**iCI approach to SFDR II**

***In the context of the European Commission consultation on the SFDR review***

22 December 2023

iCI welcomes the opportunity to participate in the [European Commission's targeted consultation](https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en) (the "**Consultation**") on the implementation of the Sustainable Finance Disclosure Regulation (SFDR). The ongoing implementation and application of the SFDR and the interplay with the EU Taxonomy Regulation remain a key operational issue for both private fund managers and investors and hence, a key priority for iCI.

The Initiative Climat International (iCI) is a global practitioner-led community of private equity firms and investors that seek to better understand and manage the risks associated with climate change. The iCI was originally launched as the iC20 (Initiative Climat 2020) in 2015 by a group of French Private Equity (PE) firms to contribute to achieving the Paris Agreement's objectives. The iCI has since expanded internally and now counts some 212 firms representing over US$3.4 trillion in AUM as of 1st October 2022. iCI's members share a commitment to reduce carbon emissions of PE-backed companies and secure sustainable investment performance by recognizing and incorporating the materiality of climate risk, and to effectively analyse and manage climate-related financial risk and greenhouse gas (GHG) emissions in their PE portfolios. The iCI is supported by the Principles for Responsible Investment (PRI), is a Supporting Partner of The Investor Agenda, and is open to all private market's firms and investors to join.

iCI understands that it is materially aligned with other key market participants on a number of responses to the Consultation and iCI is generally supportive of a product categorisation system that enhances the existing disclosure categories under Articles 6, 8 and 9 of the SFDR. The views set out below accompanies our formal consultation response. The views expressed below and in our formal iCI consultation response may not represent views held by all iCI members.

1. Product categorisation system

iCI is supportive of "Approach 2", as described in the Consultation, which proposes converting Articles 8 and 9 of SFDR into formal product categories and adding minimum criteria that underpins existing concepts within the SFDR. iCI has set out below what it proposes these new product categories would require.

1. **"New" SFDR II Article 8**

**Minimum standard**: In respect of all or a specified minimum proportion of investments, the manager must commit to "binding elements" with an ex-ante and/or ex-post effect on the fund's investments, either by:

1. selecting or excluding investments in order to meet a clear characteristic or investment objective (thereby narrowing the fund's investment universe); and/or
2. pursuing a meaningful stewardship strategy to achieve outcomes after an investment has been made.

A product under this category may, but is not required to, be in line with the definitions of the Principles for Responsible Investment (PRI) for responsible investing approaches. An ambitious exclusion screen may be eligible under provision (a) if it meets specific set rules.

**Good governance assessment:** A good governance assessment should be required. However, the requirement should not apply on day one but to give sufficient time to have these in place within the investee companies. It should be possible to take a proportionate approach taking into account the geography, size, nature and sector of the investee business.

**Consideration of PAIs:** PAIs will not need to be considered at product level for this product category.

1. **"New" SFDR II Article 8+**

**Minimum standard**: Must commit to making at least 10% Article 2(17) "sustainable investments" or Taxonomy-aligned investments and up to 70% "sustainable investments" and/or Taxonomy-aligned investments (distinction from "New SFDR II Article 9").

**Good governance assessment:** Yes, with regard to the proportion of investments that are not defined as (a) SFDR "sustainable investments" or (b) Taxonomy-aligned investments (for these investments, "good governance" is inherently included due to alignment with international standards/minimum safeguards). However, the requirement should not apply on day one but to give sufficient time to have these in place within the investee companies. It should be possible to take a proportionate approach taking into account the geography, size, nature and sector of the investee business.

**Consideration of PAIs:** PAIs will need to be considered at product level for this product category.

1. **"New" SFDR II Article 9**

**Minimum standard**: Must commit to making more than 70% SFDR Article 2(17) "sustainable investments" and/or Taxonomy-aligned investments.

**Good governance assessment:** Yes, as above for the New Article 8+ category.

**Consideration of PAIs:** PAIs will need to be considered at product level for this product category.

To support the above, iCI proposes the following:

1. **A "disclaimer rule" category**

The disclaimer rule category would provide room for funds, which may or may not have an ESG focus yet still provide ESG reports to their investors. These funds must prominently caution in all fund and marketing literature that "EU law does not oversee any ESG commitments this product might present (if any) other than demanding all declarations to be clear, fair and not misleading, and EU SFDR disclosure requirements do not pertain to this fund".

This category would be exclusively available for funds directly marketed to professional investors.

1. **Amending the definition of "sustainable investment**"

The definition of "sustainable investment" in SFDR Article 2(17) should be revised to:

1. include investments that may not initially be sustainable, but possess a credible pathway to becoming sustainable within an acceptable time frame, which would be determined based on ESG topic, geographical and sector-specific criteria, and contingent on particular measures supported by an underlying budget. This would include transition and impact investments.
2. incorporate an express materiality qualifier to the Do No Significant Harm (DNSH) test.
3. Key priorities

In addition to the development of a product categorisation system, iCI believes it is imperative to consider and address the following issues:

1. **Grandfathering**: Private funds, which are typically closed-ended and long-term, should be allowed to disclose under the existing requirements for the remaining life of the product. All closed-ended funds (whether disclosing under Article 6, 8 or 9) which were fully closed to new EU investors, or established and in the process of concluded their fundraising period, as at the date of SFDR II's application should be optionally exempt from SFDR II requirements providing that they continue disclosing to investors in line with SFDR I requirements.

Open-ended products should be subject to an 18-month transition period starting on the date of SFDR II's application permitting them to either change the strategy to keep the classification or to scale down and permitting investors to redeem.

1. **Website** **disclosures**: Firms are obligated to disclose information publicly concerning the SFDR contents of their fund documents. However, other global laws limit private funds from making their offering documents available to the public. Obligations to disclose information publicly on websites under SFDR II should be limited to retail funds, or funds that are offered publicly. Private funds should be given the choice to share product level disclosures with investors – this could be done through password-protected website access, or any other method with comparable results. In addition, we considered that private funds should not be requirement to translate the “Summary” section of the website disclosure into one of the official languages of each host EU member state where a financial product is made available as professional investors are used to reviewing disclosures in English.
2. **Firm-level PAI reporting**: The firm-level PAI regime does not operate effectively for private fund managers who manage a variety of strategies. The firm-level PAI regime should be eliminated due to the following:
3. The aggregated data at manager level is not only statistically insignificant, but also expensive to collect;
4. Aggregate reporting does not provide any advantages to investors, particularly since the data for specific strategies is often unavailable, forcing firms to merely provide estimates, which could be construed as deceptive.

If the firm-level PAI regime continues to be used, it should be made clear that the regime is separate from product-level PAI considerations, meaning that managers will be allowed to take into account PAIs for particular products even if they do not do the same at firm level.

1. **Good governance**: where an obligation for "good governance" is in place, it should be balanced and flexible (primarily intended to eliminate poor governance practices), rather than being founded on presumptions regarding the governance standards of listed companies in developed markets. The requirement of good governance should also be achievable through modifications that are implemented post-acquisition to ensure proper governance practices, rather than it having to be a mandatory condition at the time of initial investment.
2. **Blind pool and portfolio composition commitments**: Private funds that invest in illiquid assets usually operate on a blind pool basis and are uncertain about the forthcoming investment opportunities. Portfolio composition rules, thresholds, or numerical commitments or minimum standards, should be measured only after a disclosed ramp-up period (or ‘investment period’) has ended. A typical investment period for private capital funds is around five years until the fund is effectively fully invested – this is the point at which any portfolio composition commitments should be measured in order to be meaningful. Analogous to how UCITS funds forgo compliance with the UCITS portfolio composition spread prerequisites for a six-month period following initial authorisation. Requirements should equally not apply during the divestment period, which, in the case of illiquid assets, can span over several years. The same level of adaptability should be extended to open-ended funds. Generally, NAV should serve as the foundation for measurement in this context, though some flexibility should be allowed for certain asset classes which typically set their minimum commitments based on alternative measures not related to NAV, such as the total capital deployed at cost, as long as these alternative measures are transparently and clearly disclosed to investors.
3. **Targets v commitments and investment restrictions**: As above, private funds that invest in illiquid assets on a blind pool basis usually cannot commit to minimum binding commitments before or during the fundraising phase. Regulators anticipate treating commitments related to the attainment of certain ESG-related outcomes (e.g. the proportion of ‘sustainable investments’) as investment restrictions with a specific methodology for monitoring and rectifying any violations (this includes, for example, the proportion of SFDR Article 2(17) "sustainable investments" or Taxonomy-aligned investments). While it is essential to monitor target commitments made to investors and periodically report on their achievements, failing to meet such commitments in a private fund investing in illiquid assets on a blind pool basis should not constitute a breach of investment restrictions, unless the manager has not taken all reasonable measures to guarantee the fulfilment of the target commitment.

The following two situations should not necessitate a 'downgrade' of the fund to a different product classification:

1. instances where investments that initially fulfil the sustainable investment criteria at the point of investment fail to maintain those requirements over the holding period due to circumstances beyond the fund's control;
2. minor passive violations of target commitments brought about by NAV fluctuations should not be classified as breaches either.
3. **Data gaps:** Private funds frequently invest in international portfolio companies that have no association with the EU, and/or in small companies, and/or in assets other than equities. These companies are less likely to be regulated by CSRD or any EU-mandated corporate disclosure framework. Additionally, the private fund manager may not have control over the portfolio company.

Allowances should be made for data gaps (in regard to investor reporting, Taxonomy alignment data, PAI data, etc.). In situations where data gaps are especially widespread, managers should not be compelled to fill these gaps using estimates in all cases, given that credible estimates for many private asset classes are often missing. Rather, managers should have the liberty to either explicate the data gaps or utilise estimates where deemed suitable.

1. **Product-level PAI reporting:** In situations where the PAI regime is applicable at the product level, it should be possible to comply with the regime by implementing measures after the investment to mitigate any adverse impacts.
2. Additional considerations to the Consultation
3. **Interoperability with the UK's SDR**

As has been acknowledged by the Commission within the Consultation, there has been a proliferation of national labels which risk "fragmenting the European market". However, the development of product labels has continued elsewhere, including in the United Kingdom's introduction of the Sustainability Disclosure Requirements ("**SDR**") and voluntary product labels.

During the course of a fundraise, managers market their products across a number of jurisdictions which often have competing or conflicting regulatory requirements. iCI considers that the Consultation and a revised SFDR represents an opportunity to create a degree of interoperability between SFDR and the UK's SDR, with a view to broadening the pool of capital available for sustainable investment. As such, consideration should be given by the Commission to adapting concepts within SFDR in order to facilitate interoperability between the two regimes, for example by expanding SFDR's definition of Article 2(17) "sustainable investments" to include investments which satisfy the requirements set out under the product labels described within the SDR.

1. **Clarifying investments that are categorized under ''#2 Other" and "#2 Not sustainable" for the purposes of the SFDR RTS**

Under the SFDR's RTS and the pre-contractual and periodic reporting templates, investments categorised under "#2 Other" or "#2 Not sustainable" are those which are not aligned with the promoted environmental or social characteristics of the product or which do not qualify as sustainable investments. Recital 12 of the SFDR RTS acknowledges that products may invest in a "wider range of underlying assets, some of which may not themselves qualify as sustainable investments or contribute to the specific environmental or social characteristics promoted by the financial product". Examples given of such investments include "hedging instruments, unscreened investments for diversification purposes, investments for which data are lacking or cash held as ancillary liquidity.".

iCI considers that derivatives and other instruments (including cash or cash equivalents) which are used for hedging purposes or liquidity management, should be excluded from the "#2 Other" and "#2 Not sustainable" categories of assets and subsequently, should not be captured by asset allocation calculations.

Assets which are held for hedging purposes or liquidity management are not investments of the product per se but are only held by reference to the core investments of the product. Such assets are typically held on a short-term basis, and the extent of a product's holding of such assets fluctuates by reference to the core investments of the product which are held over a longer period of time. As such, there is no practical reason to treat such assets as 'investments' under "#2 Other" or "#2 Not sustainable". Further, including such assets within the asset allocation calculations required under the SFDR's RTS presents a unnecessary technical challenge to managers which does not provide any additional benefit to investors.