## Guest Snapshot:

# Private Fund Adviser Rules and ESG

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**ESG and impact investing advisory with the goals of value enhancement and risk management.**

Blue Dot Capital is a sustainable finance consultancy. We partner with financial services firms to support the end-to-end development and execution of ESG and impact investing programs, capabilities, and products. Our clients and partners include traditional and alternative investment managers, family offices, and data providers.

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# Blue Dot's Guest Snapshot Series

In our Guest Snapshot series, the Blue Dot Capital team, in collaboration with guest experts, will unpack topics such as regulations, geopolitics, and energy policy, and their ramifications for how investment managers design and execute their sustainable investment strategies and programs.

# Snapshot: SEC's Private Fund Adviser Rules and ESG

For this Snapshot, we are joined by Catherine Skulan, Partner and Colleen Meyer, Counsel at Ropes & Gray to discuss the potential impact of the Securities and Exchange Commission's ("SEC") new private fund adviser rules adopted in August 2023 on private investment managers' environmental, social, and governance ("ESG") programs and practices.

# Background

The SEC adopted its much-anticipated private fund reforms on August 23, 2023. These reforms impose new rules on private fund managers (including both registered investment advisers and, in some cases, exempt reporting advisers), including quarterly reporting requirements with respect to performance and fees and expenses, increased transparency regarding side letters and other "preferential treatment" for fund investors, prohibitions on certain liquidity rights and information sharing with fund investors, limitations on the ability of fund managers to allocate fees and expenses on a non-pro rata basis, and restrictions on the ability of fund managers to charge or allocate to a private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination or investigation of the adviser or its related persons. This Snapshot analyzes key considerations for private fund managers grappling with how these private fund reforms implicate ESG matters for advisers and the funds they manage.

# Q&A

### Q: Does the quarterly statement rule capture ESG-related fees and expenses paid by a fund, and what are the implications of this increased transparency, if so?

A: Under the quarterly statement rule, registered investment advisers are required to provide the following information to fund investors each quarter, in most cases within 45 days of quarter-end (or within 90 days of fiscal year-end), with respect to the funds they manage: (i) a detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons by the fund or by portfolio investments of the fund during the reporting period; (ii) a detailed accounting of all fees and expenses allocated to or paid by the fund during the reporting period other than those listed in (i), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and

(iii) the amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons. Managers generally cannot group smaller expenses into broad categories when reporting expenses on the quarterly statement, but it is currently unclear what level of specificity is required for the categories.

Managers will have to exercise their judgment to determine the appropriate level of specificity of the categories and whether an ESG expense, depending on the type of expense, should be reported within another category or be a category of its own. To the extent permitted by a fund's organizational documents, an adviser would treat ESG expenses allocated or paid by the fund as a fund expense and either (i) list ESG expenses as its own separate line item in its quarterly statements or (ii) include ESG expenses within another category such as deal and/or diligence expenses and not separately list out ESG expenses. One note to this discussion is that, to the extent an ESG expense is a deal diligence expense, which a significant portion of ESG expenses incurred by many funds tend to be, such expenses will typically be capitalized into consummated deals and not necessarily reported separately on the fund's quarterly statements. Therefore, it is possible that many managers will only report ESG expenses for broken or in-process deals, and as discussed further below, may determine to include those expenses within these broader categories rather than as a specific ESG line item.

Managers should expect focused questions on ESG expense reporting from investors who seek to understand the nature of the expenses – whether they are the result of laws or regulations applicable to the fund or are more affirmative expenses incurred by the fund in connection with its investment activities. For example, those investors who focus on the pecuniary effect of ESG on investments may ask managers to identify which expenses were "discretionary" as opposed to imposed by law or regulation and expect managers to show how such expenses play out in investment returns. Therefore, investor scrutiny may influence managers' approaches to reporting ESG expenses. Depending on the investor base, some managers may determine to highlight such expenses by providing line-item breakouts, while others may include such expenses in another category (e.g., diligence or deal expenses), if they can reasonably do so.

## Q: Will the 45-day timeline for disclosure of regulatory, compliance, and examination fees and expenses under the "restricted activities rule" apply to disclosure of ESG expenses as well?

A: The restricted activities rule restricts an adviser from charging or allocating to a private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons, unless the adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to investors in writing on at least a quarterly basis and within 45 days after the end of the fiscal quarter in which the charge occurs. Many registered investment advisers will satisfy this requirement through quarterly statement reporting with respect to its first three fiscal quarters, so this aspect of the restricted activities rule is most impactful for exempt reporting advisers (who are not subject to the quarterly statement reporting requirement) and for all advisers with respect to expenses that are within scope and incurred during the fourth quarter (when the quarterly statement is due within 90 days after quarter-end).

Similar to other types of expenses, each specific ESG expense would need to be analyzed to determine whether the expense is due to a regulatory obligation of the adviser (which would generally trigger application of the disclosure requirement) or whether the expense is an obligation of the fund (which would generally not trigger application of the disclosure requirement).

ESG expenses could include, for example, the cost of environmental surveys conducted as a part of deal diligence on the one hand or specific reporting requirements under certain ESG laws and regulations on the other. In the EU, certain types of ESG expenses could be considered regulatory expenses of the adviser and such expenses, if allocated to the fund, would accordingly be subject to the 45-day disclosure requirement. For example, as an obligation of the adviser, reporting expenses associated with the Sustainable Finance Disclosure Regulation ("SFDR"), which is a regulatory regime that is triggered when an adviser markets in the EU, or the EU's Taxonomy Regulation would be captured expenses that require disclosure if allocated to the fund. As another example, a recently enacted California law, the Fair Investment Practices by Investment Advisers ("SB 54"), mandates reporting with respect to the diversity, equity, and inclusion metrics of certain investments made by "venture capital companies" (which the law defines broadly enough to seemingly capture a wide range of private investment funds). Notably, while SB 54 was first drafted to apply to advisers, the text of the law was revised to impose the reporting requirement on the funds themselves. Therefore, because the reporting requirement is the obligation of the fund, and not the adviser, we would not necessarily categorize expenses associated with compliance with SB 54 as currently drafted as adviser regulatory expenses that are captured by the rule.

## Q: How will the SEC's restricted activities rule that "...prohibit[s] an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment" potentially impact how ESG-related expenses such as due diligence, monitoring, etc. are allocated?

A: As long as an ESG-related expense is "related to a portfolio investment," we would advise managers to treat such expense as subject to the restricted activities rule. Under the restricted activities rule, non-pro rata allocation is allowed if (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating such fees or expenses to a private fund client, the manager distributes to each private fund investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances. Therefore, before making a non-pro rata allocation of ESG-related expenses, an adviser would need to make the fair and equitable determination and provide the required notice. In the scenario where an ESG fund and a non-ESG fund advised by the same manager co-invest in the same portfolio company, advisers may choose to allocate any ESG-specific expenses “related to” the “portfolio investment” to the ESG fund. In advance of doing so, however, the adviser would be required to determine that it is fair and equitable that the ESG fund bear all ESG expenses due to its strategy, and to disclose such determination and the amount of the non-pro rata allocation or charge in writing to fund investors.

## Q: How does the preferential treatment rule impact the dissemination of ESG information by advisers to investors?

A: The preferential treatment rule generally prohibits private fund advisers from providing information about portfolio holdings or exposure to any private fund investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets, unless the adviser offers that information to all investors in that fund and any similar pool of assets at substantially the same time. Advisers must therefore consider whether in-scope information disclosed to individual investors (as opposed to all investors), such as in response to bespoke ESG DDQs or other investor questions or reporting mandates, includes portfolio holdings or exposure information (including, for example, portfolio investment case studies), and if so, whether they reasonably expect that the disclosure of such information would have a material negative effect on investors in the fund or a similar pool of assets. This analysis is heavily facts and circumstances dependent, and managers will need to adopt policies and procedures that both comply with the rule and are customized to the manager’s business. In addition, the “legacy” provisions of the preferential treatment rule would allow managers to provide information to certain investors and not others if such information is provided pursuant to a contractual agreement (e.g., a side letter) entered into prior to the compliance date of the rule (September 14, 2024, for most private fund managers).

Another prong of the preferential treatment rule requires advisers to distribute to each prospective investor prior to the investor’s investment in a private fund notice relating to any material economic terms provided to other investors in the fund. This would include terms such as those relating to liquidity rights, fee breaks, and co-investment rights. We do not generally believe that agreeing to provide individual investors information about ESG matters would constitute a material economic term as contemplated by the rule, and therefore would not expect such provisions to require *pre-admission* disclosure under this rule. Note however that managers must also distribute to current investors, following the fundraising period (for open-end funds) or the investor’s investment (for closed-end funds) and on an annual basis, written notice of any preferential treatment provided to investors in the same private fund. Managers would need to include in such notices the selective provision of ESG information to certain, but not all, fund investors.

Blue Dot Capital and Ropes & Gray will continue to watch closely how the reporting of ESG-related information and corresponding expenses evolve in response to the private fund adviser rules.

**For a full summary of the private fund adviser rules, please see Ropes & Gray’s alert on the topic.**

## About Ropes & Gray

Ropes & Gray, a preeminent, global law firm, has been ranked in the top-three on The American Lawyer's prestigious "A-List" for seven years and is ranked #1 on Law.com International's "A-List" in the U.K.— rankings that honor the "Best of the Best" firms. The firm has approximately 1,500 lawyers and legal professionals serving clients in major centers of business, finance, technology, and government in Boston, Chicago, Dublin, Hong Kong, London, Los Angeles, New York, San Francisco, Seoul, Shanghai, Silicon Valley, Tokyo and Washington, D.C. The firm has consistently been recognized for its leading practices in many areas, including asset management, private equity, M&A, finance, real estate, tax, antitrust, life sciences, health care, intellectual property, litigation & enforcement, privacy & cybersecurity, and business restructuring. Consistently recognized as a leading practice in Chambers, more than 300 Ropes & Gray lawyers globally focus on advising a global client base of asset management firms across the entire spectrum of private and registered fund structures, investment strategies, and asset classes. Our deep asset management experience enables Ropes & Gray to identify significant commercial, regulatory and economic issues, understand emerging trends, and craft innovative solutions that are unique to the concerns of clients throughout the industry and in jurisdictions around the world.

Ropes & Gray also has a leading ESG, CSR and business and human rights compliance practice. We offer clients a comprehensive approach in these subject areas through a global team with members in the United States, Europe and Asia. In addition, senior members of the practice have advised on these matters for more than 30 years, enabling us to provide a long-term perspective that few firms can match.


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