ESG Regulations and Legislative Changes on the Horizon?

Investors are beginning to see ESG become a critical component of fund due diligence, with detailed – but diverse – assessments coming earlier in the process

Tiffany Lauterbach
Chief Compliance Officer

Capstone Partners

You'd be hard pressed these days to read any private equity report and not find at least one article focused on environmental, social and governance (ESG). This is not new. Many European LPs and GPs have had ESG on their radar for quite some time; however, it is only in recent years that this has become a global focus, with investors all over the world increasingly seeking disclosures related to ESG.

Investors in North America have just begun to make ESG a standard and critical component of their fund due diligence. Although there are no hard and fast regulations regarding marketing and reporting on ESG, that is expected to change, as indicated in commentary from the Securities and Exchange Commission (SEC), as well as changing policies within the LP community. For example, late last year we saw eight of the leading public pension investors in Canada issue a collective statement calling for enhanced ESG risk oversight and disclosures. Fund managers seeking capital from these eight funds must demonstrate ESG as an integral component of their investment decision processes.

We are increasingly receiving ESG-specific diligence requests from investors, often during the early stage of the process, and with varying degrees of complexity. Due to the lack of a global standard framework for measuring ESG, LPs are using a diverse set of criteria for establishing their ESG criteria, resulting in largely subtle nuances across various diligence questionnaires.

Investors Drive ESG in North America

From a regulatory perspective, Allison Herren Lee issued a call earlier this year, when acting SEC Chair, for public input on climate change disclosure requirements. Commissioner Lee made it clear that climate change, and the broader arena of ESG, are on the SEC's radar, with the goal of establishing clear and consistent ESG disclosures. The scope of these disclosures and method by which they will be measured is very much a work in progress, with differing views from within the agency. Thus, for the foreseeable future, it is likely going to continue to be the LPs setting the standards when it comes to ESG disclosure. But, GPs are well-advised to take note of the growing LP sensitivity to ESG, and to update their internal processes and investment strategies accordingly.

The fact that there are no hard and fast regulations in North America for GPs to follow related to ESG is only one of many challenges firms have as they develop, evaluate, and execute ESG policies. The most basic among those challenges is the actual definition of ESG. We all understand the acronym; but what does that really mean? The answer to that question depends upon whom you ask. For many years the primary focus was on the 'E', with issues such as climate change and carbon footprint data leading the charge relative to ESG disclosures. In

more recent history, there has been a growing focus on the 'S', which includes issues such as diversity, equity, and inclusion. You may have heard terms such as sustainability, impact investing or socially responsible investing, which are all synonymous with ESG, which is seeking positive environmental and social benefits through investing. Ultimately, firms need to say what they do, and then do what they say, in all areas of their investment strategy. Therefore, disclosures made during a diligence process related to ESG should be an accurate representation of the firm's actual processes, with documentation to back-up those processes.

EU Forces the ESG Agenda

The tone is a little greener in Europe (pun intended) thanks to the EU's decisive action plan to re-orient capital flow towards sustainable finance. Over the next decade, sustainable development will be a top priority for the EU. The 2030 target date for achieving the environmental goals laid out in the Paris Agreement and the UN's Sustainable Development Goals will directly impact asset managers and financial market advisors as a series of legislative measures on sustainable finance are rolled out.

The first phase of the EU's Sustainable Finance Action Plan resulted in the implementation of the Sustainable Finance Disclosure Regime on March 10, 2021. This milestone regulation asks GPs to decide whether their products have sustainable investments as an objective. If so, they should adapt their website disclosures and their marketing materials. For those GPs with no ESG focus or strategy, this needs to be disclosed, justified, and accompanied by a statement on when one will be adopted.

If that wasn't enough to put market players into a frenzy, the Taxonomy Regulations – a framework that aims to classify environmentally sustainable economic activities – goes into effect on January 1, 2022. In-scope GPs are asked to disclose to what extent they've used taxonomy in determining the sustainability of underlying investments and to what environmental objective the investments contribute.

ESG Will No Longer Be Optional

The legislative and disclosure implementations have already changed how we talk about ESG in the industry and ESG factors are becoming critical to investment decisions globally. The best way for businesses to prepare for the upcoming legislation changes is to put ESG risk at the forefront of their decision making and long-term planning.

Most private equity firms have already instituted ESG-specific policies and procedures in response to both regulatory requirements and investor demands. However, for those who have yet to do so, the proverbial clock is ticking on the period of self-disclosure and unregulated reporting. It is no longer a matter of if ESG will become a standard component in global regulatory reporting and oversight, but when, and to what degree.

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Tiffany Lauterbach is responsible for the regulatory compliance of Capstone Partners' global platform.

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