Malk PARTNERS

Debevoise & Plimpton

SFDR Compliance for U.S. Funds

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BACKGROUND

The recent implementation of the European Union's Sustainable Finance Disclosure Regulation ("SFDR") presents practical challenges for US asset managers that raise capital in Europe. While there is no express provision in the SFDR relating to non-EU fund managers, the European Commission confirmed that the SFDR, including its product-related disclosure and reporting obligations, applies to funds marketed in the EU under the Alternative Investment Fund Management Directive ("AIFMD") National Private Placement Regime ("NPPR").

Malk and Debevoise have collaborated to produce this white paper on complying with the EU's SFDR, particularly Article 8, for US financial market participants ("FMPs"). The purpose of the white paper is to detail SFDR's effects on US-based FMPs including taxonomy-aligned and non-taxonomy-aligned funds. The paper begins by discussing ESG programming in the US prior to SFDR. We then explore new SFDR requirements in more detail. Finally, the paper provides guidance on how US FMPs with existing ESG programs should approach modifying their programs to comply with SFDR Article 8.

ESG PROGRAMMING IN THE US BEFORE SFDR

US-based FMPs that have developed Environmental, Social, or Governance ("ESG") programs focus on four primary areas in escalating order of intensiveness (i.e., time, expertise, and resources required from FMPs): marketing, due diligence, portfolio monitoring, and stakeholder reporting.

Marketing

Marketing refers to the extent to which FMPs advertise or brand their funds as incorporating ESG factors or seeking to achieve specific ESG goals, both publicly and directly to investors when fundraising. Clear public ESG marketing of funds is not a

common practice by US FMPs in the middle market presently. If an FMP chooses to market its fund as having an ESG orientation, it must communicate as precisely as possible what ESG practices the fund adheres to. For instance, it should disclose its specific ESG and sustainability objective(s), the processes used to achieve objective(s), and be included in PPM wrappers and annual reports. Forward-looking statements on ESG commitments should be cautiously reviewed to ensure that an FMP can produce and collect strong data or evidence to support the commitment under scrutiny.

Due Diligence

US-based FMPs with ESG programs often conduct ESG due diligence on their investments and newly acquired portfolio companies. ESG due diligence occurs either via an internal function, such as an in-house ESG team that collaborates with investment professionals, or via an external engagement such as a third-party consultant.

ESG due diligence typically addresses both ESG risks and ESG opportunities the target investment could further capitalize on to generate increased returns for investors. FMPs that engage on ESG often mandate that all investment targets receive ESG diligence for Investment Committees ("ICs") or equivalent bodies to incorporate into investment decisions.

FMPs frequently track key performance indicators ("KPIs") for ESG alongside qualitative performance indicators. While interest in ESG data has increased over the past three years, types of data and methods of collecting data are inconsistent. One common obstacle is the lack of baseline data within portfolio companies, and the corresponding time and cost required to recreate baseline data. Problems with ESG data, such as inconsistencies and inaccuracies, are abundant today, reducing effectiveness and limiting FMPs' abilities to benchmark performance.

Portfolio Monitoring

US-based FMPs with robust ESG programs conduct ESG monitoring on their portfolio companies. Approximately one year after a target company has been acquired and integrated into a portfolio, the investment professionals responsible for the company will reach out to the company's management team to check in on ESG performance. ESG performance checks may include initiatives that were identified during diligence and value creation planning including risk mitigation or value creation opportunities. Depending on the FMP, ESG monitoring may be conducted either internally via investment and ESG professionals or externally via a third-party consultant.

Monitoring usually also involves collecting and tracking key ESG metrics or KPIs to assess trends. KPIs used in monitoring are often reported quarterly with an annual deep

dive. In the past, ESG data tracking has been a voluntary venture for US-based FMPs that believe ESG contributes to improved returns. Limited Partners ("LPs") are now increasingly encouraging FMPs to quantitatively track and benchmark ESG performance, using voluntary membership organizations such as the ESG Data Convergence Initiative ("EDCI"). Data on ESG areas such as employee turnover, diversity, safety, and carbon emissions are emerging as standard LP expectations for FMPs to monitor, track and disclose.

Stakeholder Reporting

US-based FMPs with ESG programming report on the ESG performance of their portfolio to key stakeholders. Depending on which stakeholders are interested in performance, these reports can either be private (prepared specifically for LPs and other investors) or public (available on an FMP's website). Reports usually cover how FMPs integrate ESG into their investment theses and overall goals for portfolio management; key case studies, metrics, and KPIs about portfolio achievements on ESG topics in a given calendar year; and go-forward items that portfolio companies are prioritizing for the next calendar year. For FMPs that report on ESG topics to investors, ESG progress and initiatives often feature in Annual General Meetings ("AGMs") and Limited Partner Advisory Commitees ("LPACs").

Noncontrolled Investments

US FMPs that engage in noncontrolled investments, such as co-investments, venture capital ("VC"), and debt investments, typically do not maintain enough bargaining power to require portfolio companies in funds to collect and report on specific ESG data or narratives. Most US FMPs with noncontrolled investments that integrate ESG into investment decisions conduct baseline due diligence to the exent possible in the cirucmstances (see below) on their minority investment prospects but face challenges in mandating ESG improvements consistently.

SFDR REQUIREMENTS

Since the mid-2000s, FMPs have been integrating ESG considerations into diligence, ownership, and reporting processes. Driven by LPs, regulator, and public pressure, ESG integration has grown in complexity and is now increasingly focused on measuring and driving improvement at portfolio companies. Topics like diversity, equity, inclusion ("DEI"), and climate change have risen to the top of stakeholders' agendas with associated expectations for measurement and disclosure.

All FMPs and financial products in scope of the SFDR must disclose firm sustainability policies and publish information on their integration of sustainability risks in portfolio

and risk-management functions. They must also explain how their due-diligence processes incorporate principal adverse impacts ("PAIs"), except for FMPs with less than 500 employees, opting out of the regime.

If a fund promotes environmental and/or social characteristics (an "Article 8 fund"), FMPs must disclose how those characteristics are met, measured, and monitored. The key requirement under Article 8 is to disclose information, using the relevant template, on the selection criteria of the underlying asset that binds the investment decision-making process. Where a fund subject to Article 8 commits to making "Sustainable Investments" as defined in the SFDR as investments in an economic activity that contribute to an environmental or social objective, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, then FMPs must build processes to assess whether an investment qualifies as sustainable and disclose how those economic activities contribute to an environmental and/or social objective without doing significant harm to other relevant objectives. If a fund's investment strategy is to invest exclusively in sustainable investments (with certain exceptions being permissible for liquidity management), it will be deemed to have Sustainable Investment as its objective and be subject to pre-contractual and ongoing disclosure pursuant to Article 9.

Under the SFDR, funds subject to Articles 8 and 9 must disclose not only on a pre-contractual basis, but also annually, again using a specific template. In their fund(s) annual report, FMPs must review the extent to which characteristics were promoted (or the extent to which Sustainable Investments were achieved), how the sustainability indicators performed, details of the proportion of investments that attained the environmental or social characteristics or the Sustainable Investment objective, and details of the actions taken to meet those characteristics or objectives.

In addition, an Article 8 or 9 fund must disclose the extent to which its investments are Taxonomy aligned . An investment is Taxonomy aligned if it makes a substantial contribution to one of six environmental objectives, does no significant harm to any of those objectives, and is carried out in accordance with the "Minimum Safeguards." Minimum Safeguards are procedures to align with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights. These include the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

As well as pre-contractual and annual report disclosures, firms with funds in scope of Articles 8 and 9 of the SFDR are required to publish and maintain information on their websites, which builds on information specified in pre-contractual disclosures; FMPs

are required to disclose information on the methodologies used, how data are sourced and processed and whether there are any limitations to the methodologies or data used to attain the environmental or social chracteristics, or the sustainable objective respectively. A summary of the information must be translated into an official language of each EU Member State that the fund markets in.

If a fund does not promote environmental and/or social characteristics or sustainable investments as part of its investment strategy, it will only be subject to a pre-contractual disclosure pursuant to Article 6 (often referred to as Article 6 funds), which still requires disclosure on whether and how ESG factors are integrated into decision-making. If a fund intends to promote environmental and/or social characteristics, it will be in scope of Article 8, and if 100% of the fund's investments are sustainable investments (with some exceptions permitted), it will be in scope of Article 9.

Uncertainty and confusion remains around funds in scope of SFDR, which, in Q3 2022, led to 41 open-ended funds to declassify from Article 9 to 8. Moreover, analyzing open-ended funds provides a barometer for the most common funds within scope of SFDR. In Q4 2022, 33.6% of funds were in scope of Article 8, 62.6% were in scope of Article 6, and only 4.3% were in scope of Article 9. Among Articles 6, 8, and 9, Article 8 has garnered the most attention from North American Private Equity ("PE") investors seeking to prove their ESG bonafides to European LPs. Many U.S. FMPs are focused on Article 8 designation and disclosure, with the goal of systematically integrating ESG alongside other factors without limiting investment opportunities across industries, themes, and theses.

ALIGNING U.S. ESG PROGRAMS TO SFDR ARTICLE 8

To achieve compliance with SFDR's Article 8 for future funds, U.S. FMPs with existing ESG programs may have to reorient and further furbish their programs including the extent to which they integrate ESG in their investment decisions and the extent to which they integrate ESG within portfolio companies' operations going forward. These improvements should be targeted across diligence, monitoring, and reporting.

Marketing

Achieving classification under SFDR Articles 8 or 9 would allow a US FMP to brand and market their fund(s) as having integrated ESG or sustainability objectives, enabling a competitive advantage in fundraising. However, FMPs should ensure that the manner in which they choose to market publicly or privately their fund(s) is aligned to the SFDR classification that the fund is in scope of and their ability to continuously provide evidence that verifies their classification. Marketing a fund as ESG or sustainability

focused without maintaining sufficient evidence to verify those claims can still introduce risk of greenwashing accusations and, potentially, liability as well as the risk of having to downgrade the SFDR classification in the future. ESG and sustainability objectives need to be specified and explained as to how they are achieved including in PPM wrappers and annual reports.

Due Diligence

SFDR will require in-scope U.S. FMPs to disclose information on how they integrate sustainability risks – an ESG event that may negatively affect the value of an investment – into their portfolio and risk-management functions. Except for those with less than 500 employees that have opted out of the regime, FMPs must disclose information on how their due diligence processes incorporate PAIs on sustainability factors in investment decisions. To do so, FMPs should prepare to disclose their policies, actions, engagement practices and adherence to responsible business conduct codes in the mandatory Level 2 Regulatory Technical Standards ("RTS") template.

If a fund is in scope of SFDR, FMPs must also include information on sustainability risks and PAIs in pre-contractual disclosures at the product level. If the fund promotes environmental or social characteristics (Article 8 classification) or has a sustainable investment strategy (Article 9 classification), further information (see above) must be disclosed in the template (usually added to the PPM).

To establish credibility, FMPs may engage with third parties to obtain external objective ESG evaluations of targets, although doing so is not required. These diligence assessments must transparently summarize key ESG findings for integrated portfolio companies. Ideally, they should also provide tangible recommendations for companies to begin developing and progressing against ESG roadmaps.

Portfolio Monitoring

If a fund promotes environmental and/or social characteristics (as an Article 8 fund), FMPs must also disclose additional information on how those characteristics are met, measured, monitored, and reported on an ongoing annual basis. Disclosure topics include the types of characteristics promoted, the indicators used to measure the characteristics, a summary of the FMP's good governance policy, and the proportion of the fund that the FMP plans to align with the characteristics promoted. Since disclosures must also be reported on an annual basis via a template, monitoring should exhibit how an FMP collects ESG data from portfolio companies and engages with them on an ongoing basis, rather than only conducting initial ESG due diligence to confirm that no prohibitive investment risks exist. Additionally, ESG monitoring should focus on tracking ESG metrics and KPIs that have been established for specific portfolio companies. ESG data, when collected consistently and comprehensively, will enable

FMPs to demonstrate how their portfolios are managing ESG risks and capitalizing on unique ESG opportunities. FMPs will need to prepare to answer specific investor and regulatory queries regarding their portfolios' ESG progress during annual monitoring periods.

Funds promoting an environmental characteristic or making sustainable investments with an environmental objective must disclose the degree to which their investments are Taxonomy aligned, regardless of whether they commit to making Taxonomy-aligned investments. However, FMPs can report zero taxonomy alignment if data are unavailable. If an investment is qualified as Taxonomy aligned, in most cases, it will also qualify as a Sustainable Investment under the SFDR. FMPs can choose to align their ESG monitoring to the Taxonomy, but for US FMPs, the majority of US companies in investment portfolios do not track specific ESG or sustainability metrics and are thus unprepared to validate Taxonomy alignment. Most US FMPs seeking SFDR compliance will need to develop an ESG data-monitoring strategy to demonstrate how they are monitoring their investments for ESG and sustainability risks outside of the Taxonomy itself. They will also need to demonstrate continuous improvement in identifying and closing relevant data gaps. An example of an improvement initiative for a company is to begin tracking Scope 1 and 2 carbon emissions, with the goal of eventually tracking Scope 3 emissions.

Stakeholder Reporting

FMPs that have already begun reporting on ESG performance, such as through website content or published reports, may amend their existing ESG reporting structures to explain how their portfolios are complying with Taxonomy-aligned or non-Taxonomy-aligned ESG disclosure areas. FMPs that do not currently report on portfolio ESG performance will need to develop mechanisms to do so, primarily for regulatory disclosures but also for investors interested in alignment to Article 8.

ESG reporting should focus specifically on metrics, with narrative describing key process steps for collection. ESG metrics should include baselines from initial diligence on companies and annual monitoring data that exhibit both improvement over time and external benchmarking. Rigorous ESG data monitoring that tracks metrics applicable to specific investments, details how and why those metrics have been chosen for tracking, and matches those metrics to ESG and sustainability risk considerations under SFDR will allow US FMPs to achieve Article 8 compliance and move their portfolios toward better aligning with the Taxonomy. FMPs ought to prepare to convey metrics to investors at AGMs, LPACs, and similar investor events to demonstrate ESG integration in their portfolios.

Noncontrolled Investments

FMPs that invest primarily in noncontrollled investments will realistically face challenges in complying with Article 8 requirements. Although ESG diligence is feasible in theory, these GPs typically cannot exercise sufficient negotiating leverage to ensure collection and monitoring of specific and robust ESG data from portfolio companies and hence are not in a position to report such data and ESG narratives to stakeholder audiences. For these FMPs, enumerating compliance with Article 6 may be more practical and achievable for their levels of control over investments.

FMPs that invest only a minority percentage of their fund activities in noncontrolled investments but maintain majority control on the rest of their portfolio must be prepared to explain how their majority investment activities meet SFDR requirements across diligence, monitoring, and reporting. They should also be prepared to explain the limitations posed by their noncontrolled investment circumstances and why they consider their fund(s) to still be SFDR compliant despite any shortcomings in ESG reporting from and monitoring of those investments. Demonstrating a commitment to continuous improvement on ESG and sustainability is an optimal strategy for doing so.

CONCLUSION

GPs planning on designating investment vehicles under Article 8 in 2023 and beyond must ensure that their ESG programs are aligned to the expectations set by Article 8. Data on ESG performance of investments must be collected during value creation planning phases and monitored regularly. Reports on ESG performance and progress over time must be driven by quantitative analysis and extremely specified for investments' operations and applicable ESG and sustainability areas.

Most importantly, under Article 8, "not disclosed" will not suffice as an acceptable answer. ESG programs for FMPs must be built to meet and ultimately exceed ESG disclosure expectations and new legal requirements.

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Please do not hesitate to contact us with any questions.

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