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Private Funds and ESG: Where Regulation Meets Market Practice

The SEC recently proposed new ESG Rules for investment advisers that would, if enacted, impose a stringent new ESG disclosure regime.

ENVIRONMENTAL, SOCIAL and Governance (ESG) factors have been a hot topic for private funds for several years. Private fund managers must balance the increasingly sophisticated investor expectations and perspectives with a growing raft of relevant regulation. Most importantly, the legal standards by which fund managers will be measured and held to account are still being established. As such, managers are flying blind to some degree when it comes to ESG.

A common ESG-related concern across the U.S.' SEC, the U.K.'s Financial Conduct Authority (FCA) and drafters of applicable EU regulations is


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the exaggeration of a fund manager's ESG practices or impact (historically known as "greenwashing" in the environmental context), to gain a competitive advantage by marketing a financial product as furthering one or more ESG goals when, the manager or the product does not meet advertised standards.

In May 2022, the SEC proposed new ESG Rules for investment advisers that would, if enacted, impose a stringent new ESG disclosure regime across all investment advisers, regardless of their size or the nature of their investor base. While these proposed new requirements would fall heaviest on SEC-registered investment advisers, particularly those advising registered investment companies (i.e., mutual funds, ETFs, registered closed-end funds and BDCs), they would also impose significant burdens on registered investment advisers to private funds, and impose new obligations on unregistered advisers. This latest example of the SEC's intense focus on managers claiming to incorporate ESG-related considerations in their investment strategies comes as the SEC seeks to address a market in which it believes investors are unable to assess and compare investment advisers on the basis of their ESG-related disclosures, which are at best inconsistent in quality and content and at worst misleading. These rules seek not only to prevent "greenwashing" and other misleading marketing practices but also to compel more detailed and standardized disclosures to the SEC and investors regarding advisers' ESG-related practices. The SEC's focus is not on ESG labels, but on how managers describe the substance of their investment strategies, and whether the reality matches the strategy. The SEC is therefore squarely focused on whether investment advisers "say what they do, and do what they say."

The SEC's proposed new rules continue a long-standing focus on ESG-related practices, which have been listed as an exam priority for the last three years and generated a "Risk Alert" relating to the exam staff's observations of problematic practices. One practical effect of the SEC's exam and enforcement focus is that investment advisers seem likely to feel compelled to agree with investors to make more detailed disclosures and to provide more extensive ongoing reporting, which will create more potential failure points for an investment adviser's compliance function to monitor.

The SEC's proposed rules are broadly aligned with EU and UK regulators, although with less of a taxonomic focus. For example, the EU's Sustainable Finance Disclosure Regulation and Taxonomy Regulation together create a common classification system and disclosure requirements for in-scope firms. In-scope firms must make specific disclosures concerning ESG credentials and effectively categorize investment products as promoting environmental or social characteristics (so-called "light-green," or Article 8 funds), having a sustainable investment objective ("dark-green," or Article 9 funds) or neither ("grey," or Article 6 funds). Firms must also make firm-level and specific product-related disclosures in relation to those products both in offering materials provided to investors and on the firm's websites. The U.K.'s FCA is developing its own ESG legislative framework, which is anticipated to be generally aligned with the EU's approach. Once the FCA finalizes its framework, it is expected to review marketing and promotional materials prepared by fund managers. Weaknesses identified by the FCA may give rise to further review, and potentially enforcement action in extreme scenarios.

In addition to ensuring prospective compliance with new and untested regulations, fund managers face a related risk of hindsight bias. Statements and assertions in fund-offering memoranda and other pre-investment marketing materials may be evaluated differently in hindsight as changing standards become adopted as new norms, particularly where those statements are general or promissory in nature. Public law claims and civil society action that often drive such norms – about environmental, societal, and corporate governance standards – will inevitably come to influence regulatory action and private litigation against managers (as well as against portfolio companies, where ESG-related representations have been made to third-party shareholders, counterparties or other stakeholders). High profile actions by shareholders and civil rights groups may not only affect investment in those sectors but may shift the understanding of what good ESG behavior and investing is after the fact.

To date, most of the attention and litigation in relation to ESG issues has focused on environmental topics such as climate change. However, there is nothing to stop this focus from broadening beyond the "E" of ESG. Managers should anticipate that societal and governance issues will increase in prominence as gender, supply chain liability, modern slavery and human rights issues move into the spotlight. A fund manager that fails to remain observant and responsive to changing expectations from investors and regulators will receive scrutiny, or worse.

Developing investor expectations are increasingly resulting in bespoke reporting requirements in investment agreements and side letters. As market practice continues to evolve toward increased investor expectations as to ESG-related reporting, unless managers are deliberate and measured in what they agree with investors, they may soon find themselves subject to burdensome obligations, entered into in good faith but without a true appreciation of their impact, on top of any new reporting requirements mandated by the SEC and other regulators.

Potentially weighing against all of the these trends are signs of ESG fatigue among certain investors. As global markets enter a downturn, investors may press for a focus on pure return, losing patience with managers who forgo profits to align with an ESG policy.

Key takeaways for private fund managers are:

1. ESG is here to stay as an investment consideration.
2. The scope of ESG will only expand and become more detailed.
3. To avoid regulatory or investor challenge, strict compliance with stated policies and procedures as well as disclosure obligations and expectations will be key.
4. Managers should avoid biting off more than they can chew in terms of investment limitations, grand promises or disclosure obligations.
5. Say what you do, and do what you say. You will be judged on that basis.

*– Proskauer partners **Joshua Newville** and **Robert Sutton** also contributed to this article.* **M&A**

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