# Private Funds CFO

# ESG

December 2023/January 2024 • privatefundscfo.com

## Charting a path

### How CFOs are navigating ESG challenges

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**Private Funds CFO**
Published 6 times a year by
PEI Group. To find out more about PEI Group visit **pei.group**

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ISSN 2632-6418 • ISSUE 34 • DECEMBER 2023/JANUARY 2024

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# Why CFOs need strength in numbers


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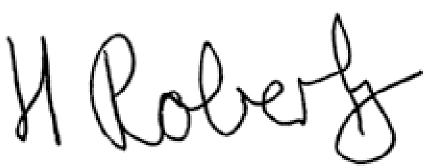
What seemed like an entirely rational move toward private markets firms adopting better environmental, social and governance practices seems to have hit a roadblock – at least in the US, where some states have launched a backlash against ESG-motivated investment.

But while such developments are being watched closely across the industry, many CFOs' approach toward ESG has moved beyond that of implementation and toward effective data management.

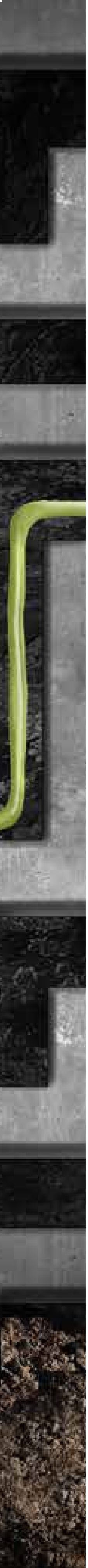
Indeed, having the statistics to back up ESG credentials is becoming an increasingly important tool in the modern CFO's kit – regardless of what individuals may think of the current political situation. According to *Private Funds CFO*'s *Private Fund Leaders Survey 2023*, 69 percent of fund leaders say that increasing demand from investors is driving adoption of greater ESG monitoring and reporting in their firms – and when LPs speak, GPs listen.

> **"Without having effective ESG data to hand, CFOs are left exposed to a number of risks"**

Without having effective ESG data to hand, CFOs are left exposed to a number of risks. Maintaining a proactive approach to regulatory developments on responsible investing, ensuring that value creation plans are based on usable, up-to-date information and meeting internal social responsibility goals: all of this falls into the lap of the modern CFO. By boosting their ranks with both internal and external expertise, and in spite of the relative fluidity of the current situation, it seems CFOs are taking a longer-term – some might say sustainable – approach to ESG.



**Hannah Roberts**



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# How CFOs are using data to navigate ESG challenges

*Private markets have accepted that ESG isn't a fad, but as backlash against such initiatives persists, effective data management may provide a solution. Rob Kotecki reports*

Despite its assumed entrenchment within the private markets, environmental, social and corporate governance issues are frequent figures in newspaper headlines – and not for wholly positive reasons. In the US, progressives dismiss ESG-focused investment programs as 'greenwashing,' arguing that they only provide PR cover for the same old bad behavior, while conservatives believe them to be part of the liberal 'woke' agenda that will sink the economy by eschewing profits in favor of expensive, feel-good initiatives.

In contrast, Europe is doubling down on its commitment to ESG priorities, with several efforts underway to ensure those three letters live up to their best intentions.

But private fund CFOs don't have the luxury of pundits or activists to simply rail against the trend even if they wanted to, instead needing to find ways to make ESG work for the firm and its stakeholders. Larger, established firms can afford to bring ESG expertise in-house, but for those that can't, ESG lands in the CFO's lap.

As such, CFOs have largely accepted that ESG needs to be more than language that gathers dust in the back of a PPM. And investors have become increasingly vocal about ESG risks, requesting massive amounts of data around ESG metrics. CFOs have responded by doing their best to tailor their programs to the unique needs of their investment strategy.

However, the common thread among CFOs is that, for now, the ESG challenge is predominantly one of data management. Tracking ESG requires a second portfolio of data that needs to be collected, vetted and reported, with the caveat that there's no standardized methodology, which raises concerns about how best to measure behaviors that affect multiple departments in the same portfolio company.

The best answer that many have right now is to focus on tapping expertise, either by hiring more staff or bringing in external consultants, getting leadership to buy into the process and remembering that any incumbent ESG program will continue to evolve for years to come.

### Walking the walk

Right now, CFOs are taking ESG issues seriously. "We always paid attention to these issues, but we've crossed that Rubicon and recognized that ESG is here to stay," says April Evans, CFO at Pace Healthcare Capital. "An increasing number of LPs are very interested in using their investment dollars to speak specifically to ESG issues."

This doesn't mean that investors are all turning into environmental activists. "LPs want to understand their exposure [to ESG risks] along a certain series of metrics," says Melissa Dickerson, CFO at Genstar Capital. The consensus is that while there are investors looking to drive toward audacious goals like net-zero emissions in the next few decades, some just want GPs to take a proactive approach to mitigating risks.

In a 2022 survey by Intertrust Group, 96 percent of CFOs said that ESG is important to their LPs. In the

same report, CFOs said that 77 percent of LPs want live or daily updates on portfolio performance, and 56 percent expected the same on ESG matters.

Meanwhile, 69 percent of respondents to *Private Funds CFO*'s *Private Funds Leaders Survey 2023* reported that increasing demand from LPs is driving adoption of greater ESG monitoring and reporting in their firms.

## The data dilemma

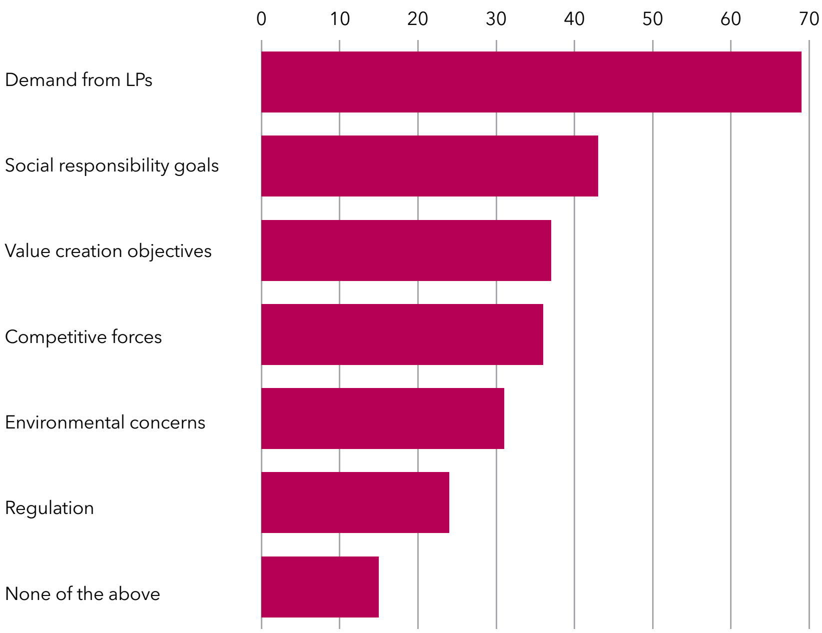
Many CFOs agree that amid the wider ESG push, one key part of any such initiatives will always end up on their desk: data management. "ESG professionals don't tend to be data gatherers," says Dwight Cupit, CFO of Bregal Investments. "But that's what the finance function does. We have the systems and the processes to collect data, so we'll do that, and pass it along to our ESG staff for interpretation."

But gathering effective data on this topic is not a simple task. Cupit recently invested in a separate tech system to gather and export ESG data from portfolio companies. "We had a portfolio monitoring system that might have been able to do some of the work, but after collaborating with our ESG team in a long process, we decided it was worth investing in a separate solution."

The dilemma isn't merely managing massive data sets, but also the lack of a common methodology, and sometimes even a sense of the best metrics to use. "CO2 is easy to track because it's something that can measured, but what about data that's spread across multiple functions?" asks Dickerson. "Some of them require gathering data from HR, operations and finance, and unlike accounting practices that have developed over years and years, this is all new."

Thomas Braun, CFO of Germany-based investment firm Golding Capital Partners, says having a common methodology is crucial to success, "because if every single player is developing their own ESG toolkit, it won't work… Investors might be grateful for the data, but then face the burden of reconciling all those separate [Microsoft] Excel spreadsheets into their own report. We're only going to get ahead of the curve around sustainability if we have a European, or even better, a global toolkit for managing this data." In lieu of that, how are CFOs tackling all the work?

Which factors are driving adoption of greater ESG monitoring and reporting in your firm? (Multiple answers allowed; %)




Source: Private Funds CFO Private Fund Leaders Survey 2023

Addressing such demands often involves hiring in-house ESG experts, but not everyone has the capacity to do so. "To a shop, everyone I know has an ESG policy in place," says Pace Healthcare Capital's Evans. "The larger shops have ESG officers, but for smaller firms, it falls to the CFO to not just craft the policy, but then also manage its implementation, to ensure we're doing what our policies say we're doing."

Half of the respondents to the *Private Funds Leaders Survey* have an internal ESG team, but 40 percent

outsource some part of their program. Those with the means to hire internal staff are big proponents of it, but CFOs agree that specific expertise is a necessity, no matter how it's contracted.

"We outsource, because we want to partner with folks with real domain expertise, in the way we would tap SEC-trained attorneys to tackle regulatory matters," says Genstar's Dickerson.

The lack of common methodology only ups the need for expertise. "There are multiple different paradigms out there from the [Organisation for Economic Co-operation and Development] to the EU's [Sustainable Finance Disclosure Regulation], and our ESG consultant is invaluable in sorting through them all," adds Dickerson. But for CFOs with the resources, they're fans of their internal ESG staff.

"We've been lucky to have built a large, dedicated, ESG team, which makes it so much easier for me," says Cupit. Even for CFOs that get lucky, there's still plenty to do.

"We work very closely with our director of ESG and director of impact, but processing ESG data and preparing the reports is part of the CFO unit," says Braun.

And hiring ESG staff comes with the added bonus of demonstrating the firm's commitment to the process, which helps win over skeptics.

**96%**
**Proportion of CFOs who say that ESG is important to their LPs**

Source: Intertrust Group, 'The future private capital CFO: Unleashing potential in the ESG era' 2022

**56%**
**Proportion of LPs who expect live or daily updates on ESG matters**

Source: Intertrust Group, 'The future private capital CFO: Unleashing potential in the ESG era' 2022

**69%**
**Proportion of fund leaders who say increasing demand from LPs is driving adoption of greater ESG monitoring and reporting in their firms**

Source: Private Funds CFO Private Funds Leaders Survey 2023

"For private equity firms, ESG has to start with the leadership," says Cupit. "When we hired an ESG team, that showed our commitment to this process."

Private equity firms are not immune to the lingering skepticism around ESG. "So many of my peers have, like me, been pleasantly surprised by our leadership's willingness to get on board with ESG priorities once we lay out the benefits logically," says Evans. "But there are those that still resist this idea of looking beyond whether an investment will simply make money, without realizing that considering other factors can improve returns as well."

"I think the biggest single change we've made to our ESG program is that it's been elevated on our investment committee, so every investment memo now has an ESG section," says Cupit. "Now if someone doesn't address ESG issues in the investment memo, it's not getting to the investment committee, so the deal team learns quickly to get that included."

## An evolving discipline

However, CFOs are aware that no ESG integration may ever be 'complete.' "ESG programs are living, breathing things," says Evans. "We may learn down the road that one component or metric, that made sense five years ago, doesn't make sense anymore. So, we revise it and might tighten some processes or find a way to be more granular around a particular issue."

Braun adds: "The solution to the status quo is to focus on collecting and evaluating data, with the idea that there will be constant reassessment in the coming years.

"Do we see a positive development? Is this transition pathway credible? So, each year builds on the last one to get more effective."

In doing so, a firm's ESG program becomes, in itself, sustainable – and clearly no one expects sustainability issues to move out of the spotlight anytime soon. ■

KEYNOTE INTERVIEW

# Moving ESG into the fast lane

*Managers need better data management and analytics to capitalize on ESG opportunities, says Andrew Pemberton of BasisPoint+*

There is little doubt that a credible environmental, social and corporate governance strategy is fast becoming a 'must-have' for fund managers. Andrew Pemberton, chief executive officer of ESG and impact investing software and services provider BasisPoint+, says firms need effective systems for responding to increasing ESG data demands from LPs and regulators. Looking beyond the back office, Pemberton believes that attention to material ESG considerations can help managers push beyond compliance and risk management to drive new value across their investments and broaden their investor base.

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**Q What does the growth of the ESG and impact investing market mean for managers and their data needs?**
All signs point to ESG and impact investing being a force that is here to stay. A 2022 study from Bain & Company and the Institutional Limited Partners Association found that 70 percent of LPs consider ESG in their asset allocation decisions, and the US Securities and Exchange Commission updated its guidance in September to include ESG investing in its Names Rule. But expectations for how exactly managers should integrate ESG and what they must disclose will continue to evolve.

As a result, more effective ESG data management will be critical within the private funds industry to meet these requirements and to see their benefits. Managers will need a data strategy to help them be proactive in responding to LPs today, while maintaining the flexibility to adapt to a changing regulatory environment. The key for GPs will be to manage both of those dynamics in a way that is relevant to their strategy and effective in creating value within their firm and portfolio.

That means integrating deeper with risk-return analysis to drill down on which ESG levers can help optimize business performance. It also means more thoughtful engagement as part of post-investment value creation plans.

This way, managers can prioritize efforts that are most valuable to them and get ahead of the reporting burden to add to their bottom line.

**Q How big a challenge do managers face in making sense of and staying current with regulatory standards and LP requirements?**

It is a bigger challenge for some managers than for others. For managers that have already spent years integrating ESG or impact into their strategy, simply making systems updates can improve efficiency and extract more useful insights. For most managers, though, it is a big lift to get a well-informed approach off the ground and it requires ongoing attention toward understanding the space once they are up and running.

There are three main factors that, as I see it, hold managers back from building an effective strategy for ESG integration. The first is at a strategic level. It takes time and effort to understand the landscape of ESG standards and their application to a given firm. Just knowing where to get started can be a big challenge in itself, especially when it is so critical to distill ESG theory down to practical, context-specific frameworks and processes.

The second factor is operational. Most managers lack clarity on where in the organization ESG expertise should sit and what resources will be needed to run a decision-useful process. It is important to understand the desired end goal and then find the right balance between empowering internal teams and engaging external partners.

The third blocker is related to return. ESG integration is itself an investment and managers are eager to see how these efforts translate to profit and cost optimization. Once a right-sized ESG strategy is determined, returns follow by applying it in due diligence and portfolio engagement – with a strong data management system – to drive business insights.

*"ESG integration is itself an investment and managers are eager to see how these efforts translate to profit and cost optimization"*

**Q What steps can managers take to start putting an ESG strategy in place?**

At BasisPoint+, we typically recommend a four-point plan to get started: designate a point person, determine scope of relevant ESG considerations, define the analytical methodology and delegate responsibilities.

Managers need to start with an internal champion to set the agenda and work toward internal alignment, since ESG implementation spans teams and functions. That person can help carry out an initial analysis to determine which ESG factors are most relevant to the sectors in which the GP invests. After that it comes down to refining the methodology and determining where execution responsibility lies across teams. By starting from a clear set of objectives and agreeing on a common language, managers can be sure to comply with relevant standards and avoid any accusations of greenwashing.

**Q What kind of external support do managers typically need?**

It depends on the gaps that exist within their firm. There are expert service providers that offer strategic planning guidance; deal team, compliance or investor relations support; or dataset access and collation for more complex analyses.

With regard to technology, there is growing recognition that process automation and business intelligence tools are imperative to make sure relevant data – ESG, financial and contextual – is accurate and useful in practice.

That's our focus at BasisPoint+. Our offering is purpose-built to meet leading standards for both investment process and reporting best practices. The templates, workflows and dashboards are easy to navigate and customize. Managers can use our platform entirely on their own, or they can rely on our industry experts to guide them through strategy set-up, due diligence, value creation and report generation.

We go a step further, too, with capital advisory services that can help managers use their ESG or impact strategy to engage new LPs and identify aligned investment opportunities across our ecosystem.

**Q It takes sustained effort to build solid ESG credentials – will the returns be worth it?**

The short answer is yes; there is a strong body of research validating ESG as a useful investment lens to accelerate revenue growth, increase profit margins and improve fund returns.

By design, ESG integration accrues benefits over the medium- and long-term. In the near-term, managers should look at time saved in research, compliance and reporting functions as a key indicator. They should also consider the benefits of positioning their strategy to maximize their appeal to target LPs and investment prospects: a credible ESG approach can help open doors and demonstrate management alignment in a new way.

It is important to remember that an ESG strategy is not designed or executed in a day. At this stage the goal is progress, not perfection. Managers should feel at ease knowing that there is significant value in getting started and having a baseline from which to learn and iterate – and that our team at BasisPoint+ is here to help along the way. ■

# Investors share their ESG and impact green flags for GPs

*Data convergence participation, sustainability skills and portfolio-level value creation plans were top of mind for asset owners and investment consultants at PEI's Responsible Investment Forum in San Francisco in September. By Snehal Shah*

## Portfolio details

**"We are increasingly seeing our LPs wanting more transparency and insight into what's going on in the portfolio in terms of ESG," said one investment consultant.**

"I get calls all the time [from LP clients] asking, 'Can I have a comprehensive ESG report on my mature private equity portfolio?'" said another consultant. "That's about 80 funds, a few thousand portfolio companies."

"One of the real value-adds is when you have a dedicated function that can go in and be an operating tool for a portfolio company," said another LP.

They added that a GP's ESG professional should be "working with the CEO or CFO to make sure the messaging is coming down from the top that these ESG KPIs are important for our company… [and] doing the day-by-day work of working with the operations, HR [and] the portco's sustainability team."

Another LP, investing from a dedicated climate investment bucket, said: "Every investment has a hundred-day plan rolling out financially material sustainability factors.

"It's several points in the deck. It's something that we hold [our GPs] accountable to; it's something that they hold their [portfolio company] management teams accountable to."

Investors want to see detailed information on environmental, social and corporate governance issues from their fund managers – including industry standard KPI data, value creation plans and direct involvement with portfolio companies.

Investors present at PEI Group's Responsible Investment Forum in San Francisco, held in September, shared the sustainability qualities they find most attractive in fund managers. The conference was held under the Chatham House Rule, meaning that comments could not be attributed to speakers.

## Firm commitment to ESG

**Dedicated ESG professionals are a positive sign for LPs.**

"It's really exciting and really encouraging to see that [firms] are starting to take action and put real dollars to work to build a bench of [ESG] talent," said one LP. "There are a lot of [investment professionals] that are getting retooled and reskilled today to have that skill set, and there's a lot of outsourced talent."

There should also be buy-in across the firm – beyond the ESG department – on sustainability issues, several LPs noted. One investment consultant said it asks GPs "how [their] investment teams, board members [and] operating partners are starting to think about sustainability considerations as a driver of value."

## EDCI participation

**Many asset owners and investment consultants expressed support for the ESG Data Convergence Initiative.**

"It resolves some of the complexities" of different ESG data requests from investors and comparing ESG data across portfolios, said one consultant.

"One of the ways we're looking at using the ESG data is to supplement our estimated greenhouse gas emissions data for our LPs with the information that we'll have access to through our GPs that are signed up to EDCI… that's really important to some of our LPs," said the consultant.

Standardization initiatives such as the EDCI have been criticized for neglecting materiality – the ESG factors uniquely relevant to different assets.

As well as providing data for the EDCI's six focus areas, "GPs need to continue to understand and look at their portfolio companies to think about which ESG factors are financially material to their portfolio companies, and not just what the industry standards have become," said another consultant.

# Regulatory shifting sands

*A consultation on SFDR has raised questions about what the regulatory framework for impact and ESG strategies will look like in Europe, writes Claire Coe Smith*

In September, the European Commission injected some uncertainty into the future regulatory environment for environmental, social and corporate governance issues and impact investing when it issued a public consultation on the EU Sustainable Finance Disclosure Regulation (SFDR). By revisiting the use of the Article 8 and Article 9 categories that impact funds currently fall into, the review could potentially lead to significant changes for the industry.

One problem with SFDR is around its use as a labeling regime, says Patricia Volhard, a partner at Debevoise & Plimpton: "While SFDR is meant to be purely a disclosure regime, for Article 9 funds it really isn't because all of your investments need to meet certain standards to qualify for that classification. Investments need to make a substantial contribution to environmental or social objectives and at the same time should not do significant harm to any other ESG factors. But that raises questions about how you define a substantial contribution and also how you determine what is significant harm, so it doesn't really work as a label as it stands."

The commission's intention was not for SFDR to serve as "a label of quality or quantity," adds Volhard. "The idea was to force people to be transparent in terms of what they are doing and to use consistent terminology. They are now trying to find out what the market thinks: should the distinction between Article 8 and 9 funds remain, should we introduce a product labeling regime instead, or should we keep to a disclosure regime and introduce in addition a product labeling regime? We have no idea where the commission will come out, but it looks probable that some kind of labeling regime is coming."

Volhard says the commission could say, for example, that in order to be classified as an impact fund you must invest within certain parameters, meet certain quality standards and align a certain percentage of your investments to the taxonomy. "My hope is that if they go down the labeling route, which is likely, they don't replace what we currently have but introduce something optional for those that want to go down that route."

## Compliance burden

Impact investors have already dedicated a lot of time and resource to SFDR compliance since the regulation came into effect in 2021. Michael Raymond, a partner at Travers Smith, says: "Ideally what we would want to see in the event of any SFDR reforms is a recognition that we've had lots of uncertainty. If we do end up with changes to Article 8, 8-plus and 9 classifications and key definitions, we need grandfathering so we are not disrupting existing funds with any new rules applying on a go-forward basis within the existing framework.

"It is perfectly possible we will end up with a labeling regime. That starts to look a lot like what the Financial Conduct Authority is proposing for UK retail funds, which is a disclosure regime for all products and then product labels that can be used on an optional basis."

The UK's FCA has made proposals for retail funds that set out three specific types of sustainable product, distinguishing between those with a sustainable focus, sustainable improvers or sustainable impact. If introduced, there is a good chance institutional investors will ask other sponsors to comply with the same terminology.

## Regional divergence

Meanwhile, the US Securities and Exchange Commission is taking its own approach. Alexandra Farmer, a partner with Kirkland & Ellis in Washington, DC, says: "Right now the proposed ESG disclosure rules from the SEC are focused on process and disclosures, which is really the same as SFDR. The EU Taxonomy, however, is more about classification of activities, and we don't have anything like that in the US or see anything that is outcomes-focused coming any time soon."

The SEC's focus is very much around transparency on risk and in relation to the investment process, explains Farmer. "GPs are also dealing with some tensions from an anti-ESG perspective, and where the two meet in the middle is in a desire for transparency and an anti-greenwashing focus. That will remain the priority, and the regulatory focus will shift from there depending somewhat on the growth of the impact investing market as regulators seek to address issues that are material to investors."

Farmer points out that the SFDR has so far led the way on the global regulation of impact, so any potential changes will have a widespread effect. "Most of our US GPs are seeking capital from EU LPs, so they are subject to the SFDR regime directly or, if not, then indirectly through requests from their LPs. Over the last few years, it has been very influential in terms of how ESG and impact programs and strategies have developed, driven by investor expectations around SFDR and what GPs can reasonably commit to.

"This most recent consultation is creating further uncertainty at a time when managers who have spent resources building their programs around existing guidance may prefer to be going into compliance mode."

Goodwin partner Patrick Deasy also notes a divergence in regulatory approaches between the US and Europe: "The US approach to date has been to say that sustainability and impact are like any other investment strategy that sponsors are looking to promote to investors, so the important thing is that managers are fair, clear and not misleading. The EU, on the other hand, sees the regulatory regime as a means of coalescing capital into the climate impact space by providing a gold standard regulatory regime that investors can take a lot of comfort in and that also seeks to stamp out greenwashing."

*"A lot of managers have invested in systems, marketing materials and reporting processes that feed into the existing regime"*

**PATRICK DEASY**
**Goodwin**

When it comes to impact investing, the direction of travel is toward more rather than less regulation, particularly in Europe, says Deasy.

However, he adds: "My guess would be that the EU and the industry will try to work with what we have got under the SFDR, rather than completely overhauling it, because a lot of managers have invested in systems, marketing materials and reporting processes that feed into the existing regime."

For now, funds need to focus on providing clarity to investors, says Travers Smith's Raymond: "What is really important at this stage is being clear with your investors about your ESG and impact proposition, so it is not about your proposition chasing evolving regulation and labeling globally and instead the regulation overlays the manager's specific impact program."

Managers may also want to consider how they work with portfolio companies on these issues, says Debevoise's Volhard. "In order to be an Article 9 impact fund you already have to pass these tests that are quite comprehensive, so you are in good shape. Maybe the next step is to think about getting taxonomy aligned: many clients want to be taxonomy aligned but the companies they are investing in are not there yet on the data. My advice would be to start with Article 9 and work with companies towards getting a certain percentage of the portfolio taxonomy aligned." ■

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