KEYNOTE INTERVIEW

How SFDR is impacting LPs

Investors are in the driving seat when it comes to GPs' compliance with the Sustainable Finance Disclosure Regulation, say Debevoise & Plimpton's Jin-Hyuk Jang and Patricia Volhard

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Q To what extent are LPs drawn to ESG investment strategies, and what is behind that?

Jin-Hyuk Jang: Everyone is talking about sustainability and carbon reduction, from governments through to corporations, so ESG strategies are a good opportunity for LPs to demonstrate to the market and to their stakeholders how serious they are about the issue. Plus, just like GPs, they have their own investors who are increasingly asking them to make sustainable investments, which means ESG is moving up their agenda on that front as well.

Patricia Volhard: There are also many ways in which institutional LPs are drawn into this from their own regulatory or policy perspective. Institutional investors such as funds of funds and pension funds are often subject to their own sustainability requirements (for example, if they are themselves subject to the Sustainable Finance Disclosure Regulation requirements).

Larger companies, including insurance companies, will be subject to the EU's forthcoming Corporate Sustainable Reporting Directive. That means they will have substantial additional reporting requirements and they will be keen to ensure the funds that they are investing in are also subject to similar reporting standards and can deliver the information they need.

We are seeing a number of funds of funds that have, because of stakeholder pressure, decided to qualify as Article 8 funds under SFDR and commit to making sustainable investments themselves, which means they need to look carefully at the funds they invest in.

Q What should LPs be looking out for from their GPs when it comes to ESG reporting?

JHJ: This is all about data, with the major issue being a lack of consistent ESG data across the investment universe. It is particularly difficult for GPs to collect data from small or medium-sized portfolio companies that are not currently subject to any ESG reporting requirements, for example. LPs need to really look into the fund and assess whether the GP is capable of providing the relevant data.

PV: LPs sometimes take an approach where they just look at the fund's classification under SFDR, but SFDR does not provide for labels but rather transparency, and LPs should therefore take a more tailored view of the fund itself.

Right now, GPs are not necessarily getting all the data required from portfolio companies. Those that are investing outside the EU or in emerging markets, for example, will be less likely to be in a position to report all the requested data than those backing European companies within the scope of the Corporate Sustainable Reporting Directive.

LPs need to take a proportionate approach. While the financial return remains the most important element, few LPs want to restrict the GP to an inappropriate extent. They should continue to afford them the flexibility to get the data where they can, but also recognise that some data will not be immediately available in certain situations. Often the data is not available at the point of making an investment, but that is something GPs will work on with the portfolio company management team going forward.

Q How has SFDR changed things for LPs?

JHJ: From a technical perspective, SFDR is now there as a legal framework setting out what investors can and cannot expect. Previously, ESG was something every manager addressed in their own way, but now we have definitions set out in law to create a harmonised legal environment.

PV: While that is clearly the idea behind the regulation, I'm not sure we are there yet. We have now had SFDR for over a year and many things are still in the making, with the scope of several key terms – such as the term 'sustainable investments' – still being discussed and the industry awaiting further guidance from the European Commission. The idea was to give LPs access to full information so they can compare products, and although I believe we will get there, at this point, we still have too much uncertainty and do not yet have a consistent approach.

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>
> **PATRICIA VOLHARD**

As GPs increasingly use templates and answer more specific questions, that will continue to improve transparency for investors. SFDR will help LPs comply with their own reporting requirements too. It is definitely a step in the right direction but there is still a long way to go.

Q What role do LPs play in SFDR compliance?

JHJ: Where GPs commit to certain ESG topics, and especially for Article 8 or Article 9 funds, they need to report on an annual basis to LPs, and that provides a certain framework for compliance. SFDR is really about transparency, and by forcing GPs to report in a particular manner about certain things, it pushes them to think hard about what they promise, which has an indirect effect on investment behaviour.

PV: Even though SFDR prescribes that national laws should ensure that the regulatory authorities monitor compliance with SFDR, in practice, it is often the LPs rather than any regulatory authority that gets to see this information, and it is mainly a disclosure issue if they are given the wrong or misleading information. In that way, it is also the LPs that drive compliance, since LPs can potentially sue if they feel a fund has not been invested or reported in line with what was promised.

Q Do you see any shift in expectations from forward-thinking LPs going into 2023? What are their emerging ESG priorities?

PV: Investors in Europe are thinking about ESG a lot and looking for impact products – that is a clear trend. Environmental protection and climate change appear to be the themes they are prioritising.

JHJ: We are also seeing a shift away from Article 6 funds. At the beginning of the SFDR journey, everybody was focused on the minimum requirements and sticking to Article 6, but there is a move now towards Article 8 as the gold standard. We expect more sustainable products to be issued and better quality ESG data to become available alongside those products.

PV: Article 9 funds are also becoming more common. Being an Article 9 fund can provide a competitive advantage, but it very much depends on the investment strategy. The most important thing is that the ESG approach (and the classification chosen) is credible. While investors may be looking more for Article 9 classification in infrastructure or real estate, LPs would not necessarily expect funds to be Article 9 in classic private equity or debt funds.

The next level is to commit to make taxonomy-aligned investments, and that is a very high bar that only a small number of investments can achieve. Investors understand that. There are still not that many Article 9 private funds committing to taxonomy alignment out there and we don't see that changing quickly. ■

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