# Navigating Uncertain Waters: ESG Takeaways for Private Capital Firms Subject to EU Law

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10 / 17 / 22


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## Introduction

Environmental, social and governance (ESG) issues continue to be a very significant topic for the private capital industry, whether through increasing demands from investors and other stakeholders or the continued stream of sustainability-focused regulations introduced in Europe, including the European Union's Sustainable Finance Disclosure Regulation (SFDR). (See our 2 September 2020, client alert, "Private Fund Managers Should Prepare for New ESG-Related Regulatory Obligations.")

On 6 October 2022, Skadden hosted a roundtable session with representatives from the private capital industry in order to get a better understanding of the practical challenges and solutions sponsors are facing. While a number of themes and practical effects were covered, the structure of the session broadly focused on the impact on capital raising, internal operations and reporting. Here is a summary of the participants' insights.

## Capital Raising

The impact on capital raising can be divided into two main themes:

- which SFDR category a fund falls in: Article 6 (sustainability not considered in investment choices), Article 8 (environmental and socially promoting) or Article 9 (targets sustainable investments); and
- investors' assessment of a fund sponsor's ESG-related credentials, and how this has driven investment behaviour.

Industry feedback indicates that uncertainty in the market about the classification of products has driven a cautious approach. Fund managers find it increasingly difficult to offer Article 6 products and are instead opting to classify products as either Article 8 or Article 9.

This has also manifested in the fund-of-funds area, where there is evidence of a waterfall effect, as Article 6 funds reclassify in order to attract capital from Article 8 funds of funds. Uncertainty as to product classifications has also led to reports of pressure from the market to classify products as "dark-green" Article 9 products where the sponsor wishes to have an ESG-related offering, even if the product may be more accurately described as an Article 8 product. For instance, a fund might promote social or environmental characteristics, but have an eventual strategy objective that is sustainable.

An alternative approach that managers are adopting is to market funds as "Article 8+", which is indicative of confusion in the market about where to draw the line between product classifications. For these cases, some fund managers are opting to state in disclosure materials that the fund is an Article 8 product for the present time, with a view to the fund being Article 9 in the future.

A lack of clarity about metrics has led to more successful fundraising for European fund managers that place more emphasis on the environmental features than on the social and governance features of ESG. From both the investor and sponsor side, the social and governance related elements are perceived as difficult to categorise using standardised metrics. Furthermore, in Europe, there are genuine concerns around the data collection points for social factors, and reluctance on the part of portfolio managers to gather potentially sensitive personal data about employees.

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By contrast, investors in the United States place a greater emphasis on social factors, particularly diversity and inclusion, and charitable giving.

## Internal Operations

Fund sponsors are also facing difficulties in interpreting exactly what investors want from sponsors in relation to ESG, particularly in sectors which may struggle from a lack of ESG data (for example, private credit). Fund sponsors have recognised that there is little appetite for slowing down investment programmes on behalf of investors, especially where an investment is difficult to benchmark, or where no investment restrictions are being impinged. Practically, this has led sponsors to seek assistance from third-party providers, which offer metrics guidance on a sector-by-sector basis.

In integrating sustainability factors into investment decisions and processes for Article 8 and Article 9 products, fund managers have developed a range of approaches, including:

- ESG questionnaires that factor into every investment decision and are reviewed at investment committee meetings;
- red flag checklists, which focus due diligence on specific ESG-related concerns;
- background checks and media searches on key individuals in the target business; and
- due diligence deep dives on cybersecurity systems and controls.

Even where sustainability factors have been considered when making investment decisions, there are still practical difficulties in obtaining compliance from portfolio companies. This is particularly difficult for investors with minority stakes in underlying companies. An industry-wide solution that has had success is to publish reports measuring portfolio companies' sustainability efforts against one another based on benchmarks in specific industries, in order to create competition.

## Reporting

The administrative and compliance burden associated with reporting has only intensified due to the uncertainty as to product classification and appropriate deployment of metrics. There is also a concern that a lack of clarity regarding ESG metrics is leading to the development of over-inclusive investor questionnaires and side letter requests, where the requested data may not be pertinent to specific sectors. In addition, stakeholders are concerned that the time and resources dedicated to reporting and responding to investor questionnaires may be more usefully deployed at the research and investment-decision stages.

In response, fund sponsors are engaging service providers who have developed templates and systems that coordinate investor requests. One example of the efforts being made is to push for standardisation of reporting, which is exemplified by ESG data convergence projects. These solutions will provide some welcome predictability, which may assist portfolio managers in communicating investor requests to their underlying portfolio companies.

The reporting requirements under Article 4 of the SFDR regarding 'principal adverse impacts' of investment decisions on sustainability are also making waves in the private capital world. There are concerns about the lack of reliable data from portfolio companies, particularly given that such companies may not carry out the testing (for example, carbon footprint assessments) on an annual or more frequent basis, making it difficult for portfolio managers to gather data for entity-level disclosures.

## Conclusion

While it is clear that most fund sponsors want to integrate ESG considerations into their operations and processes, this should not be to the detriment of their core objective: high financial returns for their investors. At the same time, fund sponsors continue to seek an appropriate balance with their investors to provide data and reporting to satisfy investor needs, without disproportionately burdening the fund sponsor or underlying investment. Achieving this balance remains a significant challenge. It is clear that technology will have an important role to play, but it seems that even more important will be achieving better convergence on the standards and metrics that the industry uses.