Private Equity International

Responsible Investment Forum: Europe
London 2024

Regulatory workshop: sustainability regulation for private markets


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CSRD

CS3D

ISSB

Parent liability risk

SDR

SFDR

TCFD

CSRD

CSRD - scope

NFRD

Public interest entities "PIEs" with >500 employees – listed on an EU regulated market

New requirement to report non-financial information

11000 companies in scope

Directive (EU) 2022/2464 - CSRD

EU COMPANIES

"Large" EU undertakings/groups

- €25m balance sheet
- €50m turnover
- 250 employees

EU Public interest entities

Listed entities (inc. SMEs)

NON-EU COMPANIES

Listed entities* (inc. SMEs)

Non-EU entities with €150m of EU turnover (plus in scope EU subsidiary or branch >€40mil)

c.50000 companies in scope

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CSRD – pain points

- Proportionate approach
- Number of data points
- Data collection
- Local law implementation
- Reporting strategy
- **What else?**

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CS3D: Corporate Sustainability Due Diligence Directive

Corporate Sustainability Due Diligence Directive

Requires organisations to ***identify, assess and act*** upon ***environmental and human rights*** impacts occurring as a result of their operations, those of their subsidiaries and in their ***chain of activities***, with a focus on obligations laid down in international laws

Corporate Sustainability Due Diligence Directive

- CSRD
- CS3D
- ISSB
- Parent liability risk
- SDR
- SFDR
- TCFD

EU companies/groups

>1,000 employees and net w/w turnover >€450 million*

Non-EU companies/groups

Net EU turnover >€450 million (no employee threshold)*

* Different thresholds for franchise/royalty arrangements

Environmental and human rights due diligence

Integration of active DD and action against any adverse impacts uncovered

Climate transition plan

Aligned with 1.5 degree Paris goal and EU's 2050 climate neutrality goal

Business Impacts

- Large EU entities and multinational corporate groups are likely to be caught
- Financial institutions, including alternative investment fund managers, are out of scope for downstream activities (for now), but holding companies may be in scope
- In-scope parent must act against impacts in its own and subsidiaries' operations
- Interplay between CS3D actions and CSRD disclosures is crucial
- **Out of scope entities in business relationships with large entities can also expect to be impacted**

Entry into force	25 July 2024
Member State implementing legislation to be adopted and published	26 July 2026
Application for largest entities (€1.5bn/5,000 employees)	26 July 2027
Application for very large entities (€900m/3,000 employees)	26 July 2028
Application for all other in scope entities	26 July 2029

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Liability risk in a private capital context

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Legal and compliance functions will have put in place a range of mitigants, which may include:

- pre-acquisition due diligence
- appropriate provisions in investment agreements
- careful and deliberate governance of the portfolio company
- training for investor-appointed / non-executive directors
- ensuring proper resourcing of the portfolio company, including hiring appropriate specialists
- careful scrutiny of public statements
- public liability insurance

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SDR: The UK Sustainability Disclosure Requirements Regime

Anti-Greenwashing: Rule and Guidance

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"A firm must ensure that any reference to the sustainability characteristics of a product or service is:

(a) consistent with the sustainability characteristics of the product or service; and

(b) fair, clear and not misleading."

Sustainability related claims **must** be:

- ***correct*** and capable of being **substantiated**
- ***clear*** and presented in a way that can be understood
- ***complete*** – they should not omit or hide important information and should consider the full life cycle of the product or service
- ***fair and meaningful*** in relation to any **comparisons** to other products or services

The Labels and FCA Good Practice Examples

Sustainable Focus

Sustainable Improvers

Sustainable Impact

Sustainability Mixed Goals™

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	Focus – 3 examples			Improver – 3 examples		
Sustainability objective ("SO") – to invest in …	Companies providing solutions to e.g. poverty, hunger, health and clean water	Companies creating positive impacts on workers, communities and the environment	Assets sustainable for the planet	Companies that reduce their carbon emissions		
Approach to investment – to invest in …	Assets deriving X% revenue from activities delivering against specific UN SDGs	Companies meeting or exceeding B-Corp standards	Assets scoring more than 300 on proprietary scoring model	Green financing bonds	Assets with a net zero commitment and decarbonisation of 7% year	Scope 1 and 2 / SBTi validated net zero target
Approach to monitoring performance against SO	Monitor revenue generated by activities aligned with the relevant UN SDGs	Annual review of companies against B-Corp standards Monitoring of GHGs, energy consumption, water usage etc	KPIs used in the model include %age of revenue from sustainable activities, GHGs and energy consumption	KPIs: scope 1-3 resulting from proceeds of the bonds issued	KPIs: short-term target of 7% year for scope 1 and 2 Medium term target: 50% reduction in scope 1 and 2 by 2030	KPIs: scope 1-3 reduction pathway towards 2050 net zero, with short, medium and long term targets
What the manager will publish	%age of gross value of portfolio meeting the SO for each theme			%age of gross value of portfolio meeting the SO %age gross value of portfolio on target		
	%age of portfolio revenue aligned with SO	Breakdown of B-Corp standards met and exceeded	Median score of assets in the portfolio			

The Disclosures: Summary

- CSRD
- CS3D
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Consumer-facing disclosures	Retail only
Pre-contractual disclosures	Detailed information on sustainability-related features of products made available before investors subscribe. Disclosures for non-labelled products are <u>only required for retail investors</u>
Periodic disclosures	Ongoing sustainability performance information, including on KPIs and metrics, 'on demand' (upon investor request) for private funds. Disclosures and 'on demand' information for non-labelled products are <u>only required for retail investors</u>
Sustainability entity report	Disclosure on how UK managers manage sustainability-related risks and opportunities (inc. details on governance, strategy, risk management and metrics/targets – i.e., in TCFD format)

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SFDR: where are we and what is happening next?

SFDR – Timeline for key developments

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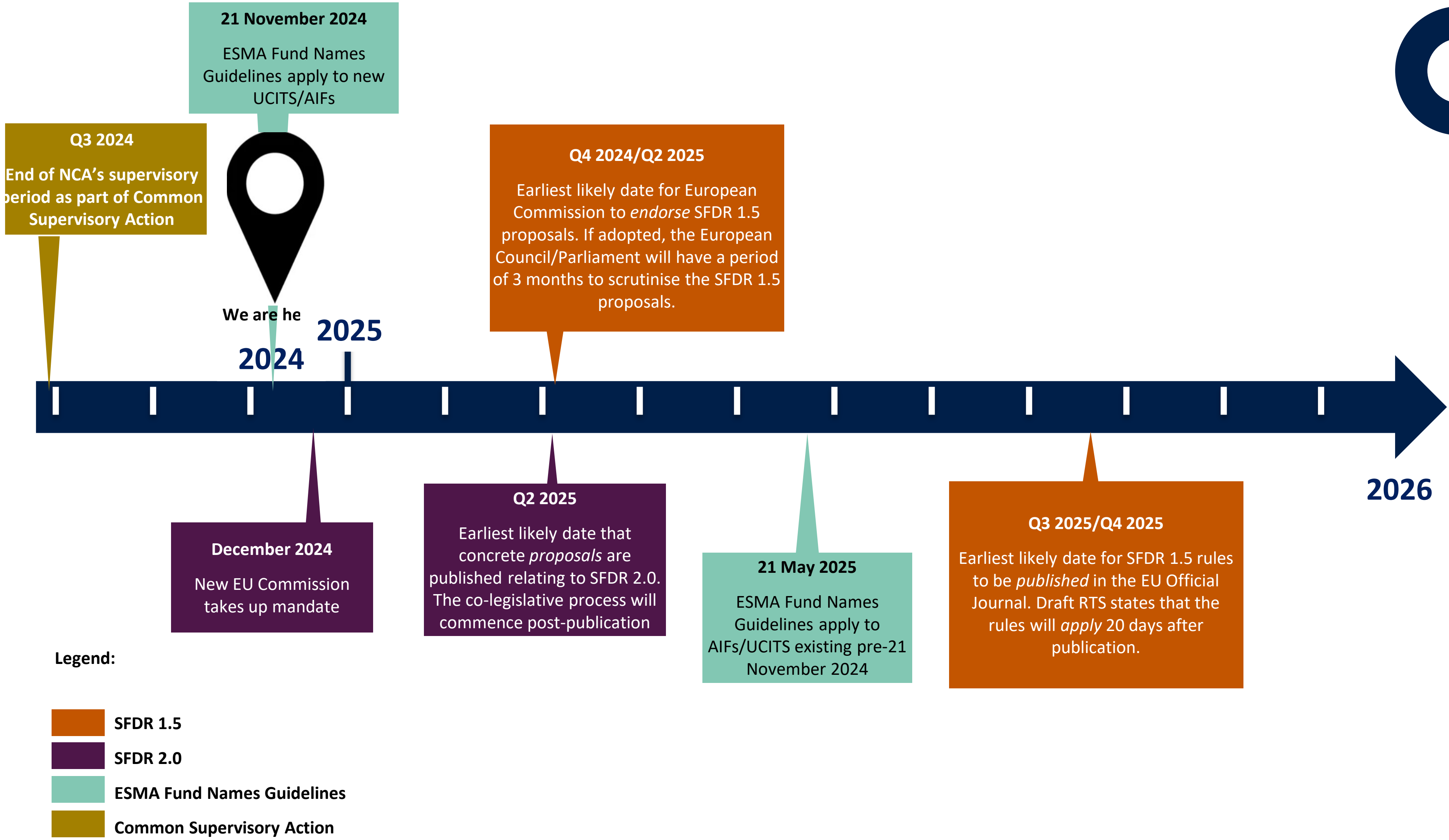

ESMA Fund Names Guidelines

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Summary

- The Guidelines break down ESG-related terms into three key categories:
  - Sustainability-related terms
  - Environmental- or impact-related terms
  - Transition-, social- and governance-related terms (new category)
- If a fund uses ESG-related terms in its name, a minimum proportion of at least **80%** of its investments should be used to meet the environmental or social characteristics / sustainable investment objectives
- Must also comply with negative exclusions under the Paris Aligned Benchmark or Climate Transition Benchmark
- Funds using sustainability-related terms must commit to invest meaningfully in "sustainable investments"
- Additional requirements for funds using transition-related terms to ensure investments used to meet the 80% threshold "*are on a clear and measurable path to social or environmental transition*" while funds using impact-related terms to ensure the same threshold of investments are made "*are made with the objective to generate a positive and measurable social or environmental impact alongside a financial return*"

Timings

- Guidelines will apply to all new funds from **21 November 2024**
- Existing funds must apply the guidelines from **21 May 2025**

SFDR Common Supervisory Action (CSA)

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In July 2023, ESMA launched a CSA with the NCAs.

- The goal is to assess the compliance with SFDR and the Taxonomy Regulation.
  - The main objectives of the CSA are:
  - to assess whether market participants adhere to applicable rules and standards in practice;
  - to gather further information on greenwashing risks in the investment management sector; and
  - to identify further relevant supervisory and regulatory intervention to address the issue.

- In 2023 and until Q3 2024, NCAs undertook supervisory activities and shared knowledge and experiences through ESMA on how they supervise sustainability-related disclosures and sustainability risk integration.

- No further commentary has been given to date on the CSA – but possible that it could trigger reporting or guidance in the form of Q&As adherence with the SFDR and Taxonomy Regulation and greenwashing risks.

SFDR 1.5 & SFDR 2.0

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SFDR 1.5 - key proposals include:

- Extension of social Principal Adverse Impacts (**PAI**) indicators
- Amendments to the PAI disclosure framework
- Modifications to current PAI indicators
- Introduction of additional disclosures for funds with greenhouse gas emission reduction targets.
- Simplified Article 8 and 9 pre-contractual and periodic disclosure templates
- Calculation of “sustainable investments” at either economic activity or investment level
- Enhanced disclosure of how sustainable investments comply with Do No Significant Harm principle

SFDR 2.0:

While it is unclear what the final changes will look like, some key anticipated changes are:

- Increased disclosure on sustainability factors considered in investment decisions
- Greater focus on the Taxonomy Regulation in SFDR classification
- Article 8 and 9 labels may be scrapped and replaced with new labels which carry minimum requirements in order to be used

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TCFD: FCA Reporting

- CSRD
- CS3D
- ISSB
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- SDR
- SFDR
- TCFD

- FCA continues to require reporting for firms with AuM/AuA above £5bn
- FCA has not announced a formal review … but we expect they will give feedback
- FCA has said that it expects reporting to improve year on year
- Things to consider for the 2025 report:
  - Re-check compliance against TCFD substantive requirements and FCA / Companies Act rules
  - Benchmark to developing regulator expectations
  - Benchmark to peers
  - Plug data gaps to ensure that there is a progression in quality year-on-year
  - Consider likely future requirements, especially ISSB climate standard, IFRS S2
  - Check consistency against other overlapping disclosures, including CSRD
  - Review for greenwashing risks, especially forward-looking statements
  - Board or director level sign off is still required ….

TCFD: Companies and LLPs

- CSRD
- CS3D
- ISSB
- Parent liability risk
- SDR
- SFDR
- TCFD

UK companies and LLPs with **over 500 employees** and:

- are listed to the **London Stock Exchange** or **AIM; or**
- are a **bank** or an **insurer; or**
- have **turnover of more than £500m**

US Update: Federal

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CS3D

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SDR

SFDR

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US Update: California

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SB 253: Climate Corporate Data Accountability Act

Coverage: US businesses with revenues over $1 billion that do business in California. Applies to both private and public companies.

GHG reporting requirements: report scopes 1, 2 and 3.

Assurance: obtain limited assurance over scopes 1 and 2 (in 2026), moving to reasonable assurance (in 2030), and obtain limited assurance over scope 3 (in 2027 for 2026 data).

Timing: reporting of scopes 1 and 2 in 2026 for 2025 data, of scope 3 in 2027 for 2026 data.

SB 261: Climate-related Financial Risk

Coverage: US businesses with revenues over $500 million that do business in California. Applies to both private and public companies.

Climate risk reporting: prepare report disclosing the entity’s climate-related financial risks and any measures adopted to reduce and adapt to climate-related financial risk.

Public availability: the report must be made available on the reporting company’s website.

Timing: 1 January 2026 and biannually thereafter.