ESG: An overview for VC and PE Managers

Following the conclusion of the Paris climate agreement in 2015, the EU has been moving through its sustainability agenda at an ever increasing pace. The EU Commission's stated aim of stimulating in the region of €1 Tn of sustainable investment during the period to 2030 has been underpinned by a 10 point action plan on sustainable finance which, through the introduction of the Sustainable Finance Disclosure Regulation ("**SFDR**") and the EU Taxonomy Regulation (the "**Taxonomy Regulation**") sets out a framework for identifying, quantifying and reporting on the sustainability of any given investment. The new regime raised a range of questions for many alternatives managers in connection with the ongoing viability of their existing investment strategies and approaches and questions remain over the success of the Sustainable Finance Disclosure Regulations and the EU Taxonomy Regulation in achieving the Commission's stated aims.

The ongoing compliance requirements of SFDR and the Taxonomy Regulation should not be underestimated and, with the EU Commission having confirmed that non-EU-managers distributing funds in Europe are subject to SFDR, UK-based managers seeking to raise European capital under national private placement regimes ("**NPPR**") will in due course face dual (and non-corresponding) compliance requirements under SFDR and the UK's own Sustainable Disclosure Regulation ("**SDR**").

Introduction

The introduction of SFDR on 10 March 2021 marked a turning point for venture capital and private equity fund managers ("**VC/PE Managers**") operating in the European market with respect to their commitments to and reporting on Environmental, Social and Governance ("**ESG**") matters.

Together with a range of other European financial market participants and financial advisory firms, PE/VC Managers became subject to a number of ESG related disclosure and reporting requirements under SFDR which was in turn supplemented by the disclosure and reporting requirements of the EU Taxonomy Regulation (the "**Taxonomy Regulation**").

The introduction of SFDR and the Taxonomy Regulation form part of a concerted effort by the European Union and EU Member State governments to promote sustainable investment and accelerate the drive toward carbon neutrality.

Although SFDR and the Taxonomy Regulation were not on-shored during the Brexit process, the UK government has also been taking steps to tackle greenwashing in the form of the SDR. A final FCA policy statement on the SDR was published in November 2023 with the SDR coming into effect on a phased basis from mid 2024. Please see our article 'ESG in the UK' for a summary of SDR.

The SDR and how it compares to SFDR will be the subject of a separate article, but in this article we will explore the background to, the content of and the current status of SFDR, the Taxonomy Regulation and the various regulatory technical standards and screening criteria that underpin them. We will also outline what VC/PE Managers need to do to comply with the regulations and their potential implications.

Background to SFDR and the Taxonomy Regulation

The years preceding the introduction of SFDR saw a marked increase in the focus of governments, regulators, investors, the media and the general public on sustainability, corporate social responsibility and the drive to combat climate change.

At the European level, the legislative and regulatory response was founded on two landmark international agreements that were concluded in 2015: the UN2030 agenda and sustainable development goals ("**Agenda 2030**") and the Paris climate agreement (the "**Paris Agreement**").

In order to achieve the aims of Agenda 2030 and the Paris Agreement, in 2019 the European Commission presented the European Green Deal, a growth strategy with the aim of making Europe the first climate neutral continent by 2050. A key component of the European Green Deal is the European Green Deal Investment Plan, presented in 2020, which sought to stimulate in the region of €1Tn of sustainable investments in the period to 2030. In order to meet these investments goals, annual investment of c. €260Bn would be required over the coming decade. While this would be funded (in part) publicly through the European Fund for Strategic Investments, private capital was expected to play a pivotal role.

To this end, the Commission developed a comprehensive policy agenda on sustainable finance and an associated action plan. There are 10 key actions set out in the plan, with the most relevant to PE/VC Managers being actions 1, 5 and 7 (outlined below), which created a framework for ensuring that an investment qualifies as 'sustainable' within the Commission's overall policy aims.

1. **Action 1:** Establishing a taxonomy to provide a clear and detailed classification system for sustainable activities.

2. **Action 5:** Developing sustainability benchmarks to provide investors with better information on the carbon footprint of their investments.

3. **Action 7:** Clarifying asset managers' and institutional investors' duties regarding sustainability, including sustainability related disclosures.

The above action points are underpinned by further legislation, namely:

1. SFDR, in turn underpinned by associated Regulatory Technical Standards ("**RTS**");

2. the EU Taxonomy Regulation, in turn underpinned by a technical annex with delegated regulations;

3. the Low Carbon Benchmark Regulation; and

4. amendments to the Alternative Investment Fund Managers Directive ("**AIFMD**") and the Markets in Financial Instruments Directive ("**MiFID**").

SFDR and RTS

SFDR

SFDR imposes transparency and disclosure requirements on a range of financial market participants and financial advisory firms relating to the integration of ESG considerations in their investment decision making and advisory processes.

Those required to comply with SFDR include managers of alternative investment funds ("**AIFMs**"), investment advisers regulated under MiFiD and EuVECA managers. Significantly, the Commission confirmed (see the Commission's most recent consolidated Q&A responses on SFDR, published on 18 May 2023) that SFDR applies to non-EU AIFMs marketing funds in the EU under NPPR in addition to EU based AIFMs.

SFDR requires in-scope firms to comply with up to three tiers of sustainability related disclosures and reporting, as follows:

1. **Sustainability risk disclosures**: These disclosures relate to 'sustainability risks', being environmental, social or governance events or conditions that, if they occur, could cause an actual or a potential material negative impact on the value of an investment.

2. **Principal adverse impact disclosures**: These disclosures relate to 'sustainability factors', being environmental, social and employee matters, respect for human rights and anti-corruption, irrespective of their effect on investment value.

3. **Additional disclosures for certain ESG/sustainability-focused funds**: these additional disclosures apply only to funds 'promoting environmental or social characteristics' and to funds which have 'sustainable investment as an objective' (i.e. impact funds). They require affected firms to

make disclosures concerning benchmarking compliance and the rationale/justification for any sustainability labels they use,

with disclosures to be made available on websites, in pre-contractual disclosures and/or in periodic investor reports (as applicable).

RTS

Much of the detailed content, methodologies and the prescribed format of presentation of the information required to be disclosed or reported under SFDR is contained in the associated RTS, which were published on 25 July 2022, entered into force on 14 August 2022 and which have applied since 1 January 2023 (subject to some clarificatory amendments made in February 2023).

Perhaps unsurprisingly given the complexity of the RTS and the overarching SFDR framework, market participants raised many questions about the RTS. This resulted in a further consultation being launched by the European Supervisory Authorities ("**ESA's**") (including the European Securities and Markets Authorities ("**ESMA**")) on 12 April 2023 to tackle proposed refinements to the RTS. This consultation closed on 4 July 2023, in light of which the ESAs are preparing a final report to the Commission on proposed amendments to the RTS. These amendments are expected to cover the expansion of the RTS disclosure framework, the main technical issues which have emerged since SFDR was originally agreed and refinements to reflect the experiences to date of stakeholders as expressed through the Commission's Q&As and observations made by national competent authorities.

The Taxonomy Regulation

The Taxonomy Regulation establishes a classification system by which managers, investors, businesses and policymakers can better assess whether economic activities undertaken or invested in are '**sustainable**' and imposes a number of additional disclosure obligations which supplement the rules on sustainability-related disclosures in SFDR. These additional disclosure obligations require those who are in scope to disclose whether (and if so, to what extent) they take account of the Taxonomy Regulation and require those who do not take account of it to clearly disclose that fact and state the reasons for it. Much like the RTS, delegated legislation establishes the content, methodologies and the prescribed format of presentation of the information required to be disclosed or reported.

The stated aim of the Taxonomy Regulation is to standardise the concept of environmental sustainability with a view to facilitating investment both nationally and across the EU, whilst making it easier for market participants to attract capital from overseas. This is to be achieved by those in scope applying technical screening criteria ("**TSC**") to any economic activities undertaken in order to determine whether those activities meet the Taxonomy Regulation's criteria of "sustainability" and by presenting the proportion of activities which are considered aligned with the Taxonomy Regulation as a percentage of all activities undertaken. Disclosure of the degree of taxonomy alignment achieved is intended to help firms better explain their sustainable strategies in a way that is consistent and easily comparable.

In order to determine if an economic activity is "sustainable", the Taxonomy Regulation identifies six environmental objectives which may be pursued, namely:

1. climate change mitigation,
2. climate change adaptation;
3. sustainable use of water and marine resources;
4. the transition to a circular economy;
5. pollution prevention control; and
6. protection and restoration of biodiversity and ecosystems

Under the Taxonomy Regulation, an economic activity will only be regard as sustainable if it:

1. makes a "substantial contribution" to one or more of the environmental objectives directly, or by directly enabling other activities which in turn make a substantial

contribution to one or more of the environmental objectives;

2. does "no significant harm" to any of the other objectives;

3. is carried out in compliance with minimum safeguards in connection with human and workers' rights; and

4. complies with the TSC.

As noted above, the TSC are used to determine when an economic activity can be considered to be 'contributing significantly' to one or more of the six environmental objectives and whether any such activity does 'no significant harm' to any of the others. The TSC are far more granular than the Taxonomy Regulation itself, establishing (on a sector-specific basis) the potential contributions that may be made to the environmental objectives, minimum requirements, quantitative thresholds and how sustainability indicators, methodologies, certification schemes and statistical classification systems may be used.

The Taxonomy Regulation came into force on 12 July 2020, albeit subject to a phased introduction for its main operative provisions as follows:

1. 1 January 2022: the effective date of application in relation to the climate change mitigation and climate change adaptation environmental objectives.

2. 1 January 2023: the effective date of application in relation to the other environmental objectives.

Discussion

The introduction of SFDR and the Taxonomy Regulation marked a pivotal point in the EU's drive to promote sustainable investment and the implications for PE/VC Managers are significant.

The first and most obvious is that it heralded the end of 'greenwashing' with ease, as PE/VC Managers looking to capitalise on ever-increasing investor appetite for socially responsible and sustainable investment must now justify their and their fund's ESG credentials by reference to prescriptive criteria.

In a marketing context, it is interesting to note that although the Commission was keen to avoid SFDR compliance being utilised as a marketing label, it seems that this is what has happened in practice. Although it is debatable whether SFDR compliance is seen as a priority by LPs investing with larger managers and those with well established track records, there is a growing perception among newer managers and those who must compete more fiercely for capital that they will be disadvantaged if their funds do not fall under Article 8 ('green products') or Article 9 ('dark green products') of SFDR. Whilst achieving a successful close is no doubt the number one priority when raising capital, PE/VC Managers who are keen to frame a fund as an Article 8 or 9 product to enhance their marketing prospects must be aware that they are now required to expend considerable time, money and human resource throughout the lifecycle of a fund in order to monitor, measure, benchmark and disclose the progress made towards any stated sustainability goals. As such, a push to bring a fund within the scope of SFDR as a marketing strategy must be carefully considered. Please see our article 'Fund Structuring 101' for a more detailed discussion of other fund structuring and distribution considerations.

Significantly, the regulations apply to any PE/VC Manager (whether EU domiciled or not) marketing a fund into the EU, with disclosures and statements of compliance (or explanations for non-compliance) required irrespective of whether the fund in question promotes ESG related goals or has sustainability as an objective. When coupled with the deemed complexity of the EU's cross-border fund marketing regime, many overseas managers are now actively avoiding marketing in Europe in order to avoid the application of SFDR and the Taxonomy Regulation to their funds. Those non-EU PE/VC Managers who do market funds in Europe may face the prospect of having to comply with both domestic and European ESG legislation. As will be the case for UK-based PE/VC Managers when SDR takes effect, dual compliance may not be straightforward if the domestic and European regimes do not align.

Those PE/VC Managers wishing to minimise the impact of SFDR and the Taxonomy Regulation by establishing funds which actively avoid ESG and/or sustainability focussed investments will need to consider the potential impact this may have on investor appetite for their funds. It is worth noting that the EU's ESG legislative framework applies to a wide range of financial market participants, including many who form the backbone of the European alternatives LP community, and many of whom will be bound to disclose their green investment credentials to their own investors. It is unknown at this stage whether the EU or individual Member States will seek to incentivise investors to deploy their capital in favour of ESG or sustainability focussed funds by (for example) reducing the cost of capital deployed in 'green' funds or offering favourable tax treatment to returns generated by such funds, but LPs will no doubt face increasing pressure to deploy capital sustainably as we move towards 2030.

With regard to LP investment decisions, the introduction of standardised disclosures and templated reporting means that investors will over time acquire the information needed to draw direct comparisons between the ESG and sustainability-related performance of various funds and managers. There may well come a time when simply being a 'green' or 'dark green' fund is not enough, and investors will scrutinise a manager's green credentials as closely as historic returns when considering investment opportunities. It is also possible that LPs will increasingly push to link carry and fees to the achievement of sustainability related objectives – indeed, certain forward-thinking managers have already started to do so. Whilst it remains to be seen if this will become commonplace, it is certainly foreseeable that it could. Together with the increasing cost of ESG compliance acting as a drag on returns, the direct linking of carry/fees to ESG performance would only add to growing downward pressure on VC/PE Managers' economics.

Finally, PE/VC Managers who are in-scope of the EU regulations face the prospect of trying to keep abreast of a raft of ongoing amendments to and expansions of their ESG disclosure and reporting obligations. By way of example, in addition to the ESA's review of specific elements of the RTS, the Commission launched public and targeted consultations on 14 September 2023 to review the implementation of SFDR more holistically (closed on 15 December 2023). The expectation is that the Commission's broader review of SFDR is a prelude to the introduction of potentially extensive changes (amounting to what some observers are referring to as "SFDR 1.5") and it remains to be seen if the ESA's review of the RTS will be subsumed into (or postponed until completion of) that wider project. In any case, it is clear that the rules suffer an inherent lack of stability at present and, as such, VC/PE Managers face an ongoing challenge when seeking to collect, collate and present the data required to comply with their ever-evolving disclosure and reporting obligations.

Conclusions

Whilst ESG disclosure and reporting remains an evolving area, what is clear is that the practical ramifications of SFDR and the Taxonomy Regulation have been and will continue to be significant and wide ranging. We will continue to monitor developments and we will provide updates as matters develop.

If you would like to speak with us regarding any of the topics raised in this article, please do not hesitate to contact us.

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