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04 July 2023

To: European Supervisory Authorities (ESAs)
Questionnaire Template submitted via Webportal

Re: Joint Consultation Paper – Review of SFDR Delegated Regulation regarding PAI and financial product disclosures (JC2023 09)

Dear Sir or Madam,

At the Standards Board for Alternative Investments (SBAI), we welcome the opportunity to respond to the European Supervisory Authorities (hereinafter "ESAs") consultation paper setting out the proposed Regulatory Technical Standards (hereinafter 'RTS') on content and presentation of disclosures pursuant to Article 2a(3), 4(6), 4(7), 8(3), 8(4), 9(5), 9(6), 10(2), 11(4) and 11(5) of Regulation (EU) 2019/2088 (hereinafter Sustainable Finance Disclosure Regulation 'SFDR').[1]

The SBAI is a global alliance of alternative investment managers and investors dedicated to improving the alternative investment industry through setting standards[2], providing industry guidance[3], facilitating collaboration, and the exchange of ideas. Our community includes asset managers representing AUM of over US$2 trillion and institutional investors responsible for over US$6 trillion in assets. The SBAI is an Affiliate Member of the International Organization of Securities Commissions (IOSCO), and we support global efforts to facilitate fair and efficient markets, reduce systemic risk and enable investors to make well-informed investment decisions, including in areas of sustainability and ESG.

Summary: Addressing Key Shortcomings in Relation to the SFDR Technical Guidance – Treatment of Derivatives and Short Positions

At the Standards Board for Alternative Investments (SBAI), we welcome efforts to help investors make better informed investment decisions by providing them with additional information on the sustainability profile and risks of investment funds, thereby enhancing comparability between different products.[4] **Our consultation response is limited to questions 14 and 15, seeking to help establish a robust framework for the treatment of derivatives and short positions in the calculation of Principle Adverse Impacts (PAIs), Sustainable Investments (SIs), and Key Performance Indicators (KPIs)**.

We believe that the root cause of the complications, that the European Supervisory Authorities (ESAs) are currently encountering in determining the treatment of derivatives and short positions, is the lack of clarity of

[1] https://www.esma.europa.eu/sites/default/files/2023-04/JC_2023_09_Joint_consultation_paper_on_review_of_SFDR_Delegated_Regulation.pdf
[2] Alternative Investment Standards: https://www.sbai.org/standards.html
[3] SBAI Toolbox Guidance: https://www.sbai.org/toolbox.html
[4] SFDR Consultation Paper: https://www.esma.europa.eu/sites/default/files/2023-04/JC_2023_09_Joint_consultation_paper_on_review_of_SFDR_Delegated_Regulation.pdf

the mechanisms through which investors contribute to positive (or negative) sustainability outcomes. In our view, once there is understanding of the transmission mechanisms, the treatment of all financial instruments logically follows.

Therefore, in section 1 of our response to questions 14/15, we set out how investors (and the SFDR) have impact in primary and secondary markets, specifically focusing on how secondary market investors affect the cost of capital of issuers. We show that buying a security in the secondary market is no different to assuming the risk of a security via a derivative in terms of its impact on the issuer's cost of capital. We also show that selling, short-selling or establishing a short position via a derivative are all equivalent in terms of impact on the cost of capital.

The ESAs have been concerned that derivatives could be used to greenwash portfolios and have tried to address this by, on the one hand, including derivatives[5] in some parts of the calculation to capture them where they have adverse "impact", and on the other hand, excluding derivatives in other parts of the calculation[6], resulting in an overly complex and inconsistent calculation framework for both PAIs, SIs and KPIs. This results in these metrics not being able to distinguish between different portfolio implementations (for example in terms of taxonomy alignment or adverse impacts), rendering them useless to compare alternative investment funds that implement market neutral strategies (i.e., using derivatives and short positions).

In section 2 of our response, we set out a methodology that addresses these current shortcomings, and is simple, consistent, and transparent, thereby enabling investors to make better informed investment decisions. The methodology provides a test for inclusion of instruments in the calculation, an approach to measurement, and a definition of the denominator. The proposed approach is implementation agnostic, leaving no room for greenwashing, or manipulation of outcomes through different implementations/approaches to structuring.

In section 3 of our response, we set out examples, showcasing:

- How the currently proposed KPIs and PAIs do not differentiate between portfolios that have very different sustainability characteristics,
- How identical portfolios (in terms of economic exposure) have different KPIs, and
- How changes in technical implementation of portfolios (from an investor's perspective) without altering the economic exposure can result in different KPIs/PAIs.

In all these instances, the adjusted methodology proposed by the SBAI delivers more accurate results with greater informational transparency.

It is important to point out that the methodology that we propose can result in PAIs or KPIs being negative. This is opposed to the ESAs' proposal: "(…) *the ESAs are of the view that displaying a negative proportion of Taxonomy-aligned investments (…) would not fit with the actual investments nor with the EU sustainable finance framework" and, for PAIs, "adverse impacts should be netted at the level of an individual counterpart without going below zero".*[7]

[5] For example in the calculation of long positions for the purposes of PAIs

[6] For example, no netting across different entities/flooring of netting at zero

[7] Joint Consultation Paper on the Review of SFDR (..), P.18; https://www.esma.europa.eu/sites/default/files/2023-04/JC_2023_09_Joint_consultation_paper_on_review_of_SFDR_Delegated_Regulation.pdf

We believe these constraints need to be relaxed in order to calculate accurate metrics, to avoid greenwashing loopholes, to create a framework that is more broadly applicable to all types of investment strategies, and to enable investors to make well-informed decisions based on metrics that do not exhibit information loss.

Simplifications through ratios and metrics are good, but they become meaningless, and at worst, counterproductive, when the metrics stop being accurate, or when calculation complexity creates new loopholes and anomalies. It is for example not clear why it should be disguised, as it is currently the case, if an investment fund builds a large short position in taxonomy aligned assets when reporting KPIs, and we believe it is also important for investors to understand that a fund has built a large short position in "heavy emitters", which should be reflected in the fund's PAIs.

It appears that the methodology, as proposed, seeks to force alternative investment funds that engage in more complex strategies and use derivatives, into a framework that is deliberately designed to only work properly for long-only funds, which then results in distorted reporting of the characteristics of such alternative investment funds.

We believe investors, including retail investors, are very well positioned to understand the metrics with relaxed constraints: The same as negative interest rates are understood by consumers, one can expect those investors taking an interest in such sustainability metrics of their investment funds to understand the difference between positive and negative outcomes.

An additional aspect that deserves attention is benchmarking. As is the case that one would not benchmark the performance of a bond fund or a market neutral absolute return fund against a long-only equity index, the appropriate benchmark matters in relation to the SFDR metrics. It is indeed possible (and would not be unusual) for a market neutral fund to report "0" (or negative) adverse impact (given it holds long and short positions), but this should not be construed as a particular sustainability characteristic, given the natural starting point for a market neutral fund is "0". Hence, additional disclosure should accompany the disclosure of all such metrics in order to put them into context. This enhanced disclosure is always better than devising an inaccurate reporting methodology that exhibits information loss.

We understand that there are many different approaches for the treatment of derivatives and short positions in circulation, including the belief that "derivatives do not matter at all" (which is not consistent with the methodology set out in this response, nor with the premise of the SFDR), or that it is important to "look at the intentionality of a position" (which is difficult to measure and highly subjective). One premise of the SFDR is that the actions of individual investors in secondary markets (e.g., buying and selling) matter in order to achieve sustainability outcomes – with the only plausible transmission mechanism for impact being "issuer cost of capital". As demonstrated in our consultation response, derivatives and short positions play the same role as buying or selling the underlying securities in terms of influencing issuer cost of capital, and thus we argue for the recognition of said equivalence of impact in the disclosure regulation.

Should you wish to discuss any elements of our response we would be more than happy to oblige.

Yours sincerely,

Thomas Deinet
Executive Director
Standards Board for Alternative Investments (SBAI)

Responses to Specific Questions[8]

Question 14: Do you agree with the proposed treatment of derivatives in the PAI indicators or would you suggest any other method?

Question 15: What are your views with regard to the treatment of derivatives in general (Taxonomy alignment, share of sustainable investments and PAI calculations)? Should the netting provision of Article 17(1)(g) be applied to sustainable investment calculations?

(Combined response to question 14/15)

The SFDR regulations are designed to increase market transparency, prevent greenwashing, and direct capital towards more sustainable businesses and financial products. To determine the right treatment for derivatives and short positions, it is important to understand the **transmission mechanisms** through which the risk taking by investors and the flow of capital actually have real world impact (e.g., furthering sustainable economic activity) and how investors are exposed to sustainability risks within investment portfolios. Following on from this understanding, the relevant metrics (KPIs, PAIs, etc.) need to be designed in such a manner that they provide an accurate representation of sustainability impact and risk, prevent greenwashing, and most importantly enable investors to make well-informed investment decisions.

1. Understanding transmission mechanisms: *How do investors (and the SFDR) have impact?*

Investors are typically one (or more) layer(s) removed from entity-level corporate decision making; hence, an understanding of how investor activities in primary and secondary markets affect decision making in the "real economy" is needed.[9]

The **first** and most direct mechanism of influence is investor engagement/stewardship. For example, in the case of equities, investors can utilise equity voting rights to influence corporate decision making. However, since the KPIs and PAIs are not assessing investors' voting behaviour, this channel of transmission, while relevant, is not further considered here.

The **second** mechanism of influence is when investors provide "new" capital via the **primary market**. This happens when firms raise financing in public capital markets, Venture Capital or Private Equity/Credit firms invest, or banks provide financing to companies. By choosing to make capital available for new projects (or not), investors influence an issuers' ability to raise capital and the cost at which capital is made available. In this instance, investors provide capital and assume risk[10].

In contrast, in the **secondary market**, there is a limited supply of securities which change hands when investors buy/sell, but no new cash is transferred to the underlying entities: it is solely an exchange of rights, such as ownership and voting rights, and accompanying risk, between different investors. This raises the question of how secondary market activities have any impact on the "real economy"?

[8] Where we have chosen not to answer a question, this should not be considered an endorsement of any or all the suggestions contained in that question.

[9] "Investor contribution mechanism for positive sustainability outcomes" have also been described in the FCA Consultation CP22-20 p.25 (Sustainability Disclosure Requirements (SDR) and Investment Labels): https://www.fca.org.uk/publication/consultation/cp22-20.pdf

[10] Note: the risks can be hedged – for example, a bank can transfer the risk of its lending book to other investors, see Appendix A for a case study

The **third** mechanism of influence is derived from the activity in the secondary markets through investors' impact on the market price. Investors collectively affect companies by influencing the price at which such companies will have access to debt or equity in the future, thereby influencing future real-world developments through impacts on the cost of capital.

For example, if a significant group of investors choose to "divest" certain assets (e.g., operators of coal fired power plants), they will need to find other investors to buy/hold more of these assets. Having to own more of these assets reduces the diversification of the portfolios of these other investors and increases their risk (compared to the optimum portfolio), and they will therefore require compensation for assuming this extra risk, in other words, the cost of capital for these assets goes up. Conversely, the cost of capital of a certain economic activity (assets) will go down when more people are prepared to carry the risk associated with it.

It is important to note that the "transmission mechanism" of *divesting in secondary markets* does not result in immediate change in the underlying economic activity, but the cost of capital at which this economic activity is evaluated going forward will increase, making investments in these and similar activities less attractive.[11,12]

What about companies that do not need to raise new capital in the future?
Even in situations where companies do not need to access the capital markets for new capital, this transmission mechanism has impact on corporate decision making.

For example, a company growing organically (i.e., it has no need to raise funding or financing through the capital markets) can allocate capital expenditure to different investment opportunities. In assessing these investment opportunities through the lens of the Net Present Value, which will be impacted by cost of capital (implied from market valuation multiples[13]) associated with these different activities (for example: a coal-fired power plant, versus a bio-gas plant, with similar investment cost and cash flow characteristics).

If the markets associate a high cost of capital (i.e., lower valuation multiple) with a coal-fired power plant, while the bio-gas plant commands a lower cost of capital (i.e., higher valuation multiple), a company will find that investment in the bio-gas plant will have a higher Net Present Value than the coal-fired power plant, and choose to invest in the bio-gas plant.

The markets will value the overall company as a function of its business segments, so engaging in activities which command a higher valuation multiple will increase the overall value of the company.

The test for inclusion of a position in the calculation of PAIs and KPIs should be whether the position has real world impact on the price at which companies will have access to debt or equity now and in the future. In this framework, buying an asset is no different to assuming the risk of (gaining economic exposure to) an underlying

[11] See https://www.aqr.com/Insights/Perspectives/Shorting-Counts

[12] It is worthwhile noting that some responsible investors set targets to reduce their ownership in certain carbon emitting assets, while other responsible investors say that "divesting" could be harmful if it results in investors who care less will own more of the controversial assets, and hence, responsible investors should actually hold on to controversial assets and influence their transition. This in turn might suggest that in an activist context, a higher PAI is an expression of efforts to make a positive impact in areas where it is most needed, rather than a measure of adversity. A further group of investors combine such "engagement" and "exclusionary" approaches.

[13] A (valuation) multiple expresses the value of an asset as a multiple of a particular value driver (of that asset), for example Earnings before Interest and Tax (EBIT): Valuation multiple = Valuation Measure (e.g., Enterprise Value) / Value Driver (e.g., EBIT). These multiples can be observed in the public markets.

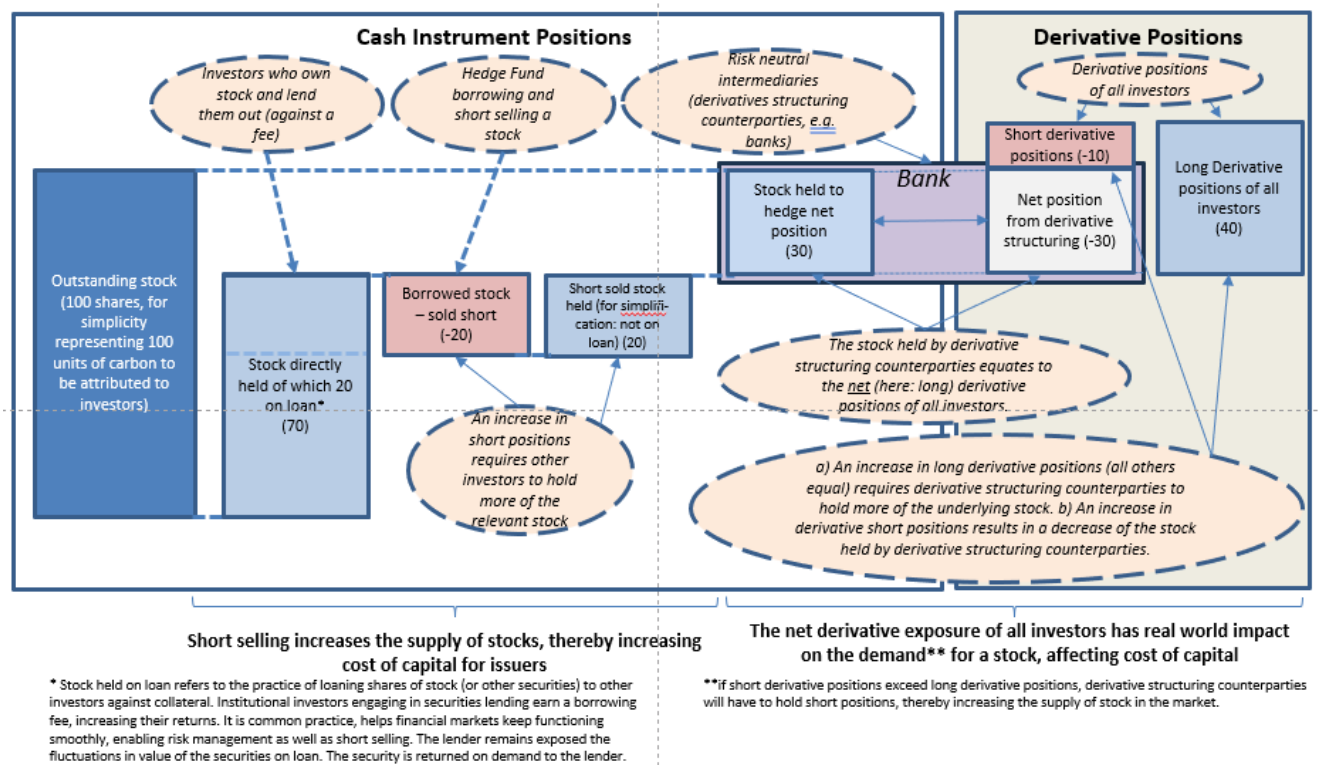
asset via a derivative, thereby enabling some other economic actor (e.g., a bank, that acts as a counterparty) to hold on to the underlying asset (i.e., increasing the aggregate number of investors willing to hold such securities at a given price). The same is true for (short-) selling, short selling or establishing a short position via a derivative; all play an effective role in modifying the conditions/cost at which capital may be made available in the future, and at which firms will assess an individual project when using market-based multiples.

Test for inclusion of a position: All positions that impact the conditions/cost at which capital may be made available in the future matter, this includes cash positions in relevant instruments (e.g., direct exposure through debt or equity holdings), short positions, and derivatives (indirect or synthetic exposure, long and short).

The impact that both short and derivative positions have on the aggregate supply and demand for securities is set out in the illustration below, where we account for the aggregate impact of long (direct exposure, cash instrument) positions, short positions, and derivatives (indirect or synthetic exposure). The illustration shows that the aggregate impact of short positions and derivatives matters, notably:

- Short positions require other investors to hold more of the underlying assets, increasing cost of capital (no different to "selling" an asset)
- The net derivative exposure of all investors assuming the risk of certain underlying (corporate) economic activities will need to be replicated in the market for the relevant cash instruments (e.g., equities) by the derivative counterparties (e.g., banks, which do not assume any of the risk). If, in aggregate, investors holding derivatives have a net long exposure, the derivative counterparties will need to hold this exposure in the market to remain market neutral, if investors hold a net short exposure, the derivative counterparties will need to replicate this short exposure through short-selling.
- There is **symmetry** of impact of long and short positions (across all instruments) in how they influence future cost of capital.
- There is **equivalence** of impact, whether a position is held via cash instruments, or derivatives.

Illustration of Long and Short Positions in Cash Instrument and Derivatives



Other observations:

- In the example, the long exposure held by investors in the underlying stock exceeds the outstanding shares (100), but all longs and shorts in the market add up to 100:

	Long	**Short**
Long only investor holdings (shares)	70+20*	0
Short seller	0	20
Bank (Derivative structuring counterparty)	30	30
Investors (Derivatives)	40	10
Total	**=160**	**=60**
	Net = 100	

*20 is the short-sold stock acquired by investors

- More generally, the illustration above can also help with the broader understanding of how market prices (and resulting future cost of capital) are impacted by the aggregate net flows of funds in or out of a secondary markets where there is a limited supply of securities: There must be a market price response to money invested in (or divested from) equity/debt markets as a whole, including to changes

in the net demand for (or supply of) securities through long (or short) positions held through derivatives.[14]

2. Design of metrics (methodology)

We agree with the ESA's concerns about enabling firms to misrepresent a product's alignment by not including derivative transactions in the calculations. In the context of Principle Adverse Impact (PAI) indicators, for example, this relates to underestimating the PAI indicators if derivatives are not included in the numerator of the calculation, which could be achieved by holding assets with adverse impacts via derivatives (rather than underlying equities), thereby underestimating the PAI indicators.

However, we disagree with the ESA's approach of not consistently accounting for both synthetic long and short exposures across PAI indicators, KPIs and Sustainable Investments, based on the assessment as set out in section (1) of this response, where we discuss the various transmission mechanisms of how investors' actions collectively influence the cost of capital to ultimately have a tangible real-world impact.

The calculation methodology and resulting metrics (e.g., KPI, PAI, etc.), as currently proposed, do not accurately reflect the taxonomy alignment of investment funds, as they misrepresent the adverse impact and exhibit information loss, particularly in relation to alternative investment funds who utilise both long and short positions, and employ derivatives.

We therefore propose the following framework for the calculation of KPIs, PAIs, and SI.

a) Test for inclusion of a position in the calculation
b) Approach to measurement
c) Clarification of approach to treatment of long/short positions (netting), and derivatives
d) Determination of Denominator
e) Implementation agnostic approach

a) Test for inclusion of a position

This principle was established in section 1:

> All positions that impact the conditions/cost at which capital may be made available in the future matter: this includes cash positions in relevant instruments (e.g., debt, equity), short positions, and derivatives (long and short).

b) Approach to measurement

"Delta" is a commonly used risk sensitivity metric by finance professionals and (European) regulators to assess changes in value of a derivative instrument for a 1 currency unit change in value of the underlying security. Delta is partially used in the SFDR methodology, e.g., to account for long derivative positions in the PAIs and short positions (derivatives, short selling) in the calculation of KPIs. As presented in section 1, investors influence the cost of capital of economic activity by choosing to assume the economic risk of these activities, hence, the association of emissions flows with the taking of risk (e.g., de-risking of other economic actors).

[14] The short selling in the example above requires 20 additional shares to be held by other investors, bringing the total long holdings of investors to 120 (out of 100), due to the 20 shares of borrowed and shorted stock.

Delta should be consistently used when accounting for derivatives and short positions in KPI, PAI, and SI calculations.

c) Clarification of approach to treatment of long/short positions (netting), and derivatives

At present, the SFDR is not consistent in its approach to the treatment of derivative positions. The inconsistencies are set out in the table below, notably:

- Long derivative positions increase PAIs but not KPIs
- Netting is done differently for PAIs versus KPIs
- No symmetry of impact between long and short positions without clear rationale for this assumption
- No equivalence of impact (cash position versus derivative position), without clear rationale for this assumption

In our view, there is **symmetry** of impact of long and short positions (across all instruments) in how they influence future cost of capital, and there is **equivalence** of impact, whether a position is held via cash instruments, or derivatives.

Overview of differences in treatment and SBAI position

Instruments	KPIs (Taxonomy Alignment)*	PAIs (Adverse Impact)	SBAI position (following from assessment above)
Long cash instruments (equities, bonds etc.)	✓	✓	**Agree**
Long derivative positions	×	✓	**Disagree with KPI approach:** ➔ **Long derivative positions should be included in KPI calculation (equivalence of impact)**
Netting of shorts / derivatives at same entity level	~ (floored, no netting below zero)	~ (floored, no netting below zero)	**Disagree with flooring at "0". Aggregate impact on cost of capital matters. Results in inaccurate outputs, information loss in metrics.** ➔ **Symmetry of impact of long vs. short requires symmetry in calculation methodology.**
Netting of shorts / derivatives across positions	× (across different entities for taxonomy-aligned positions)	× (across different entities)	**Disagree with lack of netting. Aggregate impact on cost of capital matters. Results in inaccurate outputs, information loss in metrics.** ➔ **For KPIs: Allow netting for all taxonomy aligned exposures to reflect the "real" weighted average taxonomy aligned activity contribution of investments.** ➔ **For PAIs: allow of netting across all exposures to show real impact (e.g., in relation to GHG emissions per value of investments)**

As a result, the nominator in the formulas should be defined as follows:

- **KPI Nominator:** Net exposure (delta) to investments in environmentally sustainable economic activities (taxonomy aligned)

- **PAI Nominator:** $\sum_n^i \left(\frac{exposure\ (\text{delta adj.})\text{to}\ investment_i}{investee\ company's\ enterprise\ value_i} \times \begin{matrix} investee\ company's\ Scope \\ 1,\ 2\ and\ 3\ GHG\ emissions \end{matrix}_i \right)$

d) Determination of Denominator

The definition of the denominator is currently vague, sometimes referring to "sum of all assets held by the financial product", or "value (EUR) of all investments". **We would propose Net Asset Value (NAV), as the denominator**, with the following advantages:

- It provides a measure of impact of "invested capital" (from the investors' perspective)
- It allows for easier aggregation (for investors across multiple funds)
- It accounts for leverage at the fund level, where the "negative impact" or "KPI goodness" is multiplied through leverage, thereby also relaxing the constraints of an upper limit of 1 (for KPIs)
- It is more suitable for funds where risk positions are held in derivatives, in combination with underlying cash, and where the "sum of assets held" might not be clear
- Long-only strategies might not be affected, given that "assets invested" might be close to or equivalent to NAV

Denominator: Net Asset Value should be used in the denominator of KPI and PAI calculations.

e) Implementation Agnostic Approach

To avoid "greenwashing", the ESAs have made modifications to the PAI calculation methodology, for example, by including long derivative positions in the calculation of PAIs, and thereby avoiding firms from using derivative exposures (instead of securities) to underestimate the PAI indicators. We agree that the results of both KPI and PAI calculations should be unambiguous (implementation agnostic). Such that, irrespective of an institutions' implementation choice, identical portfolios in terms of underlying risk taking should produce identical PAIs and KPIs. Otherwise, there is room for manipulation/greenwashing as a function of portfolio implementation. Section 3b contains an example, showcasing how the currently proposed methodology is not implementation agnostic, and how the methodology proposed by the SBAI provides accurate results, where identical risk taking does not result in different outcomes as a function of implementation choice.

Adopting the changes proposed by the SBAI will result in identical outcomes in the calculation of KPIs and PAIs, for funds / investors with similar risk profiles.

3. Case studies

A benefit of metrics expressed through ratios such as KPIs and PAIs is that they facilitate comparisons, but they are also susceptible to information loss. In particular, if the method deployed does not carry forward all information contained in the original data, e.g., due to the implementation of 'caps', 'floors' (as in SFDR), etc., and thereby reduce the ability of the ratios to distinguish between or account for very different underlying scenarios.

The following examples illustrate the short comings:

- **Example a)** shows that the methodology proposed in the SFDR is not able to distinguish between vastly different implementations in long/short portfolios (market neutral funds), and how the adjusted methodology proposed by the SBAI in section 2, delivers accurate results.
- **Example b)** shows how two investors with identical risk taking can have very differing KPI/PAI outcomes.

a) Example: Market neutral fund

Market neutral funds minimises exposure to systematic risk factors (overall market risk), by combining long and short positions, seeking to capitalise on the selection skill of an investment manager by exploiting the relative performance of assets. Institutional investors, who have limits on the amount of market risk they can take, can benefit from low or no correlation of the returns with their other allocations.

Calculation for two market neutral funds (A, B) with significantly different investment approaches, and fund C, which replicates the strategy B through derivatives.

Fund	Investment Approach	Fund Positions				Assets invested (EU definition)	Assumed NAV (for Adjusted KPI)	KPI Results	
		Taxonomy-aligned		Non-taxonomy-aligned				SFDR KPI	Adjusted KPI*
		Long	Short	Long	Short				
A	Long taxonomy-aligned investments, as well as shorting other taxonomy-aligned investments	100	100	0	0	100	80	**100/100= 1**	**(100-100)/80= 0**
B	Long taxonomy-aligned, short non-taxonomy-aligned investments	100	0	0	100	100	80	**100/100= 1**	**(100-0)/80= 1.25**
C	Identical to fund B, but only using derivatives	0** (100 ***)	0	0	100	100 (or 0 – unclear definition) ****	80	**0/100= 0 (or undefined)****	**100/80= 1.25**

* using the methodology set out in section 2.
** for SFDR KPI calculation
*** for adjusted KPI calculation
**** if held in assets are held in cash, unclear if they count as "Assets invested".

Observations:

- **The SFDR KPI overestimates the taxonomy alignment:** it does not differentiate between the very different "taxonomy alignment" profiles between Long Short Fund A and Long Short Fund B., i.e., both score identically, despite Fund B entering a large short positions in taxonomy aligned investments, neutralising the aggregate "taxonomy alignment" of the fund. **The adjusted KPI provides a more accurate perspective,** since it takes account of the significant reduction in taxonomy alignment due to the large short position.
- **The SFDR KPI does not account for the multiplier effect of leverage** by using "Assets invested", rather than NAV in the denominator, as demonstrated by the adjusted KPI of 1.25 for Fund B opposed to 1.

- Fund C is identical to fund B in terms of risk taking, but the SFDR KPI does not account for the long derivative positions, the KPI for fund C will differ from the KPI for the otherwise identical fund B. **The adjusted KPI, however, is identical for B and C.**

Similar results can be observed for the PAIs as the only distinction is that the PAI calculation accounts for long derivative positions in the nominator (while the KPIs do not), hence, the conclusions for fund C would not be applicable. It is worth noting that the value of the adjusted KPIs and PAIs is not constrained to the interval from 0 to 1, but can be both negative, and larger than one, to properly measure short positions, as well as leverage.

Key takeaway: SFDR KPIs (and PAIs) do not accurately measure the differing qualities of long short portfolios and introduce differentiation of results where there are no differences (in terms of actual impact, exposure, and risk). The adjusted methodology proposed by the SBAI delivers more accurate results and allows for the inclusion of Long Short strategies in the KPI/PAI calculations.

b) Example: Calculating Taxonomy Alignment in Investor Portfolio

KPIs and PAIs provide a tool for (institutional) investors to calculate the aggregate taxonomy alignment[15] and adverse impact of their overall investment portfolios (a precondition for this is that NAV is used in the denominator of the KPIs and PAIs - see section 2d). It is important that the results of these calculations are unambiguous (**=implementation agnostic**, as set out in section 2e). Such that, irrespective of an institutions' technical implementation choice, identical portfolios in terms of underlying risk taking should produce identical PAIs and KPIs. Otherwise, there is room for manipulation/greenwashing as a function of portfolio implementation.

Institutional investors, such as pension funds, sovereign wealth funds, and others diversify their portfolios across many different asset classes and investment strategies, and implement their investment strategy through many different approaches, including using third-party investment managers (versus insourcing investment management where assets may be held directly on their balance sheet), as well as different structuring options (commingled funds versus managed accounts).

The current proposed approach in the SFDR will not result in identical outcomes for identical strategy implementations, as demonstrated in the example below:

- **Pension Fund A** uses external managers for its allocations, with a) a large, low-cost passive allocation to ETFs representing the global equity and bond markets through cash instrument positions and derivatives, and b) a satellite portfolio of absolute return managers (e.g., hedge funds, which use both cash instruments and derivatives) that design a market neutral total return strategy, making use of long and short positions. Pension fund A monitors its aggregate "taxonomy greenness" (KPIs) as well adverse impact of its portfolio (PAIs) by aggregating the reported KPIs, PAIs etc. from underlying managers.
- **Pension Fund B** internalises all portfolio management: its portfolio consists of a passive long portfolio of direct holdings of most global equities and bonds. The pension's internal "alpha team" implements a hedge fund strategy, which, instead of borrowing stock to sell short, just sells off the equivalent positions from the fund's passive long book – thereby "synthetically" implementing the overall alpha

[15] "overall weighted average taxonomy aligned activity contribution"

strategy by tilting the overall portfolio. Long positions are implemented via cash instruments, rather than derivatives. Pension Fund B calculates its KPIs and PAIs using the SFDR methodology.

- **The net exposures of Pension Fund A and B are identical.**
- However, the KPI and PAI metrics will differ between Pension Fund A and B. Pension Fund B will likely exhibit a better KPI and less adverse impact (lower PAI) than Pension Fund A, despite the identical exposure profile. This is due to the distortions introduced by the flooring in the netting of short positions (Pension Fund B reduces the amount of "long positions", whereas Pension Fund A has a separate implementation affected by the limitations to netting) and the lack of consideration of long derivative positions in the calculation of KPIs (because the derivative exposure of Pension Fund A to taxonomy aligned activity does not count towards the taxonomy alignment).

Key takeaway: SFDR KPIs (and PAIs) methodologies are not implementation agnostic.
In contrast, the adjusted methodology proposed by the SBAI will deliver identical outcomes for identical risk taking and leaves no room for manipulation.

Appendix A: Case study – Cash versus Risk

A bank wants to provide more credit funding to one of its clients, a taxonomy-aligned green company, but the bank's risk limits prevent it from taking on additional risk with this client. The bank therefore enters into a credit default swap with a credit fund manager, who now assumes the credit/default risk, and thereby enables the bank to provide more capital to the green company.

- **Who should account for "taxonomy greenness" of this additional funding?**
    - **The bank providing the cash (but not bearing the extra risk)?**
    - **The credit fund manager carrying the risk?**
    - **Both? (results in double-counting)**
    - **None of them?**
- **What matters in this context – the provision of risk-free cash (by the bank), or the assumption of the economic risk of the activity?**
- **Should there be a distinction between primary cash funding and risk bearing, so, for example a flow metric to measure new cash provision to economic activity (Financed Emissions) versus an "inventory measure" of Endorsed Emissions (or Risk Underwritten Emissions)?**

Terminology: "Financed Emissions" versus "Endorsed Emissions" (or Risk Underwritten Emissions"

"Financed Emissions" is now widely used in the SFDR context and beyond, in describing the holdings of investors, but strikes us as misleading in the context of secondary markets. The term might suggest that reductions in "financed emissions" relate to actual reductions in carbon emissions in the real economy, which is obviously not the case, since only the risks are transferred between market participants when securities change hands, or positions are hedged, but no new cash is provided to or withdrawn from underlying economic activities.

Therefore, rather than focusing on the aspect of "cash financing" (which happens in the primary market), a suggested approach would be to assess this through the perspective of risk transfer, and attribute emissions to those investors who assume the risk of economic activities, and thereby influence the future cost of capital of these activities.

A more accurate way to describe this is **"Endorsed Emissions"** or **"Risk Underwritten Emissions".**