight of the ESAs' Q&A.

We would be delighted to meet with you to discuss any of the points in this letter or its Annex.

Yours faithfully,

Martin Bresson
Director of Public Affairs

Annex 1: Suggested Questions and Answers on the application of SFDR and the Taxonomy Regulation

Annex 1: Suggested Questions and Answers on the application of SFDR and the Taxonomy Regulation, inspired by questions posed by Invest Europe members

1) OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights

Question:

For SFDR purposes, how are firms expected to assess "whether the sustainable investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights" (as required by the final draft RTS, Articles 14, 21, 30, 34, 47, 59 and 65)?

Suggested Answer:

Although the SFDR (Level 1) does not include a reference to these international standards, they are explicitly mentioned in Article 18 of the Taxonomy Regulation (TR) in the context of the minimum safeguards required by TR Article 3(c) for environmentally sustainable activities. Furthermore, Recital 36 to the TR requires the regulators to develop their rules on DNSH in the SFDR RTS in a way that is consistent with these specified international standards.

Therefore, the final draft RTS includes a requirement to make an assessment according to the specified international standards for investments that are intended to be categorised as "sustainable investments" under SFDR Article 2(17). Such an assessment is part of the process to determine whether an investment passes the "do no significant harm" (DNSH) test. Unlike in the TR, it is not a self-standing requirement.

The full text of the requirement included in the final draft RTS (Article 59) is as follows:

For financial products that included a commitment to make sustainable investments, an explanation of how the sustainable investments have contributed to a sustainable investment objective and not harmed significantly any of the sustainable investment objectives during the reference period, including:

(i) how the indicators for adverse impacts in Table 1 of Annex I, and any relevant indicators in Tables 2 and 3 of Annex I, were taken into account; and

(ii) whether the sustainable investment was aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

In this context, "alignment" with the OECD Guidelines and UN Guiding Principles (and relevant ILO standards) is not understood to mean that the investee company has to follow each and every one of the detailed recommendations of the specified international standards. Indeed, for most investors looking at a prospective or existing investee company, such a detailed assessment would be impossible or, at best, impractical, and for many smaller or lower risk businesses, such compliance would in any event be disproportionate. Rather, the requirement is for the financial market participant to undertake due diligence to determine, as part of its DNSH analysis, whether there is any evidence that the business is being carried on in a way that is inconsistent with those international standards and, therefore, harmful.

Further support for that view comes from the use of the word “whether” in the relevant Articles. That implies that a “sustainable investment” can be a “sustainable investment” (and, therefore, not fail the DNSH test) even if it is not fully aligned with the standards. The standards are relevant in assessing DNSH, but not in themselves determinative. In particular, this leads credence to the market understanding that building operational systems to diligence investments in relation to the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights is not mandatory.

In the context of the TR, the Technical Expert Group (TEG) on Sustainable Finance (in its March 2020 final report, pages 45 et seq.) considered the question of how investors should assess Taxonomy alignment in the absence of information from the company itself. According to the TEG, companies and issuers are expected to have conducted due diligence on the operations related to those activities that they wish to qualify as Taxonomy-aligned. This due diligence should be **risk based** (i.e., commensurate to the severity and likelihood of potential adverse impacts) and **proportionate** (i.e., take account of factors such as enterprise size, context of operations, business model, position in supply chains and nature of products and services). On the latter, the TEG note: “The principle of proportionality applies to investors and to the entity assessed. “The nature and extent of due diligence, such as the specific steps to be taken, should be appropriate to a particular situation and will be affected by factors such as the size of the enterprise, context of its operations, the specific recommendations in the OECD Guidelines, and the severity of its adverse impacts”.” It goes on to say that, for a private equity, real estate or infrastructure investor, the pre-investment obligation is to: “conduct research to assess compliance and identify [responsible business conduct] risk”. Post-investment the obligation is to “include RBC risk in ongoing monitoring”. There is also a recommendation to follow the due diligence recommendations of the OECD.

Therefore, we interpret the requirement to assess and report on “alignment” with the specified international standards for SFDR purposes as a requirement – subject to principles of proportionality – for an investor to conduct due diligence as part of its assessment of DNSH for SFDR “sustainable investments”. Such due diligence may rely on publicly available materials and is designed to identify whether the business is being carried on in a way that is inconsistent with the principles enshrined in the specified standards. It is not designed to identify whether the detailed requirements of the principles are being applied, and, while it may include such analysis, does not require analysis of the internal procedures implemented by the company to ensure compliance.

2) PAI indicators for real (estate) assets

Question:

Can the PAI indicators for real estate assets set out in Annex I of the draft SFDR RTS be used for other real asset categories such as infrastructure or renewables if the focus of the investment is on the real asset (and not any operating activity carried out by an investee company)?

Suggested answer:

In our view, this should be possible. The PAI indicators for investee companies do not adequately capture the impact of real assets which are either held directly or via special purpose vehicles without any own business other than holding the respective asset. This would also be in line with Recital (4) of the Draft SFDR

RTS (February version) according to which principal adverse impacts should be assessed at the level of the asset rather than at the level of a holding company, collective investment undertaking or special purpose vehicle (look-through principle).

3) SFDR DNSH test

Question:

If, for sustainable investments, the SFDR DNSH test needs to be carried out in addition to the Taxonomy alignment assessment, is it possible that an investment is Taxonomy-aligned, but fails to meet the SFDR DNSH test and therefore does not qualify as sustainable investment under Article 2 (17) SFDR?

Suggested answer:

In our opinion, this should not be possible. In the Background section to the Draft Taxonomy SFDR RTS (October version) (p. 8) the ESAs noted that for formal reasons it is not possible to derogate from the SFDR DNSH test even if as part of the Taxonomy alignment, a Taxonomy DNSH test has already been carried out. However, since Article 18 (2) Taxonomy Regulation makes reference to the SFDR DNSH principle, requiring companies to adhere to it when implementing minimum safeguards, we do not see any additional scope of application for the SFDR DNSH test.

4) Concept of PAI

Question:

Is the concept of PAI used in the context of SFDR and other pieces of regulation (sustainability preferences under IDD/MiFID II and due diligence policies of AIFM and UCITS managing companies) the same, i.e. can FMPs subject to these different regulations use the PAI indicators and the respective procedures to meet all respective requirements?

Suggested answer:

In our opinion, this should be possible to ensure common standards and effective and strategic implementation of the "double materiality" concept. Requiring FMPs to use different indicators or assess them differently for the purposes of each regulation would render the respective procedures unmanageable.

5) "Consider" versus "Take into account"

Question:

Does the wording "consider" PAI (as used e.g. in Article 4 SFDR) and "take into account" PAI (as used in Article 21 (d) (i) SFDR RTS (October version)) refer to different requirements for FMPs or are they to be understood as synonyms?

Suggested answer:

In our opinion, both refer to different concepts. Under both concepts FMPs are required to collect data on PAI indicators, although, in the context of the SFDR DNSH test, there is no obligation to collect data according to a specific PAI when there is manifestly no harm arising from that issue and/or the firm has a more reliable indicator available. In the context of the entity-level PAI obligations FMPs must in a second step only disclose their procedures to mitigate potential negative impacts visible on the basis of the data collection (if any). On the contrary, with regard to the SFDR DNSH test for sustainable investments, we understand that FMPs must define their own thresholds based on the data collected to determine whether the SFDR DNSH test is met for a specific investment and there is no obligation to publish data relating to the specific PAIs. The disclosure requirement for SFDR DNSH is to explain how the PAIs have been taken into account, but that does not impose an absolute requirement to collect data for each of them.

6) PAI indicators for the SFDR DNSH test

Question:

Which PAI indicators will FMPs need to collect data on and take into account for the purposes of the SFDR DNSH test?

Suggested answer:

In our opinion, FMPs will need to collect data on the PAI indicators set out in Annex I Tables 1-3 they consider to be relevant for the specific investment (if any) where they do not have data based on an indicator that they consider to be at least as informative as the relevant PAI. It is for the FMP (based on its internal thresholds, see No 5 above) to determine whether an investment meets the SFDR DNSH test and, although it must explain how it takes into account the PAIs, it must make that determination based on what it believes to be the most appropriate indicators.

7) Financial products with investment options which are not themselves financial products

Question:

Can a financial product with investment options which are not themselves financial products (e.g. future on an index) qualify as Article 8 SFDR financial product if all investment options meet the standards applicable to Article 8 SFDR financial products? Or does Article 28 (3) (c) SFDR RTS (October version) require that all investment options meet the standards of Article 9 SFDR financial products to permit this financial product to qualify as Article 8 SFDR financial product?

Suggested answer:

In our opinion, a financial product where all investment options meet the standards for Article 8 SFDR financial products should qualify as Article 8 SFDR financial product. There is no reason why higher standards should be applied to financial products with investment options than to “ordinary” financial products. Requiring a financial product with investment options to follow Article 9 SFDR standards to qualify for Article 8 SFDR would be an inconsistency disadvantaging such products which in our view is not required to protect customers or ensure proper disclosures.