BVCA submission to FCA CP22/20 on Sustainable Disclosure Requirements and investment labels

As per the BVCA response to CP22/20, we believe that certain inherent features of PE/VC funds, in particular their nature as blind-pool, closed-ended funds that invest in illiquid assets, may make it challenging for them to meet the qualifying criteria for the proposed sustainable investment labels. As agreed with the FCA, this further submission sets out BVCA members' specific concerns in this regard, and suggests alternative approaches for the qualifying criteria.

Although we expect most generalist PE/VC funds will unlikely qualify for a label (because sustainability outcomes will not be a binding objective), we also think it is important that PE/VC funds are able to use the sustainability labels, for a number of reasons. These include the following:

- **Transparency around sustainable activity:** PE/VC funds typically acquire large minority or majority ownership positions in unlisted companies, which often gives them significant influence over those companies' activities, including in relation to sustainability performance. Where PE/VC funds have a binding obligation to use that influence specifically to further sustainability objectives amongst their portfolio companies, we believe the labels should be available because they will enhance investors' visibility of this activity. This will often be precisely the kind of real-world sustainability-related activity that sustainability regulation is intended to illuminate, and the impact of the SDR framework would be limited if the labels were effectively only available to products investing in listed companies. Indeed, the FCA acknowledges in the consultation that the Sustainable Impact label, for example, is particularly suited for private markets because of the need to demonstrate "investor contribution".

- **Interoperability and comparability:** The precedent set by SFDR suggests institutional investors will likely press PE/VC fund managers to use labels where possible. If PE/VC funds are unable to use the labels, investors will find it harder to compare the sustainability characteristics of PE/VC funds with the range of other asset classes they invest in.

- **Consumer protection:** As SDR has a retail focus, we think it would be confusing for retail investors if PE/VC funds marketed to retail investors (albeit typically to sophisticated, high net worth investors through distributors and banks) are unable to adopt a label.

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	Sustainable Improver	Sustainable Focus	Sustainable Impact
Problematic qualifying criteria	Asset specific KPIs cannot be set during the marketing period for blind pool funds, because at that stage the fund may know very little about the assets they will invest in. Many funds invest across a variety of sectors and geographies, and the underlying companies will be at different stages of development, including as regards their approach to sustainability. Stewardship is a concept that has been designed with listed companies and mind and is too limited for PE/VC (see COBS 2.2.3). Restrictions on disclosure of 'hypothetical' e.g. projected performance under overseas marketing rules. Escalation via divestment is generally not a feasible option and could significantly damage investor's interests, as well as hindering sustainability outcomes.	Asset specific KPIs cannot be set during the marketing period for blind pool funds, because at that stage the fund may know very little about the assets they will invest in. Many funds invest across a variety of sectors and geographies, and the underlying companies will be at different stages of development, including as regards their approach to sustainability. 70% of investments threshold cannot be an absolute constant requirement for closed ended blind pool funds (because of 'lumpiness' and shifting valuations). There is insufficient publicly available data for unlisted SMEs to measure alignment with E&S themes. Escalation via divestment is generally not a feasible option and could significantly damage returns investor's interests, as well as hindering sustainability outcomes.	Asset specific KPIs cannot be set during the marketing period for blind pool funds, because at that stage the fund may know very little about the assets they will invest in. Many funds invest across a variety of sectors and geographies, and the underlying companies will be at different stages of development, including as regards their approach to sustainability. For example, a PE fund with a Global blind pool mandate to invest in sustainable water technologies will likely invest in businesses whose solutions are relevant to a broad range of industry sectors/ applications in developed and developing geographies with impact outcomes across GHG emissions, microplastics and PFAS pollutants. The KPIs and ToC for each of these investments would vary significantly and could only be developed after the fundraising phase, when the fund is in its deployment phase. Most strategies cannot apply the same theory of change to each portfolio company.

			Funds cannot define the target "real-world" outcomes for each portfolio company during the marketing period. Escalation via divestment is generally not a feasible option and could significantly damage investor's interests, as well as hindering sustainability outcomes. Enhanced impact measurement standards are not well established and there is no endorsed impact measurement framework as a reference point for "additionality" (without a counterfactual, additionality is difficult to evidence both in terms of thesis and actual contribution).
Proposed solutions	In applying the qualifying criteria, a product could have as its sustainability objective the aim of 'improving' portfolio companies to the point where they meet a 'credible standard'. That would be its 'sustainability objective' as required by the rules, and would inform its strategy. Investment decisions would be based on a firm's reasonable belief that a prospective portfolio company may meet a 'credible standard' by the time the	Approach to sustainability objective, and KPIs as per Sustainable Improvers. Rather than requiring 70% of the portfolio's value always to be attributable to sustainable investments, a PE/VC fund should be permitted to meet the 70% requirement where: • its constitution establishes a target of investing in sustainable investments 70% of the	Approach to impact objective, (including real world outcomes) and KPIs as per Sustainable Improvers. As with KPIs for Sustainable Improvers, the fund should, at the time of the establishment of the fund, make a commitment to selecting appropriate KPIs and develop illustrative examples of sector-specific theories of change based on the sectors that they expect to invest in, which are then

	fund exits its investment in that company. The range of 'credible standards' firms should be permitted to use in this context would include regulatory, industry-developed, third-party and proprietary standards. In the BVCA's view, the 'sustainability objective' does not require a separately formulated test on significant harm, as is the case in the EU SFDR / Taxonomy with the 'do no significant harm' tests. Rather, firms should consider, as part of the 'sustainability objective', whether significant harm may be caused. In the case of Sustainable Improvers, this harm may even be what the particular fund is seeking to address. The firm would seek to identify assets capable of improving to a point where they can meet a credible standard over the course of the investment, as is seen in the Sustainable Focus label. Similarly to the approach to setting credible standards for the Sustainable Focus label, the firm would have the flexibility	aggregate investor commitments that the fund manager has drawn down by the end of the fund's investment period; or • at the end of the investment period, it has invested 70% of the aggregate investor commitments that the fund manager has drawn down in sustainable investments. FCA to provide similar guidance as for Sustainable Improvers on KPIs, except noting that the credible standard must be the target of the fund to meet at the point of investment, and not in the future as is the case for Sustainable Improvers. The FCA should work with industry to agree a pragmatic approach in scenarios where assets underperform from a sustainability perspective, as divestment will generally not be a feasible option for private capital funds (see our suggestions for the Sustainable Improvers label for our more detailed suggestions on this).	adapted for each portfolio company upon investment. Re-frame additionality as the "contribution the investor makes to creating the enterprise impact" and specify that this contribution may be financial or non-financial. We expect private capital impact funds will demonstrate "investor contribution" through provision of capital and/or via disclosures relating to the industry's active ownership model, which typically sees funds providing 'stewardship' (in the broad sense) to portfolio companies, usually including active engagement with management. We believe that provision of capital to fund the company's activities should be clearly stated as sufficient (although not always necessary) to satisfy the "investor contribution" requirement and it should not be necessary to show that the capital is directed to "underserved markets or to address observed market failures". Including this latter requirement would likely limit impact funds to emerging markets or concessionary capital.

	to decide how it assesses significant harm in respect of that particular fund. At the time of establishment of the fund, the particular fund could disclose a non-exhaustive list of example asset-specific KPIs, based on the types of investments it expects to make as per the investment policy or strategy in its marketing materials. The fund would commit to selecting appropriate KPIs for each asset (either pre or shortly after investment), and to aiming for each asset to meet this standard in the course of the fund's investment in such asset. If the standard is not reached in respect of a particular asset, this would not automatically lead to the fund losing its label provided the intentionality to meet the standard has remained (i.e. this was a binding commitment) and the manager had taken reasonable steps on the facts. This would need to be a binding investment policy commitment, perhaps with a (binding) requirement to select (an) appropriate credible standard(s) and set more specific KPIs / time-bound targets at the asset level for each investment when made, with a plan of	FCA to explicitly confirm that a proprietary "credible standard", tailored for private companies, is acceptable.	Private capital impact funds are likely to seek to describe their activities' contribution to enhancing outcomes and solutions as part of their Theory of Change. However, we think the concept of a 'Theory of Change' whilst a helpful tool for funds, and widely used, is insufficiently well-defined to be the basis for an FCA rule. We would instead suggest strengthen the defining criteria for this label by setting out the following as clear requirements: • (1) A definition of the environmental or social problem that the company is seeling to mitigate or solve (or "enterprise contribution") • (2) An empirical evidence base that supports the definition of the problem and solution proposed • (3) A description of the way in which a specific investment will contribute to that solution or mitigation (as a fundamental part of its business model, rather

	how to achieve them and an escalation plan if not achieved. The fund could define its intent and list of potential KPIs in its strategy and marketing material. In recognition that the KPIs for an asset may change over time, the fund may re-assess and change specific KPIs over time. The fund would then be required to measure and report against these KPIs on an ongoing basis. Qualifying criteria could be attributed to the types of investments a fund is looking to invest in: • climate objectives: Scope 1 and 2 emissions, Net Zero Strategy; • workforce: Real living wage, Zero Hours, Adoption of FairWork principles; and • inclusivity: Equality, Diversity and Inclusion principles / policies Additionally, in applying the qualifying criteria, a PE/VC fund could: • describe the processes it will use in its marketing materials, to effect better impact over the		than as an incidental effect of the way it conducts its business) • (4) The means to monitor and report on success / progress with an escalation plan if needed. The FCA should work with industry to agree a pragmatic approach in scenarios where assets underperform from a sustainability perspective, as divestment will generally not be a feasible option for private capital funds (see our suggestions for the Sustainable Improvers label for our more detailed suggestions on this).

	course of investment such as through due diligence, investment agreements/action plans, assumptions around stewardship based on influence, and how it will report; • adopt a framework, such as becoming a signatory to the 'Principles for Impact Management' to evidence some level of external transparency and verification; and • report on the asset level KPIs selected in the fund annual report. "Stewardship" should include other levers more relevant to private markets, such as environmental and social action plans, selection and placing of non-executive directors, and covenants. FCA should work with industry to agree a pragmatic approach in scenarios where assets underperform from a sustainability perspective as divestment will generally not be a feasible option, particularly due to the illiquid nature of PE/VC fund investments. It is important		

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	that these rules are considered in the context of managers' wider duties (e.g. fiduciary duties to act in the best interests of investors). In the case of an underperforming asset, it will often be more appropriate for a fund to create a plan for re-engagement with the portfolio investment's management team – e.g. remediation action plans, engagement etc. for an appropriate period determined by the manager and if there is no improvement at the end of that period, where feasible, managers can explore an exit strategy. Investors would be provided updates and transparency through annual reporting. The BVCA requests that the FCA provides examples to demonstrate what kinds of objectives may qualify for the Sustainable Improvers label, particularly where social objectives/KPIs may meet the Sustainable Improvers label.		