Skadden

ESG Disclosure Requirements Put New Spotlight on Private Capital Managers

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Takeaways

- New EU regulations require detailed disclosures about the ways in which asset managers implement sustainability policies in the businesses they investment in. Similar rules are being considered in the U.K. and U.S.
- The EU requires that some disclosures be made public on asset managers' websites, not just in offering documents circulated to investors on a confidential basis.
- The EU rules have an extraterritorial impact because they apply to non-EU firms raising funds within the EU, and some non-EU firms are opting to comply simply to demonstrate their ESG credentials.
- The public disclosures open up private capital firms to the risk of public criticism, investigation and litigation from a range of stakeholders.

For decades, the private capital industry strived to stay out of public view. Beginning in 2007, IPOs of fund managers prompted some of the industry's leading firms to reveal for the first time details about their investments and inner workings. Other disclosures mandated in the U.S. under the Dodd-Frank Act in the wake of the global financial crisis put additional information about fundraising and fund managers into the public domain. The current wave of ESG-related regulation, which is impacting the entire financial community, is indirectly causing private capital firms — including private equity, venture capital, private debt, real estate and infrastructure fund managers — to increase disclosures about their investments and their operations.

The EU Takes the Lead

For some time, many investors in private funds have required their managers to demonstrate some form of ESG credentials — whether that was adherence to the United Nations Principles for Responsible Investment, or narrower restrictions on investing in particular sectors such as gambling or fossil fuels. The significant growth of so-called "ESG funds" has, unsurprisingly, led to new regulatory initiatives, with the EU leading the pack in implementing requirements largely targeted at preventing "greenwashing" — misleadingly advertising investments as having a positive ESG impact.

The EU's Sustainable Finance Disclosure Regulation (SFDR), which came into force in March 2021, requires entities that fall within its scope to make a number of disclosures to their clients or investors and more publicly on those firms' websites. (See our September 2, 2020, client alert "Private Fund Managers Should Prepare for New ESG-Related Regulatory Obligations.")

The U.K. appears set to follow suit. The U.K. Financial Conduct Authority has begun consultations on new rules regulating the information to be provided in relation to ESG funds.

In the U.S., the Securities and Exchange Commission (SEC) has stated it is considering rules for private capital funds and other investment advisory businesses regarding ESG factors, including ESG claims and disclosures. SEC Chair Gary Gensler has singled out funds marketing themselves as "green" or "sustainable" and has noted there are no standardized meanings for such terms. In addition, the SEC has established a Climate and ESG Task Force within its Enforcement

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Division to identify and investigate ESG-related disclosures by corporate issuers as well as disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

A New Era of Public Scrutiny

What is perhaps most notable about the EU's SFDR is the requirement for entities within its scope to make disclosures on their websites. Private fund managers that operate, or raise money, in Europe are likely to be subject to these rules. Even where a private capital firm is technically outside the scope of the SFDR, investors may demand compliance.

The SFDR requires an in-scope firm to include on its website details of how sustainability risks are integrated into investment decision-making; how remuneration policies are consistent with the integration of sustainability risks; and a statement on the firm's due diligence policies with regard to potential adverse impacts of investment decisions on sustainability factors. It seems likely that, by forcing firms to provide public disclosures of this nature, some private capital firms may have to alter their behavior rather than make adverse disclosures that could be detrimental to their public profiles and, consequently, their ability to raise capital.

For private capital firms, this means a new era of public scrutiny, where an increasingly wide base of stakeholders will seek to hold them to account. Private fund managers will continue to be subject to scrutiny by their investors, aware that bad investment decisions or activities could impact future fundraising prospects and thus the ability to keep their business running. Moreover, if "greenwashing" is found to have occurred, it may result in claims by investors who have suffered losses due to untrue or misleading statements or omissions made by private capital firms.

A number of hedge funds have noted that investors are particularly keen to see detailed evidence of so-called "ethical" practices in the supply chains of potential investments. The M&A community has seen plenty of examples of auction processes where sellers have not been able to complete a disposal, have had to accept a lower price than anticipated or have provided the buyer with indemnity cover or other risk protection, as a consequence of the divested business having significant ESG issues. While these risks commonly mean a problem for the seller, for the right buyer, which may often be a private fund, there is an opportunity to create value by addressing the problems and bringing the business into compliance with global ESG standards.

Disclosures Could Create New Risks

The growth of private capital, coupled with an increased public focus on ESG, raises the prospect of new risks to private fund managers. For example, having to make public disclosures raises the prospect of a much broader universe of potential complainants. If something goes wrong, private fund managers could conceivably face the risk of class actions or litigation brought by experienced nonprofit organizations.

Even without litigation risk, the industry and individual firms may encounter more negative PR as the non-financial media becomes more familiar with private capital activities. Unfavorable PR is likely to be noticed by investors and that, too, could negatively affect fundraising.

And, lest we forget, regulators will also be watching. Should a portfolio company of a private fund be seen to be having a damaging or adverse impact on the environment or society, regulators will be under pressure to investigate whether any blame lies at the door of the private fund manager. Regulators, especially in the U.S., will be watching to see whether investment advisers adhere to claims about ESG investment strategies and whether all aspects of their business are run in a manner consistent with their public stance on ESG issues. Where they find ESG claims are not supported, it is likely that the private fund manager will be asked to provide more information to support those claims, or otherwise drop such labels.

Bracing for the Changes

The private capital industry needs to prepare for these new challenges. Those within the industry are well aware that public perception of private equity and other forms of private capital is not always positive. As a result, many firms have taken steps to demonstrate the contributions their investments make — whether through job creation or other benefits — to their wider communities. Now there will also be a stronger desire to tell a positive ESG story on a firm website. With the press, regulators and a wide universe of stakeholders watching, firms will have to ensure their disclosures can be verified. In a world of 24-hour news and social media, it is not possible to predict all the potential public scrutiny that private capital may face. But it does seem clear that stories about private capital's ESG efforts, or misrepresentations about them, will start to appear, and private capital firms need to be ready.