

# ESG and Private Equity in 2022

*The private equity and investment space has become increasingly conscious of ESG concerns over the past decade, with legislation introduced across the EU, the US and the wider world in an attempt to enforce greater transparency in disclosures. In this feature, Nathan Blatz discusses the current ESG and private equity landscape and what fund managers should be conscious of as we move through 2022.*

**In brief, could you explain what is meant by environmental, social and governance (ESG) considerations when it comes to private equity and investment?**

ESG considerations in private equity have come about quite recently because, as the opposite of listed companies, non-listed companies are less subject to non-financial disclosures. Thus, ESG concerns were mostly limited to socially responsible investments in which they are a core principle.

However, ESG criteria have now become tools for enhanced returns in supporting more efficient governance and management practices and in reducing long-term risks. For some years now, ESG principles have been enshrined in binding regulations by EU and national lawmakers, which extends the reach of ESG criteria to all asset managers, financial advisers and investors. Still, ESG is not yet fully integrated in asset managers' strategies.

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**Stemming from this, how are “greenwashing” and emissions transparency becoming matters of concern for asset managers?**

Environmental matters are becoming a major concern for regulators, which is translated in stricter regulation. It means more transparency requirements regarding environmental impact for companies and more liability related to the subsidiaries' behaviour.

Since 10 March 2021 (SFDR regulation),

financial companies and funds are required to disclose how externalities and potential negative impacts affect their investments and must show how the environmental risks are integrated in their decision process and how they are compatible with compensation policies.

Member States in the EU are also extending the obligations of reporting and transparency. In France, a law from March 2017 (n°2017-399) requires companies with more than 5,000 employees in France or 10,000 worldwide to establish a “vigilance plan” that must identify environmental risks, including for subsidiaries abroad.

CO2 emissions are also a concern for investors and companies because of the cost of such emissions for companies. The price of CO2 on the EU carbon market (ETS) went from €23 a ton in November 2020 to €98 in February 2022. This trend seems structural because even if it went down due to the increase of energy prices following the war in Ukraine, it is already back to more than €80 a ton in June 2022.

Some companies are granted free carbon allowances to prevent gross competitive disadvantages with companies located outside the EU. But as soon as 2023, the EU will enforce a Carbon Border Adjustment Mechanism (CBAM) to tax imported carbon-intensive products, which could lead to the end of free carbon allowances in the EU.

Therefore, ESG considerations – especially the environmental ones – are now a matter of credibility for funds and asset managers.

**What other potential legal risks have risen from investors' growing focus on ESG?**

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for companies and investors because of the potential impact of scandals on sales and on brand image. These concerns are now becoming real legal issues for companies that are required to be more cautious about the activities of their subsidiaries abroad.

For example, in the US, since December and the establishment of the UFLPA law, companies are prevented from importing goods from China's Xinjiang region unless the importer can clearly prove that the goods were produced free from forced labour or human rights abuses. Additionally, the EU Commission proposed in February 2022 an ambitious Directive that would impose on companies a duty of vigilance over subsidiaries and commercial partners in supply chains. Executives would be liable for breaches of duty. New national agencies with powers to investigate, sue and fine violations would also be established.

The scope of the Directive would also be much broader than the precursory French act of 2017 because the obligations would apply to companies with at least 500 employees and 150 million euros in revenues and 250 employees and 40 million euros in revenues for companies in high-risk areas (textile, agriculture, oil, gas, etc.). Germany also adopted a similar regulation for companies with more than 3 000 employees that will enter into force on 1 January 2023.

Any investment in Russia is also at risk because the broad sanctions adopted



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by the EU could target any companies considered as supporting the war effort in Ukraine, even indirectly, and because of the current high legal uncertainty for foreign companies in the country.

More generally, investors and asset managers should be aware that the current higher scrutiny on bad governance and human rights abuses may have negative impact on investments-related supply chains in countries with bad records, such as Russia or China. This is due to the greater difficulty that companies face in tracking and monitoring their subsidiaries' behaviour in these countries, and therefore in complying with their ESG duties.

### Is there any notable litigation already existing in these areas?

The duty of vigilance, which is applicable to environmental, social and governance issues, is already a subject of litigation in France. A first judgement was rendered in December 2021 in the Total Ouganda case, brought before courts by NGOs, which seems to show that the duty of vigilance is not merely a matter of internal corporate governance but a matter of broader liability for companies.

Environmental issues are still the major source of ESG litigation, but with new regulations in the EU focused on social

and governance concerns, especially in relation with supply chains, litigation could increase significantly as soon as in 2023. These risks of litigation should already be taken in account in 2022 by asset managers and investors.

### What impact is the rollout of the EU's sustainable financial disclosure Regulation likely to have on private equity in 2022 and beyond?

The sustainable financial disclosure regulation (SFDR), which entered into force on 10 March 2021, aims to help investors to have access to better ESG information regarding financial products. The SFDR aims to create two categories of financial products with specific disclosure requirements: the products promoting environmental or social characteristics and the sustainable investments.

But the regulation also requires all asset managers and financial advisers who are based in the EU or sell products to clients in the EU to provide information on Principal Adverse Impacts (PAIs) of their investments. The PAIs are the negative effects, even potential, on sustainability resulting from the investments, such as CO2 emissions and carbon footprint. The disclosure requirements will be reinforced in 2023 and 2024.

### In your view, what should fund managers be mindful of when it comes to regulatory pitfalls in 2022, whether ESG-related or otherwise?

The EU Taxonomy applicable from 1 January 2022 requires companies offering financial products within the EU to disclose how sustainability is included in their activities, with three indicators: compliant share of turnover with the EU Taxonomy, compliant capital expenditure and compliant operating expenses.

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factors taken in account is expected to enter into force on 1 January 2023, but because EU lawmakers have not yet enacted the regulation, this additional regulation could be postponed.

In addition to this, the International Sustainability Standards Board (ISSB) was established on 3 November 2021 by the IFRS Foundation to provide standards for sustainability-related disclosure. The guidelines provided should be of great importance for fund managers in the coming years.

Finally, it must be pointed that the regulatory environment for 2022 is still favourable to private equity, and this should be a record year for investments.