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Implications of Sustainable Finance Disclosure Regulation (SFDR) in European private markets stakeholder conversations

VINCENT TRIESSCHIJN | ERIC ZUIDMEER

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DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

IMPLICATIONS OF SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR) IN EUROPEAN PRIVATE MARKETS STAKEHOLDER CONVERSATIONS

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ABSTRACT

The European Union's Sustainable Finance Disclosure Regulation[2] (SFDR) aims to make the sustainability profile of investments better understood by end investors. The extent of required product-level disclosures depends on the sustainability profile. The SFDR defines three different potential categories for products, depending on their sustainability profile and the characteristics defined in Articles 6 (non-ESG), 8 (ESG promotion) and 9 (Sustainable Objective) of the SFDR. SFDR applies to "financial markets participants" including private markets and private equity fund managers or general partners ("GPs"). According to our experience from stakeholder conversations, GPs generally embrace ESG, if not for intrinsic (perhaps altruistic) motivation, then certainly through the lens of value creation, i.e., companies acquired today should become more sustainable in order to be sold successfully in the future. This paper provides an insight into the growing expectations of our stakeholders on ESG and sustainability and conversations with third parties in the private markets investment space.

1. INTRODUCTION

In times of crises, regulatory environments may change at a pace that is faster than expected. The COVID-19 pandemic has shown us not only how quickly public policy can change, but also how quickly we, as a society, can respond and adapt to extreme situations. The sudden drop of greenhouse gas (GHG) emissions experienced during the opening months of the pandemic was impressive. The sharp increase in emissions, when the pandemic receded, shattered the hopes of many that the subsequent economic recovery could be decoupled from the emissions of the past; illustrating, once again, how difficult it is to predict climate transition pathways.

Such effects may come with transition risk for companies and investors. Urgent action is needed by policymakers, companies, and individual citizens, and a clear role can be seen for financial institutions and investors to help enable the changes that are required by our society. At the same time, the financial services sector has to safeguard a fiduciary duty and act accordingly. Although our clients' ESG (environmental, social, governance) and sustainable investment portfolios have performed well on a historical, long-term basis, we have seen a challenging start to 2022, where, for the first time in years, many ESG and sustainable investment portfolios financially underperformed traditional portfolios.

[1] Special thanks to Karin Bouwmeester, Senior Manager ESG Reporting and Stewardship, ABN AMRO Bank N.V. The views expressed in this article solely represent those of the authors and are in no way representative of the views held by the ABN AMRO Bank N.V., or any of its subsidiaries or affiliates.
[2] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

At a time of increasing ESG expectations from our stakeholders, including changing regulatory expectations, we need, as investors, to balance expectations between financial returns, risk, and sustainability preferences. In addition, we need to widen our scope in terms of asset classes – where investor engagement used to focus more on public markets investments (due to larger holdings and thereby more greenhouse gas emissions),[3] "private markets" lag in terms of ESG implementation.[4] We, therefore, expect an increase in private markets engagement with ESG.

This paper provides insights into the growing expectations of our stakeholders regarding ESG and sustainability and in conversations with third parties in the private markets investment space.

2. SUSTAINABLE FINANCE REGULATION IN THE EUROPEAN UNION

The "Action Plan on Sustainable Finance", as initiated by the European Commission (E.C.) in 2018 to support the implementation of the sustainable development goals (SDGs) and the Paris Agreement, defines disclosure requirements for financial market participants [see Sustainable Finance Disclosure Regulation (SFDR)], an E.U.-wide taxonomy on environmentally sustainable activities, and a regulatory change on client's sustainability preferences by including ESG in the MiFID II regulation.

2.1 Sustainable Finance Disclosure Regulation

The SFDR aims to make the sustainability profile of investments better understood by end-investors. This is achieved through various mandatory disclosure requirements, such as (1) entity-level principal adverse impact disclosure, (2) remuneration policy disclosure, (3) sustainability risk integration disclosure, (4) product pre-contractual disclosure, (5) product website disclosures, and (6) product-level periodic disclosures. The extent of product-level disclosures required depends on the sustainability profile. The SFDR defines three different potential categories for products depending on their sustainability profile and the characteristics defined in Articles 6, 8 and 9 of the SFDR:

- **Article 6:** financial products with no binding or only legally required ESG characteristics
- **Article 8:** financial products promoting environmental and/or social characteristics, provided that the companies in which the investments are made follow good governance practices
- **Article 9:** financial products with sustainable investments as their objective, whereby sustainable investments are defined as: "an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."

Implementation of the SFDR is being carried out in phases; the first set of disclosure requirements, Level One, came into effect on March 10, 2021. After several extensions, Level Two disclosure requirements are to be implemented on January 1, 2023. The next section provides a summary of some of the disclosure requirements, though it is by no means exhaustive.[5]

2.2 Reporting requirements for alternative investment fund managers

SFDR applies to "financial markets participants" including GPs and investment advisors and managers, as defined in the AIFMD and MIFID regulations. The regulation also applies to non-E.U. market participants that enter the E.U. and may also apply to private placements.[6] The regulation ensures that both firms and funds disclose ESG information in consistent ways by means of using standardized reporting templates that have been designed to report on a 1) a firm and 2) a fund level.[7]

[3] https://bit.ly/3EcMLH2
[4] https://bit.ly/3CemBkK
[5] A full list of all disclosure requirements can be found in the Official Journal of the European Union's legislative act and in related guidance documents – https://bit.ly/3C8072K
[6] https://bit.ly/3V4Y622
[7] Invest Europe, 2022, "SFDR and the Taxonomy regulation," July

2.2.1 FIRM LEVEL DISCLOSURES

Firm level disclosures disclose policies and practices that apply to the entire firm, regardless of the fund, strategy, or level of ESG integration or sustainability. These reporting requirements also apply to investment advisory services and customized discretionary investment management mandates. For all these services, clients should receive similar information based on the standardized templates.[8] They should consist of the following elements that should be published on the market participant's website:

- **ESG policies:** from March 2021 onwards, market participants should disclose information on their sustainability-related policies, including, but not limited to, the integration of ESG risks into investment considerations and decisions, risk models, and remuneration policies. This should include sustainability risks that could directly affect the firm and its clients and/or LPs.
- **Principal adverse impacts:** from January 2023 onwards, market participants need to report on principal adverse impacts of investment decisions on sustainability factors (principal adverse impacts or "PAIs") – on a firm level. It needs to disclose how the market participant could potentially have harmful social and/or environmental effects on society (provided in English and the local language of the relevant E.U. member state). An overview of the relevant PAIs has been included in Table 1. In some cases, market participants with less than 500 employees may explain why they do not consider certain PAIs[9]. Invest Europe (July 2022) mentions that PAIs require GPs to systematically assess ESG with their portfolio companies. According to this guidance, GPs have some freedom in the way that they should "consider PAIs", and that they are not prohibited from investing in portfolio companies that might potentially be exposed to PAIs.

Table 1: Principal adverse impacts overview

CORPORATES (TABLE 1)
1.GHG emissions
2. Carbon footprint
3. GHG intensity of investee companies
4. Exposure to companies active in the fossil fuel sector
5. Share of non-renewable energy consumption and production
6. Energy consumption intensity per high impact climate sector
7. Activities negatively affecting biodiversity sensitive areas
8. Emissions to water
9. Hazardous waste ratio
10. Violations of U.N. Global Compact principles and Organization for Economic Cooperation and Development (OECD) guidelines for multinational enterprises
11. Lack of processes and compliance mechanisms to monitor compliance with U.N. Global Compact principles and OECD guidelines for multinational enterprises
12. Unadjusted gender pay gap
13. Board gender diversity
14. Exposure to controversial weapons (antipersonnel mines, cluster munitions, chemical weapons, and biological weapons)
SOVEREIGNS (TABLE 1)
15. GHG intensity
16. Social violations

PAIs (https://bit.ly/3fJ3IPf) are defined in the Regulatory Technical Standards of SFDR (Table 1 RTS). Additional PAIs from Tables 2 and 3 have not been included in this overview (market participants should choose at least one additional PAI from each of these tables).

2.2.2 FUND LEVEL DISCLOSURES

GPs should also disclose specific information on funds and strategies regarding, amongst others, sustainability-related risks, sustainability objectives, and PAIs, depending on the respective SFDR classification. Different reporting templates apply for Article 8 and 9 strategies. GPs need to explain in their pre-contractual information where they do and do not consider certain sustainability-related risks and/or PAIs for certain strategies or funds. In addition, GPs have the obligation to meet "good governance standards" and to consider "do no significant harm" criteria for strategies that classify as Article 8 (or higher).[10] The European Securities and Markets Authority (ESMA) also provides guidance on the naming of funds, in particular when using definitions like "sustainable" and "impact".[11]

- **Pre-contractual information:** an abstract of the GP's consideration of PAIs (if and how these are being considered) and assessment on good governance practices

[8] RTS 6.4.2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council
[9] https://bit.ly/3EgidnS
[10] https://bit.ly/3dZPIQJ
[11] https://bit.ly/3RzXGgU

of investees should be included in the pre-contractual information for LPs.[12] For Article 8 classified funds, information needs to be disclosed on the environmental and social characteristics that are being promoted and the indicators used to measure these. Information on the proportion of the fund (the asset allocation) that the GP plans to align with the environmental and social characteristics in the investment decision-making process and binding elements in the strategy need to be disclosed by means of disclosing minimum proportions and minimum safeguards. For Article 9 classified funds, the sustainability objective of the fund needs to be specified, information needs to be disclosed on the proportion of the fund (the asset allocation) that the GP plans to align with certain sustainability objectives, and the GP should mention how it prevents doing "significant harm" from a societal point of view.

- **Ongoing periodic investor reporting:** on an ongoing basis, GPs should report according to the relevant templates for Article 8 and 9 classified funds, including a historical comparison with previous reference periods. Among others, this means that the GP needs to disclose the sustainability-related performance of the fund (based on the ESG indicators that were mentioned in the pre-contractual information), the actual asset allocation (based on the minimum proportions and relevant ESG characteristics or sustainability objectives), and minimum safeguards of portfolio companies. GPs also need to describe their specific actions to meet the pre-contractual ESG characteristics or sustainability objectives, how PAIs were addressed, and how the investment did not cause significant harm to society.[13] Specifically, GPs need to describe how the investments were aligned with the "OECD guidelines for multinational enterprises" and "U.N. guiding principles on businesses and human rights".

2.3 Fund level disclosure: practical challenges

According to the experience that we have gained through stakeholder conversations, GPs generally embrace ESG, if not for intrinsic (perhaps altruistic) motivation then certainly through the lens of value creation – i.e., companies acquired today should become more sustainable in order to be sold successfully in the future.

> *"The industry is moving and several initiatives are trying to coordinate monitoring and reporting efforts. Most initiatives, however, will not cover the full scope of the reporting obligation under SFDR."*

Providing pre-contractual information may be challenging for GPs from our perspective. Typically, GPs launch a new fund on the basis of commitments from investors, LPs, and do not know beforehand exactly what investments they will pursue. Sector-focused managers are most likely to have more insight into their expected portfolios, compared with generalist investors, secondary investors, or fund-of-funds managers. Overarching targets will help them focus on ESG-supportive investments and with measuring key performance indicators (KPIs); however, uncertainty and perceived lack of flexibility might result in GPs opting for SFDR Article 6 classification.

Ongoing periodic investor reporting requires GPs to collect specific data from all portfolios and aggregate data on a fund (and firm) level. This might be a challenge, especially for more diversified funds, such as secondaries and fund-of-funds. Aggregating data on a fund-of-funds level will be especially challenging when underlying funds use different KPIs. This will require, in most cases, dedicated resources (or full integration in the investment monitoring process). At this moment, we observe that especially the larger (often global) firms with dedicated ESG teams take the lead in international initiatives to harmonize data collection and reporting across the industry. Dedicated impact funds often target specific investments that by definition contribute positively to ESG KPIs, but that are not covered by such initiatives. Benchmarking these KPIs for SFDR Article 9 funds is still a developing field and will often require support from dedicated consultants.

[12] Questions related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR)
[13] JC 2022 23 Clarifications on the ESAs' draft RTS under SFDR, June 2022

The industry is moving though, and several initiatives try to coordinate monitoring and reporting efforts. Most initiatives will, however, not cover the full scope of the reporting obligation under SFDR. The “data convergence initiative”[14] is a joint effort from the Institutional Limited Partners Association (ILPA) and a growing group of GPs, LPs, and investment advisors. By agreeing on a limited number of currently fifteen KPIs across six ESG categories, the initiative aims to bring a more standardized approach to the industry. This should improve the comparison and exchange of data and lower barriers to monitor and report on ESG performance. Arguably, improved standardization might also simplify the reporting duties under SFDR Article 8 or 9.

Other initiatives, such as the U.N. convened Net Zero Asset Owner Alliance,[15] aim to mobilize the industry to commit to lowering GHG emissions by engaging with companies and funds and reporting on carbon emissions. At this moment, the focus is still on listed equity, private loans, and infrastructure, but other asset classes will follow and private equity will be included in the next revision of the protocol, which is expected in 2023.

2.4 SFDR classification dispersion and flows

Analyzing SFDR classifications comes with the challenge that there is limited publicly available data for private markets flows and transactions. Some exchange traded funds (ETFs are securities that track a particular index, sector, or commodity and can be traded on stock exchanges) have been classified SFDR Article 8 and 9, allowing analyses on some funds and flows, as traded in financial markets. When comparing ETFs based on this limited dataset, excluding non-E.U. ETFs, ABN AMRO Group Economics[16] (July 2022) concluded that the universe of SFDR Article 8 classified funds is much higher than the SFDR Article 9 universe and that the range of fixed-income or debt-based ETFs that have been classified Article 8 or 9 is much smaller than equity-based ETFs. With approximately 60 percent of total new funds incepted in the E.U. being classified as Article 8 or 9 funds, and with more than 700 funds upgraded from Article 6 to 8 or 9, Article 8 and 9 SFDR classification categories have surpassed 50 percent of total market share (Morningstar, July 2022).[17] Based on a sample of 2,476 Article 6 funds, 1,764 Article 8 funds, and 268 Article 9 funds, 84.7 percent of the Article 8 funds report on PAIs, while 94.8 percent of all Article 9 funds report on PAIs.[18]

3. IMPLICATIONS OF SUSTAINABLE FINANCE REGULATIONS ON FINANCIAL INSTITUTIONS

As part of the Sustainable Finance Regulation roll-out, MiFID II regulation has been amended per August 2022 to include ESG preferences of clients in their suitability profiles, with the intention of creating a fit with SFDR reporting requirements.[19] In addition, the AIFMD regulation has been amended to include sustainability risks and factors by alternative fund managers.[20]

3.1 Sustainability considerations in private markets investment advisory

In a private markets advisory context, there may be clients with certain sustainability preferences, corresponding with the SFDR environmental and social characteristics, sustainability objectives, PAIs, and the E.U. Taxonomy for environmentally sustainable activities. Financial markets participants need to take these sustainability preferences into consideration when advising clients and when selecting suitable investment funds. For this reason, we are investigating the offering of SFDR Article 8 and 9 classified funds within a private markets context, particularly the private equity industry. Over the last few months, we spoke with multiple GPs to understand their approach towards SFDR classification and reporting.

3.1.1 FUND SELECTION UNIVERSE AND SUSTAINABILITY PREFERENCES

In our conversations with GPs, it has become clear that most funds that are being offered (in Europe) are funds that have been classified SFDR Article 6 – this means that there is limited sustainability reporting and that such funds potentially may not be suitable for clients with high sustainability preferences. In our conversations with advisor Stepstone Group LP, we discovered that although many GPs have sustainability policies and guidelines in place, the classification of funds as Article 8 and 9 is still nascent, due to the reporting requirements and, specifically, to the availability of data with portfolio companies (July 2022). LGT Capital Partners mentions in its 2022 ESG

[14] www.esgdc.org
[15] United Nations Environment Programme, 2022, “U.N. Net-Zero Asset Owner Alliance: target setting protocol,” second edition
[16] Larissa de Barros Fritz, ESG Strategist ABN AMRO Group Economics, July 2022
[17] Morningstar, July 2022
[18] https://bit.ly/3UUWV57
[19] https://bit.ly/3UTUwrc
[20] https://bit.ly/3SDoApq

Report that only 13 percent of the GPs opt for an Article 8 or 9 classification, based on a survey of around 200 GPs.[21] The New York based private equity firm Clayton, Dubilier & Rice LLC mentioned that regardless of its funds' SFDR classifications, it continues to focus on enhancing the ESG profiles of its portfolio companies. For the moment, its funds are classified as SFDR Article 6 (August 2022). There are also some exceptions where GPs focus on SFDR Article 8 or 9 classification as a unique feature of their funds. EQT has classified all applicable funds in scope for reporting disclosures at least as SFDR Article 8 funds, according to SFDR, and to consider PAIs where this is material. Also, according to EQT, there remain challenges on reporting, for example, with the PAIs on biodiversity; however, it does not refrain the company from classifying funds according to Article 8 and 9 (July 2022). The Dutch Venture Capital manager Innovation Industries focuses on investing in technology companies that potentially contribute to the SDGs, as an overall sustainability objective. It has invested in dedicated staff to work on related ESG and SDG measurement and reporting; and its investment committee will only approve investments where there is a clear case of societal benefit linked to ESG and/or the SDGs (August 2022).

3.1.2 SFDR PRIVATE MARKETS DEVELOPMENTS AND RECLASSIFICATION OF FUNDS

We have also noticed that there are GPs that consider upgrading or downgrading the SFDR classification of their funds. In our conversations with Brookfield Infrastructure, it became clear that they were considering upgrading its flagship infrastructure fund from SFDR Article 6 to SFDR Article 8 classification, pending research of the required reporting indicators (May 2022). In June 2022, the company decided to classify the fund according to Article 8. With this decision, the fund may potentially be suitable for a wider audience of investors given their sustainability preferences. In our conversations with GPs, it was also mentioned that there are examples of managers downgrading funds from SFDR Article 8 to Article 6. We were, however, unable to find such examples or to verify the cases that were mentioned.

4. CONCLUSION

Being aware that we only spoke to a limited number of GPs, making these conclusions far from statistically relevant, we believe that we were able to provide some insights in our stakeholder conversations on SFDR, in particular with GPs. In general, we see a growing interest from GPs with a fundraising focus on Europe in classifying (or reclassifying) funds as SFDR Article 8 and 9. Except for some examples in the "venture capital" and "impact investing" space, reporting requirements can be a reason for GPs to opt for SFDR Article 6 status for the moment. Our general feeling is that this does not slow down ESG initiatives and that, over time, GPs are slowly moving towards more SFDR Article 8 and 9 classifications, especially when there is more clarity on regulation and market consensus regarding the reporting and data requirements. However, this does create a difficult situation for advisors of clients who prefer to invest in ESG funds that are classified as SFDR Article 8 or sustainable (impact) investment funds, classified as SFDR Article 9.

[21] LGT Capital Partners, 2022 ESG Report, page 16

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