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Private Investment Funds and ESG: EU Regulatory Changes on the Horizon

This client alert, part of a series focused on ESG regulatory developments, provides an overview of the upcoming EU regulatory changes. It should be read together with our ESG Lexicon, available [here](#), which provides definitions of any terms not defined herein.

Key Takeaways

- *New EU regulations will require EU fund managers and non-EU fund managers marketing funds in the European Union to make new disclosures related to sustainability.*
- *The regulations require new pre-commitment disclosures to be made to prospective investors, additional periodic investor reports and new disclosures on the fund manager's website.*
- *U.S. fund managers that market funds in the European Union or establish an EU fund need to be aware of the complex regulatory changes ahead, which they may need to comply with as early as March 2021. In preparation for these regulatory changes, fund managers will need to review their existing policies, investment processes and disclosure to ensure compliance.*

Overview

The European Union will impose ESG disclosures as part of its Action Plan for Financing Sustainable Growth (available [here](#)). Two regulations will affect fund managers and financial advisers, in particular -- Regulation 2019/2088 on sustainability-related disclosures for the financial services sector (the "SFDR") (available [here](#)) and the Taxonomy Regulation (available [here](#)), which creates an EU-wide classification system for sustainable activities (the "EU Taxonomy"). These regulations will require "financial market participants," financial advisers and other regulated firms to make new disclosures related to (i) how sustainability is addressed in the investment decision-making process and (ii) disclosures related to "financial products" characterized as sustainable investments or that promote environmental and/or social characteristics. A number of the disclosure requirements will be effective March 10, 2021. In April 2020, the European Supervisory Authorities ("ESAs") set out draft regulatory technical standards ("RTSs") that provide details on how the disclosure obligations should be met; these may only be finalized at the end of this year.

For purposes of this alert, we focus on the aspects of the SFDR and the EU Taxonomy relevant to alternative investment fund managers ("AIFMs"), which come within the SFDR's definition of "financial market

participant,” and alternative investment funds (“AIFs”), which come within the SFDR’s definition of “financial product.”

Objectives and Key Requirements of the SFDR and Taxonomy Regulation

The SFDR

The SFDR was adopted in 2019 to enhance and harmonize ESG disclosures related to investment decision-making and advisory processes. It establishes unifying and cohesive standards to enhance the comparability of AIFs. The SFDR will first come into effect on March 10, 2021, with additional requirements that become effective at later stages through 2022. It requires new disclosures to be made by AIFMs in pre-contractual disclosures made to investors, periodic investor reports and on their entity websites, as summarized in Annex A, including:

- policies on the AIFM’s integration of sustainability risks in its investment decision-making process and information on the manner in which such risks are integrated into investment decisions;
- information as to whether or not the principal adverse impacts of investment decisions on sustainability factors are considered at the AIFM level and, where considered, the due diligence undertaken;
- information in AIFM remuneration policies regarding how such policies are consistent with the integration of sustainability risks;
- results of assessments of the likely impacts of sustainability risks on the returns of the AIF;
- information as to whether and, if so, how particular AIFs consider principal adverse impacts on sustainability factors;
- in the case of AIFs that promote environmental and/or social characteristics, information regarding how those characteristics are met and, if an index is designated as a reference benchmark, information as to whether and how the index is consistent with such characteristics; and
- in the case of AIFs that have “sustainable investment” as their objective, information regarding the designated index, if one is provided, or where no index is designated, how the objective is to be attained.

Taxonomy Regulation

The Taxonomy Regulation establishes an EU-wide classification system (*i.e.*, a taxonomy) of sustainable activities. The Taxonomy Regulation follows the entry into force of the SFDR, and will therefore need to be incorporated in disclosures from March 10, 2021. The Taxonomy Regulation’s classification system defines environmentally sustainable economic activities, and outlines six environmental objectives, including climate change mitigation and climate change adaptation. The regulation also amends the SFDR in various ways:

- It provides that in order for an investment to be characterized as environmentally sustainable, the underlying economic activity must make a “substantial contribution” to at least one of the Taxonomy Regulation’s six objectives and not cause any significant harm to any of the others (the “do no significant harm” or “DNSH” principle). Additional disclosures must be made, as summarized in Annex B.
- If an AIF purports to have a sustainable investment objective or promotes environmental and/or social characteristics, then the relevant AIFM must disclose the percentage of the investments underlying the AIF that qualify as environmentally sustainable economic activities.
- If the AIF does not purport to have a sustainable investment objective or promote environmental and/or social characteristics, the Taxonomy Regulation requires the AIFM to include a statement that the investments underlying this AIF do not take into account the EU criteria for environmentally sustainable economic activities.

Pending Developments—the RTSs

In April 2020, the ESAs set out draft RTSs (available [here](#)) in respect of the content, methodologies and presentation of the information required in relation to “principal adverse sustainability impacts” and in respect of AIFs that promote environmental and/or social characteristics or that have sustainable investment as their objective. The final RTSs are due by the end of 2020 and will supplement the SFDR.

The consultation sets out proposals for content, methodology and presentation of ESG disclosures at the AIFM and the AIF level, as well as for the DNSH principle under the Taxonomy Regulation. For example, the draft RTSs propose a requirement to use a mandatory reporting template for the presentation of pre-contractual and periodic disclosures.

In September 2020, the ESAs published a survey setting out the details of the presentation and content of certain information to be disclosed pursuant to the SFDR, including illustrative mock-ups of pre-contractual and periodic disclosure templates of products promoting environmental and/or social characteristics (available [here](#)).

Forthcoming Changes that Only Apply to EU AIFMs

Some upcoming regulatory changes will only apply to EU AIFMs because non-EU AIFMs are not subject to the organizational or conduct rules of the AIFMD simply by reason of marketing in EU member states under separate local private placement rules (known as the National Private Placement Regime). The four relevant draft delegated regulations and directives – which will amend the AIFMD Delegated Regulation, the UCITS Directive, the Markets in Financial Instruments Directive (“MiFID”) Delegated Regulations and the MiFID Delegated Directive – were announced on June 8, 2020. These upcoming changes supplement or underlie external or client-facing disclosures required under the SFDR. One draft delegated directive also introduces a new concept of “suitability preference,” which relates to a client’s choice as to whether either of the

following should be integrated into their investment strategy: (i) financial instruments that have sustainable investment objectives, or (ii) financial instruments that promote environmental and/or social characteristics, and either pursue sustainable investments or consider principal adverse impacts on sustainability factors. Generally, EU AIFMs should:

- take into account sustainability risks in their existing governance and organizational structure as part of their compliance with these organizational requirements;
- update existing conflicts of interest policies and processes to take account of conflicts that may arise from the integration of sustainability, or a client's sustainability preferences;
- update their investment due diligence processes to address sustainability risks;
- ensure investment advisory and management processes reflect the particular client's sustainability preferences in making their "suitability assessment" related to the client's investment objectives under MiFID; and
- take into account the sustainability preferences of the target market, which will likely involve updates to AIF origination and marketing/distribution strategies.

Looking Ahead

The SFDR makes no explicit distinction between EU and non-EU fund managers. Guidance on the Taxonomy Regulation suggests it will "apply to anyone offering financial products in the European Union, regardless of where the manufacturer of such products is based." As a result, U.S. fund managers that market funds in the European Union or establish an EU fund need to prepare for the regulatory changes ahead. In addition, non-EU AIFMs that undertake functions under AIFMD delegation principles, while not having direct obligations under the new regulations, may nonetheless still need to provide information to the EU AIFM in order to facilitate the EU AIFM's compliance with its own disclosure obligations.

While private equity firms in the United States have thus far dealt less with regulatory imperatives and more with market imperatives when it comes to ESG disclosures, the reach of the SFDR and the Taxonomy Regulation suggests that non-EU investment advisers marketing funds in the European Union must consider the evolving ESG regulatory landscape. The EU has moved to harmonize ESG disclosure standards, and may well set the market standard over time, with more global implications.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman
+44-20-7367-1601
mbergman@paulweiss.com

Ariel J. Deckelbaum
+1-212-373-3546
ajdeckelbaum@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Conrad van Loggerenberg
+1-212-373-3395
cvanloggerenberg@paulweiss.com

Lindsey L. Wiersma
+1 -212-373-3777
lwiersma@paulweiss.com

Scott P. Grader
+1-212-373-3284
sgrader@paulweiss.com

David G. Curran
Chief Sustainability & ESG Officer
+1-212-373-2558
dcurran@paulweiss.com

Associate Sofia D. Martos contributed to this Client Memorandum.

Annex A**Key Provisions of the SFDR**

| Provision | Form of Disclosure | Subject of Disclosure | Information Required | Effective Date |
|------------------|---------------------------|---|--|-----------------------|
| Art. 3 | Website | Sustainability risk policies at AIFM level | Policies on the integration of sustainability risks in its investment decision-making process | March 10, 2021 |
| Art. 4(1) | Website | Adverse sustainability impacts at AIFM level | Where the AIFM considers principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts; ^(a) where it does not consider such adverse impacts, clear reasons for why it does not do so (including whether and when it intends to) | March 10, 2021 |
| Art. 5 | Website | Remuneration policies in relation to the integration of sustainability risks | Include in AIFM remuneration policies information on how those policies are consistent with the integration of sustainability risks | March 10, 2021 |
| Art. 10 | Website | AIFs that promote environmental and/or social characteristics (Art. 8 AIFs), or have sustainable investments as their objective (Art. 9 AIFs) | <ul style="list-style-type: none"> ▪ A description of the environmental and/or social characteristics or the sustainable investment objective; ▪ Information on the methodologies used to assess, measure and monitor the environmental and/or social characteristics or the impact of the sustainable investments selected for the AIF;^(b) and ▪ The information covered by pre-contractual disclosures and periodic reports referred to in Arts. 8, 9 and 11 | March 10, 2021 |
| Art. 4(3) | Website | Adverse sustainability impacts at entity level | FMP (with more than on average 500 employees or parent thereof): due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors | June 30, 2021 |

| Provision | Form of Disclosure | Subject of Disclosure | Information Required | Effective Date |
|------------------|--|--|--|-----------------------|
| Art. 6(1) | Pre-contractual disclosures | Integration of sustainability risks | <p>The manner in which sustainability risks are integrated into AIFM investment decisions and results of assessments of likely impacts of sustainability risks on the returns of AIFs made available</p> <p>Where the AIFM deems risks not to be relevant, the descriptions are to include a clear and concise explanation of the reasons therefor</p> | March 10, 2021 |
| Art. 8 | Pre-contractual disclosures | AIFs that promote environmental and/or social characteristics | Information about how the environmental and/or social characteristics of the AIF are met; if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics, as well as whether the methodology used for the calculation of the index can be found | March 10, 2021 |
| Art. 9(1) | Pre-contractual disclosures – gloss on Art. 6(1) and (3) disclosures | AIFs with sustainable investments as their objective, with an index as a reference benchmark | How the designated index is aligned with the AIF's sustainable investment objective and an explanation as to why and how the designated index aligned with that objective differs from a broad market index | March 10, 2021 |
| Art. 9(2) | Pre-contractual disclosures – gloss on Art. 6(1) and (3) disclosures | AIFs with sustainable investments as their objective, with no index as a reference benchmark | How the sustainable investment objective is to be attained | March 10, 2021 |
| Art. 9 (3) | Pre-contractual disclosures – gloss on Art. 6(1) and (3) disclosures | AIFs with the reduction of carbon emissions as their objective | The objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement | March 10, 2021 |

| Provision | Form of Disclosure | Subject of Disclosure | Information Required | Effective Date |
|------------------|-----------------------------|---|---|-----------------------|
| Art. 11 | Periodic reports | AIFs that promote environmental and/or social characteristics (Art. 8 products) | The extent to which environmental and/or social characteristics are met | January 1, 2022 |
| Art. 11 | Periodic reports | AIFs that have sustainable investments (including the reduction of carbon emissions) as their objective (Art. 9 products) | The overall sustainability-related impact of the AIF by means of relevant sustainability indicators; or where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the AIF with the impacts of the designated index and of a broad market index through sustainability indicators | January 1, 2022 |
| Art. 7 | Pre-contractual disclosures | Adverse sustainability impacts at AIF level | Whether and, if so, how the particular AIF considers principal adverse impacts on sustainability factors or, if they do not consider these to be relevant, a statement that the AIFM does not consider the impacts and the reasons therefor | December 30, 2022 |

- (a) Disclosure shall include: information about policies on the identification and prioritization of principal adverse sustainability impacts and indicators; a description of the principal adverse sustainability impacts and of any actions in relation thereto taken or, where relevant, planned; brief summaries of engagement policies in accordance with Article 3g of Directive 2007/36/EC, where applicable; and a reference to adherence to responsible business conduct codes and internationally recognized standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement.
- (b) Disclosures shall include: data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental and/or social characteristics or the overall sustainable impact of the AIF.

Annex B**Key Provisions of the Taxonomy Regulation**

| Provision | Form of Disclosure | Subject | Information Required | Effective Date |
|------------------|---|---|---|-----------------------|
| Art. 5 | Pre-contractual disclosures and in periodic reports | Environmentally sustainable investments that contribute “to climate change mitigation” or “climate change adaptation” | Information on AIF’s underlying environmental objective or objectives Description of how and to what extent the investments underlying the AIF are in economic activities that qualify as environmentally sustainable, as well as percentage of the investments in environmentally sustainable economic activities selected for the AIF | January 1, 2022 |
| Art 6 | Pre-contractual disclosures and in periodic reports | AIFs that promote environmental characteristics | Required disclosures must be accompanied by the following statement: “The ‘do no significant harm’ principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.” | January 1, 2022 |
| Art. 7 | Pre-contractual disclosures and in periodic reports | AIFs that do not take into account the EU criteria for environmentally sustainable economic activities | Required disclosures under the SFDR must be accompanied by the statement: “The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.” | January 1, 2022 |

| Provision | Form of Disclosure | Subject | Information Required | Effective Date |
|------------------|---|---|---|-----------------------|
| Art. 5 | Pre-contractual disclosures and in periodic reports | AIFs that contribute to sustainable investments | Information on the AIF's underlying environmental objective or objectives A description of how and to what extent the investments underlying the AIF are in economic activities that qualify as environmentally sustainable, as well as the percentage of the AIF's investments in environmentally sustainable economic activities | January 1, 2023 |