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Investment Funds & Private Capital

AIFMD Refresher: ESG & the Sustainable Finance Disclosure Regulation (“SFDR”)

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The AIFMD contains numerous ongoing obligations that apply to sponsors and funds long after fundraising has completed. As part of our AIFMD refresher series, this article summarises one of the key AIFMD ongoing requirements that both EU and non-EU alternative investment fund managers must comply with for each fund marketed in the European Union and the United Kingdom. As most sponsors are aware, the AIFMD includes ongoing compliance requirements, including ongoing reporting to regulators and investors, post-deal notifications to EU and UK regulators and ongoing ESG investor reporting – this article focusses on the ESG disclosures and reporting required under the Sustainable Finance Disclosure Regulation (“**SFDR**”).

Key Takeaways:

- Sponsors should be carefully considering a fund’s SFDR categorization and ensure a clear, credible ESG strategy is set at the outset.
- Given the requirement to include ESG reporting under the EU SFDR in a fund’s AIFMD Annual Report, fund managers should be live to a potential increase in investor requests for a fund’s AIFMD-compliant annual report.

Article:

Both EU and non-EU fund managers marketing an alternative investment fund in the EU or the UK (either under an EU marketing passport or the relevant national private placement regimes (collectively referred to herein as “**AIFMs**”)) are required to appropriately categorize a fund under Sustainable Finance Disclosure Regulation (“**SFDR**”).

The SFDR implements a tiered categorisation of financial products, including funds, as follows:

- Article 6 – financial products which typically only consider major ESG risks or impacts in investment decision-making;

- Article 8 – financial products promoting environmental or social characteristics;
- Article 9 – financial products with the objective of “sustainable investments” (including a specific subset with a reduction in carbon emissions as an objective).

Under the SFDR, sponsors are required to include the following ESG-related disclosures alongside the pre-investment disclosures under Article 23 of the AIFMD:

- a description of the manner in which sustainability risks are integrated into the manager’s investment decisions;
- a description of the results of the assessment of the likely impacts of sustainability risks on the returns of the fund;
- whether the manager considers adverse impacts of its investment decisions on sustainability factors (“PASI”). If the manager does consider PASI, it must include (i) a clear and reasoned explanation of whether and, if so, how it considers PASI for the specific fund, and (ii) a statement that information on PASI is available in the fund’s AIFMD-compliant annual report;
- in respect of any fund which promotes environmental and/or social characteristics (an “Article 8 Fund”), information on how those characteristics are met; and
- in respect of any fund which has sustainable investment as its objective (an “Article 9 Fund”), an explanation of how that objective is to be attained.

There are detailed disclosure templates, which need to be used for these disclosures.

For both Article 8 and Article 9 funds, the periodic report must describe the extent to which investments are in economic activities that qualify as environmentally sustainable under the Sustainable Finance Taxonomy Regulation.

Capturing data from relevant portfolio companies, in order to prepare ongoing reports under the SFDR, has proved challenging for some sponsors – particularly where smaller portfolio companies have no or limited resources to dedicate to ESG data gathering.

Given the focus on ESG for many investors, and inclusion of the SFDR ESG reporting data in a fund’s AIFMD-compliant annual report, it is likely that EU investor requests for a copy of the AIFMD-compliant annual report will increase.

As well as the additional Article 23 and Article 22 disclosures, the SFDR also requires sponsors to make ESG-related disclosures on their websites.

Key takeaways for sponsors are to carefully categorise fund products under the SFDR while also setting realistic and yet credible ESG investment strategies, noting the ongoing reporting requirements to investors on progress made.

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