REPRESENTING ALTERNATIVE INVESTMENTS

POSITION PAPER: EU COMMISSION'S TARGETED CONSULTATION on the IMPLEMENTATION of the SUSTAINABLE FINANCE DISCLOSURES REGULATION (SFDR)

On 21 November 2023, the German Federal Ministry of Finance hold a workshop with German associations from the financial industry and other stakeholders regarding the SFDR review. The workshop was subtitled as follows:

"Practical check: Simplifying the SFDR and making it fit for transformation".

From our point of view, this is exactly what the review is about. Therefore, we are also enclosing our position paper for the attention of the German Federal Ministry of Finance hereinafter in an adapted form.

General preliminary remarks from the perspective of the alternative investments industry

SMEs are the backbone of the European (and German) economy. They account for around two thirds of economic output, but also for a correspondingly high proportion of greenhouse gas emissions. (Debt) financing for SMEs in Europe (and Germany) has traditionally been provided by banks, but for the last ten years or so, with enormous growth rates, it has also been provided by credit funds – private debt in its various forms, dominated by corporate direct lending. SMEs are generally not listed on the stock exchange – equity financing is provided by private equity and possibly also venture capital. Despite multiple crises, private equity has also become an increasingly important part of the portfolios of institutional investors over the past decade, and this form of financing has become extremely important for the the European and German economy. Moreover, private debt is often used in combination with private equity.

The necessary transformation of the economy ("grey to green") requires enormous investments (we are talking about around 800 billion to be invested annually across the EU by 2030), which should help companies, SMEs, to produce more energy-efficiently, switch their production to non-fossil energy sources and develop new business models. **This requires private capital, for example in the form of private equity and/or private debt.**

Enormous sums are also required for the energy transition, the expansion of wind and solar power plants, hydrogen production and (battery) storage capacities, etc. **An enormous number of BAI members are active in this area and provide such capacities through AIFs with the capital of institutional investors, whether equity-financed or debt-financed (infrastructure equity/infrastructure debt).**

In addition to transport and the manufacturing industry, the building stock and the construction industry are known to be responsible for a high proportion of emissions. Energy-efficient refurbishment of existing buildings, energy efficiency measures, etc. ("brown to green") also require enormous sums of money to improve the energy balance and reduce greenhouse gas emissions. **The capital for this often also comes**

from AIFs with a focus on real estate/real estate (real estate equity/real estate debt).

Infrastructure, private equity/private debt and real estate are traditionally the most important asset classes in the field of alternative investments. These are typically illiquid in nature.

Despite the enormous importance of these asset classes for the transformation/transition and the necessary financing outlined above, sustainable finance regulation rarely suits to the characteristics and specifics of the (illiquid) asset classes, and the challenges are different:

- There is regularly **no ESG data for illiquid assets** that can be acquired from one of the well-known data providers. If the availability and reliability of ESG data is already low, this problem is exacerbated in the case of alternatives.
- The **nature of illiquid asset classes** is geared towards the long term, which is why the structures are usually **closed-ended funds**. Accordingly, unlike with liquid assets, a portfolio cannot be put together/built up, adjusted or liquidated in a matter of seconds on each trading day. The set-up/rump up and liquidation phases of closed-ended funds therefore require special regulations, for example with regard to any threshold values (which may only be reached after a three- to five-year set-up phase), the question of the frequency of valuations (there are no price values at the touch of a button), etc.
- **The structures of alternative asset classes/illiquid asset classes and real assets often differ significantly from traditional/liquid asset classes.** Real estate and infrastructure projects are often held or financed by special purpose vehicles (SPVs) for a variety of reasons. These reasons can be the separation of projects in SPVs, liability shielding for individual projects, but also the better transferability of shares in SPVs compared to transfers of ownership of real assets.

This starting point made the challenges for asset managers in the area of alternative investments even greater than they already were when the SFDR was due to be implemented. **The implementation of the SFDR was extremely burdensome for asset managers, as many aspects of the regulation were and are unclear or not fully compatible with alternative investment strategies.** Asset managers have made considerable efforts, both in terms of time and cost, to achieve full compliance with the existing regulation. However, almost three years after its introduction and after the experience with the first PAI statements, it is still clear that many of the SFDR rules (Level I and Level II) do not suit to the specifics, characteristics and numerous types of alternative investments.

We believe that a certain degree of flexibility in the application of the SFDR would be helpful for (alternative) asset managers to take into account the many different investment strategies and asset classes that alternative asset managers pursue or in which they invest. Only in this way the intention of the SFDR to reorient capital flows towards sustainable finance in order to finance the transition to a net zero economy can be achieved. **The SFDR should be an enabling regulation and not a regulatory obstacle, or, in the words of the German Federal Ministry of Finance, "be simplified and made fit for transformation".**

The BAI has pointed out to the EU Commission and the ESAs on various occasions that the infrastructure asset class in particular, which is so important for transition, transformation and (green) energy production, is not adequately covered by the regulatory framework. The following is a brief outline of the specific challenges and problems, primarily with regard to Principle Adverse Impacts or PAIs.

For the BAI and its members, PAIs are a core element of sustainability concepts and one of the central instruments for the standardized measurement of negative impacts on the environment and society. They are also important for risk management. **However, the SFDR Delegated Regulation only recognizes three categories of PAIs, each with a number of mandatory and additional PAI KPIs: for Sovereigns & Supranationals, for Real Estate and for Investee Companies. The treatment of infrastructure is not regulated separately, which raises a number of application issues.** Just a brief outline of what is at stake: Do you apply the KPIs for real estate to infrastructure because it is also a real asset? Or the KPIs for investee companies because infrastructure is usually held via SPVs, i.e., companies**? It should be emphasized that both or even more variants are somehow "feasible" in a technical sense; the question is, however, what makes sense in order to meet the objectives of the SFDR.** The SPVs are regularly "shells" with possibly one or two formally appointed directors, because this is required by law. Collecting KPIs for these investee companies defeats the purpose of capturing the real and main negative impacts of an investment, because this "shell" has no staff, for example, which is why practically all social PAI indicators are collected and measured without meaning or purpose.

The BAI has been discussing implementation and practical issues relating to the numerous regulations of the Sustainable Finance Initiative for a long time in the BAI Sustainable Finance & ESG working group in order to develop positions and statements, always keeping the special needs of alternative and often illiquid asset classes in mind. For example, numerous representatives in the BAI Roundtable on PAI coverage for real estate, infrastructure and private equity/private debt developed "best practices".
We have shared our insights publicly with the alternative investment industry via webinars and publications of "BAI Best Practices for PAI KPIs under SFDR" which can still be found on our website (under documents/contributions).

Disclosures

- Appropriate scope of discosures

It can be stated that the type, number, form and granularity of the SFDR disclosure requirements have failed and continue to fail to achieve the intended objectives of the SFDR. Private investors tend to be overwhelmed by the existing disclosure requirements and are exposed to a counteracting information overload, while institutional investors in turn do not need templates of the prescribed type and rigidity.

In principle, a small amount of meaningful information would be more effective, especially in the retail sector. In the environmental sector, for example, a few KPIs on CO2 or biodiversity would already be meaningful, while other appropriate (social) KPIs would also be welcome for thematic funds.
This core set of PAIs would be mandatory; significantly more PAIs than before would be voluntary and could be selected and adapted depending on the strategy and asset class. Voluntary does not mean arbitrary, but the (voluntary) PAIs relevant (in the meaning of the really Principle Adverse Impacts) to a fund must always be selected. However, significantly greater flexibility and more leeway would be appropriate.

The current disclosure requirements (especially the PAI statements) are, in their granularity, more suited to institutional investors, who would and could do ESG reporting (or PAI reporting) even without regulatory requirements. But whether they are actually helpful for private investors when making decisions is questionable.

Overall, a stronger focus on the materiality of the KPIs would be desirable. After all, these are key performance indicators or Principal Adverse Impacts. **With regard to the PAIs, synchronization with the materiality provision according to the CSRD/ESRS should be introduced in any case: Only PAI**

indicators that are material under ESRS should be considered material under SFDR.

At present, the BAI members do not consider PAI reporting at company/entity level in accordance with Art. 4 SFDR to be expedient and the majority are of the opinion that these disclosure requirements should rather be deleted. The focus should be on PAI reporting at product or fund level. Granularity is more important here than consolidation; the portfolio level is more meaningful than the company level.

However, the BAI also believes that it is not yet possible to make a final judgment on this after just one PAI statement and sees potential in future for PAI reporting at company level (for the purposes of risk identification, for synchronization with the CSRD, because this data is becoming increasingly important for lenders and banks, for fund of funds managers, etc.).

- Distinction between retail and professional investors with regard to the scope of disclosures requirements

Although the degree of sustainability of a financial product/fund does not depend on the type of investor, it is generally true that institutional investors have little to no need for regulatory disclosure requirements. On the other hand, institutional investors are far more likely to be in a position to (also) process and evaluate extensive information and, if necessary, integrate it into their own systems/reporting obligations.

It would be appropriate to differentiate between different types of investors (i.e. retail investors vs. professional investors) and adapt the disclosure requirements accordingly. A fundamental principle of EU financial services regulation is that disclosure requirements should be tailored to the information needs of the (respective) end investors. The distinction between the disclosure requirements for funds open to retail investors and those open only to professional investors (as defined in the AIFMD) is widely recognized in existing EU legislation. This distinction can also be found in the AIFMD and UCITS Directive.

It remains to be seen how the "dashboard" presented by the ESAs in their “Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation” will exactly be structured at the level of the Delegated Regulation to the SFDR. Such a mandatory one- or two-page template could be beneficial. **However, if a fund only has professional investors, it would be more appropriate to take a more flexible approach rather than requiring the use of templates that are not always suitable for all asset classes or meet the information needs of professional investors – certainly not in the alternatives sector.** The professional investors who invest in our members' funds regularly speak directly with fund managers to discuss the investor's sustainability preferences or objectives in detail to ensure that a fund's strategy is aligned with the investor's objectives. Professional investors often have their own sustainability preferences or objectives and, unlike retail investors, they are able to engage directly with potential or existing fund managers to ensure that the professional investor is investing in products that align with their ESG preferences. We therefore believe that pre-contractual and periodic disclosure requirements for products aimed exclusively at professional investors should be revised, as we do not believe that mandatory templates are required for such products. This would help to reduce the administrative burden and costs and make the information more relevant to the target audience.

In terms of volume, a much greater condensation of information would be helpful for retail investors. This could possibly be done in the above mentioned dashboard or by means of ESG scales, categories or labels. These are debatable alternatives to the existing templates. The presented, revised dashboard at the beginning of the templates could be a step in the right direction to quickly obtain an assessment of the sustainability level of a product at a glance.

- Exemptions for professional investors

In cases where the information on the website is only aimed at a professional audience, it would be beneficial if it did not need to be translated into other languages and was only available in English. This would help to reduce the administrative burden and costs and increase relevance for the target audience.

If you think the preliminary question through to the end, it could even be helpful to abolish all regulatory requirements for professional investors. However, this would not mean that PAIs, for example, would not be collected, just possibly in a less formalistic manner.

- Simplifying disclosures (PAI indicators, DNSH criteria)

The collection and calculation of PAI indicators poses considerable problems for our members from the world of alternative investment funds, especially for illiquid asset classes, as described at the beginning in our general remarks. This is particularly the case if data is not available, or if the data is limited, or if a PAI indicator is not relevant for all asset classes. We generally believe that a greater degree of flexibility in the PAI indicators would be helpful to ensure that relevant indicators are reported – they should be Principal Adverse Indicators. It would be helpful if the PAIs were applied on the basis of the materiality of the indicators. In our view, PAI indicators should only be required to be reported if they are relevant and material to the company's activities. In our view, a focus on a few highly meaningful indicators, primarily the climate-related KPIs, would be more important than having a large number of KPIs "somehow" covered. Against this background, we also spoke out against the inclusion of further social PAI KPIs during the ESAs consultation on the review of the Delegated Regulation on the SFDR in summer 2023, for example, as these seemed to us to have been chosen more or less at random, and in any case their informative value was not particularly significant.

Under all circumstances, consistency and coherence with the CSRD/ESRS should be established with regard to the PAI indicators. If a PAI KPI is classified as not material for the purposes of the ESRS, this should also apply without further ado for the purposes of the SFDR. Although this opinion seems to have already been accepted by the European authorities, we would like to emphasize this point once again.

In terms of quantitative disclosures, we note the increasing use of a "coverage" metric that reflects the proportion of a fund's underlying portfolio for data relating to a particular PAI indicator. This approach deserves support. Thus, if data is not available for a particular PAI indicator, asset managers should not be required to disclose that indicator and instead disclose the coverage metric, in line with the SFDR's idea of transparency.

With regard to the type, location and sequence of disclosure obligations, it should also be the case that these should be harmonized: The same indicators should be disclosed in the same way, in the same order etc. in pre-contractual information, on homepages and in periodic reports. We therefore see potential for improvement, particularly in terms of presentation and standardization. We also see potential for improvement with regard to standardized reporting and the possibility of enabling machine readability or processing with a focus on mandatory indicators in particular. The industry standard European ESG Template

(EET) offers a good and useful template for this.

Labelling & Product Categories

- Need for a labelling regime (?)

The signaling effect of labels is huge, especially in retail sales. They represent an enormous concentration of information if the processes leading to the label are trustworthy. FCA researchers found through behavioral research (exploratory analysis, online experiments and qualitative research) that ESG fund images, fund descriptions and fund strategies do not have a statistically significant impact on how participants invest in their analysis setup[1]. Participants do not appear to be more likely to select funds if the factsheet contains an ESG attribute than if it is neutral. However, they found that medals have a significant impact on participants' investment decisions in their analysis setup. In our opinion, medals can have a similar influence on an investment decision as labels.

Examples of this include credit ratings, scorings, scales, TÜV certificates, etc. These also seem to be a need of the industry, especially for retail investors, but in some cases also for institutional investors.

The starting point is that SFDR is used as a de facto label by parts of the market, as the European Supervisory Authorities and the EU Commission itself have also noted. This also shows the need for some kind of label. We expressly support the proposals of the German government's Sustainable Finance Advisory Board for an ESG scale within the framework of the existing SFDR regime. We also believe that the EU Commission's proposals for product categorization made as part of the SFDR review consultation are worth consideration. Both proposals thus also address the needs of the industry.

The current "charm" of the SFDR with its provisions on Art. 8 and 9 lies in its great flexibility, which in turn fits in well with the various investment strategies, especially in the alternative investment sector. If the EU Commission is of the opinion to introduce a label system, this should in any case be designed as a separate and voluntary label or labeling system with minimum standards in addition to the existing SFDR disclosure rules. A label system also seems to be more suitable for retail investors than for institutional investors. A label system could set a higher bar for the use of a label by including minimum standards for financial products that are eligible for a label.

Should a label system be considered, the EU Commission should limit its application to products aimed at retail investors and focus a more detailed disclosure regime (i.e. SFDR) on institutional and professional investors.

Any label system should include additional categories such as "transformational investment" or "impact".

We see the draft and final versions of the UK SDR published on 28 November 2023 with the labelling system as positive and pragmatic. In any case, they are very worthy of consideration, which the EU Commission should also look at in detail.

If it is maintained, like the ESAs and the COM do, that the SFDR "only" aims to promote transparency and is

[1] Cf. https://www.fca.org.uk/insight/sustainable-investing-objective-gradings-greenwashing-and-consumer-choice.

purely a disclosures regulation, it would logically not be obsolete despite the introduction of a label. There may still be an interest in transparency.

A label would primarily have a pre-contractual effect and possibly replace the pre-contractual disclosure obligations, but not the periodic reports or, for example, the PAI statement.
As outlined above, the BAI would see a labelling system as voluntary and in addition to the existing disclosure regime.

- Thresholds to create product categories based on hard/measurable criteria?

Thresholds are problematic, especially for illiquid asset classes with generally closed-end fund structures due to the set-up phase of a fund vehicle. However, illiquid asset classes (primarily real estate/ infrastructure/private equity) are essential, especially for transformation issues ("brown to green", "grey to green"). The need for thresholds is understandable, but a pragmatic solution should be found for the specifics of closed-ended structures for the investment and divestment phase, whereby thresholds do not have the same significance.

The deal pipeline of an AIF is often not as predictable (blind pool) as that of liquid asset classes, and in some cases opportunistic. Deals are also not equally predictable in terms of time (long due diligences, contract negotiations, complexity, etc.).

We are therefore critical of the introduction of thresholds – at the very least, these would have to be adapted to the specifics and characteristics of illiquid asset classes and their structuring.

The answer on the question whether to introduce thresholds also depends on whether a label regime is introduced as part of the SFDR with additional "labels" such as "transformation investments" or "transitional investments". Should an additional category of investments be included as "transformation investments", consideration could be given to thresholds for all categories. Without the inclusion of "transformation investment" in the SFDR as a new investment category, strict thresholds risk excluding this type of investment, which would ultimately counteract the objectives of the Green Deal and the Sustainable Finance Initiative as a whole, because investments in transformation/transition are among the most important for achieving these objectives.

Transition and transformation

The current definition of "sustainable investments" in Art. 2(17) SFDR is broad and therefore offers the necessary leeway and flexibility for very different sustainability strategies. Accordingly, a definition that is too detailed harbours the risk of inflexibility and rigidity.

In our opinion, it is crucial that the EU Commission retains the flexibility for companies to develop their own approaches to the key concepts of the SFDR. This includes the question of what constitutes a "sustainable investment". The SFDR does not prescribe a specific approach to determine the contribution of an investment to environmental or social objectives. Financial market participants must disclose the methodology they have used in carrying out their assessment of sustainable investments, including how they have determined the contribution of the investments to environmental or social objectives, how the investments do not materially harm any of these lines (DNSH) and how the companies invested in fulfil the requirements of a 'good governance' requirement.

We believe this is the right approach as this general definition of 'sustainable investment' allows for flexibility and is broad enough to cover a wide range of asset classes. Asset managers should be able to set their own targets and disclose their approach in a transparent manner to end investors. This flexibility is particularly helpful for the alternative investment industry as it allows investment managers to develop customised approaches that apply to the asset class in question.

The BAI is therefore opposed to the introduction of a stricter definition of "sustainable investment". Whilst we understand that there is a need for clarification in some areas, introducing a more restrictive definition of "sustainable investment" would likely limit the market and the development of funds. In particular, we believe that the definition of "sustainable investment" should not be defined solely by reference to the EU Taxonomy, as the EU Taxonomy only covers selected economic activities. The broader definition in the SFDR compared to the Taxonomy allows for a variety of strategies, especially sustainable strategies with a social focus.

Having said that, there is nevertheless a rather high level of legal uncertainty with strategies such as transition, transformation financing and impact. However, this could be achieved through opening clauses similar to Art. 9(3) for decarbonisation without changing the definition as a whole.

Given the political intention and objective of the SFDR to channel capital into sustainable assets, it seems necessary to us to consider the inclusion of transformation and transition in Article 9 funds. Particularly in the case of transformation, assets will not have "green" or sustainable characteristics from day one, but will only develop in this direction over time. For real estate funds that focus on development or “brown to green strategies”, it is just as difficult to develop a framework that easily falls under Art. 8, let alone Art. 9, even if at the end of the investment period the entire portfolio may consist of sustainable properties, as it is for a private equity fund that has adopted transformation as its investment strategy.

The EU Commission's Q&As suggest that a transition plan alone is not sufficient for an investment to be considered sustainable. However, transition plans that are credible and verifiable (e.g., by aligning with the Paris Agreement targets or publishing regular progress reports on decarbonisation and/or science-based targets) can play an important role in supporting the transformation. It would therefore be helpful if the EU Commission were to recognise in the fundamental revision of the SFDR that transition investments (if, for example, transition investments are supported by credible and verifiable transition plans) can be considered sustainable investments.

The same applies to the requirement of "good governance" in connection with transition assets. The SFDR requires "good governance" to be in place at the time of investment, but it would be helpful to have some flexibility to apply the good governance test after the time of investment. This is important, for example, in fund strategies for distressed debt. The manager of such funds wants to improve good governance in such companies, but this requires a certain amount of time.

As already noted in the opening remarks, the requirement of Art. 9 SFDR, for example, that 100% of investments should and must be invested in "sustainable investments", is particularly difficult to reconcile with "brown to green" or "grey to green" strategies, in which not all assets are naturally "green" or sustainable at the start of the investment strategy. Enabling regulation or the "upgrading of the SFDR" for the transformation should explicitly take these particularities into account.

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The **Bundesverband Alternative Investments e.V. (BAI)** is the cross-asset and cross-product lobby association for the alternative investment industry in Germany and we consider ourselves as a catalyzer between professional German investors and suppliers of alternative investment products worldwide. The overarching goal is that German institutional and professional investors must be able to diversify their investment with regard to alternatives better and more easily. The BAI is promoting a broad diversification which includes alternative investments as indispensable, in particular in terms of safeguarding long-term retirement pensions and the provision of money for construction, maintenance, and development of public infrastructure and renewable energies.
BAI members are recruited from all areas of the alternative investments' industry, e.g., AIF managers and banks as well as service providers. At present, the BAI counts almost 300 national and international member companies and is growing continuously.