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It Ain't Easy Being Green: Raising Funds in the Age of Decarbonization and Electrification

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Any fund manager that has raised capital in the last 10 years will tell you that environmental, social and governance (ESG) principles have gained increased prominence with investors globally. But has ESG given rise to a new asset class? Recent history might suggest that it has: Generation Investment Management, an investment firm chaired by Al Gore, launched the Just Climate Fund to invest in assets that mitigate climate change in 2021; the Brookfield Global Transition Fund (co-run by Mark Carney) raised US$15 billion in 2022 to invest in assets that accelerate global decarbonization; and in 2022, TPG raised US$5.4 billion for its Rise Climate Fund.[1] The hot play for investors and fund managers has become funds that invest in assets that will help cool the world.

Raising an energy transition fund, or any fund with an ESG focus, is not for the faint of heart. Many institutional investors have started to expect divestments of carbon-centric investments on specific timelines[2] while seeking sustainable returns and enhanced ESG and D&I reporting. Meanwhile, securities regulators in Canada and the United States have turned their sights to "greenwashing," the practice of misleading investors with language describing investment funds.[3] A Canadian regulated investment fund's use of terms such as "ESG," "sustainable," "responsible investing" and "green," including in a fund's name, must now be supportable (for example, by being aligned with the fund's investment strategy).

In the current environment in which competition for investor attention is fierce and regulatory scrutiny is increasing, a fund manager that wishes to focus on electrification, decarbonization or energy transition needs to get ahead of the curve by focusing on certain aspects of the fund, including key fund terms:

- **Fund Mandate.** First-time funds or funds that are adjusting their investment mandates to focus more on energy transition should carefully consider both the description of the mandate and the investment restrictions that will apply. For example:
  - An overall investment strategy that targets companies that have a positive impact on the environment might, on its face, be seen to exclude mining companies. However, a decarbonization investment strategy may well involve investing in companies that mine or process lithium or other critical renewable battery materials. Fund managers need to clearly delineate what type of investments could and could not fall within the fund's investment mandate and why.
  - Depending on the nature of its investment strategy, a fund may need to build in flexibility regarding the type of its investments (for example, debt or equity; growth capital vs. buyout capital) and the nature of the co-investment opportunities that may be offered to investors and third parties (for example, participation in project financings or other investment or development opportunities that are fundamentally different from passive co-investment opportunities and, as a result, may be offered more strategically).
- **Fund Economics.** Fund sponsors with an emphasis on energy transition or decarbonization may wish to consider whether to adjust traditional economic terms that would reward the investment team for achieving certain decarbonization or other goals with increased economic incentives. While this approach appears sensible and desirable, the devil is in the details – fund managers who wish to design tiered levels of carried interest or other economic incentives linked to climate change goals should consider how best to frame those goals so that they can be assessed objectively.
- **Fund Size.** As is the case with any fund, energy transition funds must assess the market opportunity and size themselves accordingly, taking into account expected market opportunities, the likely size of the deals and their ability to participate in deal flow, all

of which will influence the composition of their management teams. For first-time funds or funds that have pivoted to a different strategy, this process may require the assistance of external advisers who can assist in rationalizing the investment thesis of the fund.

- **Fund Team.** Funds that focus on decarbonization or electrification may need to consider augmenting their teams with individuals with technical or regulatory expertise (or strengthening relationships with key service providers) and/or a better understanding of the growth or scale-up capital and project finance needs of companies in the space. This expansion of a fund manager's team may also necessitate a review of its carried interest or other compensation plans to ensure an appropriate alignment of interests.

Beyond the terms of a fund, fund managers should adopt a prudent and cautious approach to marketing and reporting in respect of energy transition funds:

- **Prudent Disclosure.** Investment fund managers must be thoughtful and contextual about the disclosure that they provide to investors about their funds and the strategies of those funds. Doing so means more than simply beefing up the risk factors in a private placement memorandum. Fund managers should ask themselves whether claims made in pitchbooks and PPMs are in fact supported by the fund's investment restrictions and strategy and the manner in which investments are expected to be made and evaluated. Fund managers should also consider implementing not only an ESG policy but also procedures to evaluate compliance and facilitate reporting.
- **Sales Team Management.** The fund's internal and external salespeople and placement agents should understand the importance of communicating the fund's investment objectives appropriately and be given specific language and guidance about how best to describe the fund and its objectives.
- **Investor Reporting.** In light of the increasing amounts of information that investors expect to receive with respect to ESG, fund managers should consider proactively developing a reporting template and/or approach to reporting that is comprehensive but not overly onerous, and developing processes or procedures to operationalize the collection of the required information. Some possible ways to do so include engaging an ESG consultant or voluntarily disclosing on the basis of third-party standards such as SASB or the SDG impact standards for private equity funds.[4]

An experienced fund manager may well look at the points listed above and conclude that they are, for the most part, nothing new. Prudent fund managers have always focused on providing accurate disclosure and avoiding the use of misleading statements. Innovative investment fund managers are often keen to explore creative ways of unlocking value, albeit not historically through a climate change lens. As the world continues to navigate political and economic risks, more change is no doubt inevitable. There will be winners and losers in the energy transition and electrification game. There will also be more pronouncements from regulators that may affect the design of energy transition funds. With that in mind, fund managers would be well-advised to focus on the fundamentals, even as they promote innovative strategies in this context.

[1] According to an S&P Global study, 2021 saw a record level of North American venture and private capital investment in assets that participate in the transition of the energy industry (representing approximately a four-fold increase in investment over 2020).

[2] For example, Caisse de dépôt et placement du Québec (CDPQ) has announced that it would divest all of its oil investments by 2022 as part of a broader strategy to reduce CDPQ's carbon footprint by 60% by 2030.

[3] See, for example, CSA Staff Notice 81-334, which seeks to ensure that funds clearly align their disclosure with their names and investment strategies to avoid confusing or misleading investors, and the SEC's proposed rule on ESG disclosures for investment advisers and companies that aims to enhance disclosure by adding specific disclosure requirements regarding ESG strategies, implementing a tabular disclosure approach for ESG funds to allow for comparison and requiring certain environmentally focused funds to disclose greenhouse gas emissions associated with investments.

[4] Note that third-party reporting standards are not always crafted optimally for investment funds (particularly small or medium-sized funds), and they should be assessed and considered with that in mind.

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