Professional Perspective

US-EU Cross-Border ESG Developments

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The importance of environmental, social, and corporate governance (ESG) is growing and globally impacting the asset management industry. The European regime on sustainability-related disclosures in the financial sector will affect European and non-European asset managers from March 2021. While there is no dedicated ESG regime in the U.S., investor demand is driving change and the existing regulatory framework has been used increasingly to review ESG related disclosures. This article discusses different approaches to ESG regulation in the E.U. and U.S.

European Sustainable Finance Regulation

European sustainable finance regulation aims to integrate ESG considerations into the investment and advisory process in a consistent manner across financial sectors.

The regulation on the establishment of a framework to facilitate sustainable investment (EU/2020/852) (Taxonomy Regulation) introduces an EU-wide classification system, or taxonomy, of environmentally sustainable activities. It seeks to establish a common language and classification tool to help companies make informed investment decisions on what can be considered environmentally sustainable economic activities. The majority of the provisions of the Taxonomy Regulation will apply from Jan. 1, 2022.

The second key legislative measure is the regulation on disclosures (EU/2019/2088) (Disclosure Regulation), which came into effect on March 10, 2021. It introduces new transparency and disclosure requirements for "financial services participants," which includes investment firms and asset managers, on how they are factoring sustainability into their investment decision making processes.

Scope of Regulation for Non-EU Asset Managers

Investment firms and asset managers based outside of Europe, for example in the U.S., will be in scope of the new requirements to the extent that they market a product to E.U. investors, for example by registering their fund in the EU by way of private placement in accordance with the Alternative Investment Fund Managers Directive (EU/2011/61) (AIFMD).

Non-EU managers that have appointed an EU AIFM as a platform to market their products across the EU are also affected by the new framework. Where this structure is adopted, typically the EU AIFM delegates portfolio management back to the U.S. manager. While it is the EU AIFM that is directly in scope of the rules, the disclosure requirements will generally be passed down to the portfolio manager.

Key Disclosure Requirements

The Disclosure Regulation requires firms in scope to make disclosures at both the firm and product level.

Firm-level disclosures will need to be made on the firm's website and includes information on their policies on the integration of sustainability risks in their investment decision-making processes, which assumes that firms have such policy. Firms with over 500 employees have to publish a due diligence statement on how the firm considers principal adverse impacts of investment (PAI) decisions on sustainability factors. Where they do not consider adverse impacts of investment decisions on sustainability factors, clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts have to be published on the firm's website from June 2021.

At the product level, firms will need to provide pre-investment disclosures to EU investors before investing in the product. As a result, firms will need to do a classification exercise of each financial product that they make available in the EU and categorize it in three different ESG fund-types:

- Art. 6 fund, called a "not green fund" or "grey/brown fund," for products that do not consider ESG factors, as contemplated by the Disclosure Regulation.
- Art. 8 fund, called a "light green fund," for products that promote a sustainable investment as one objective amongst other objectives.

- Art. 9 fund, called a “dark green fund,” for products that have sustainable investment as their main objective, such as an impact of climate fund.

There are minimal disclosure requirements for Art. 6 funds and the most onerous disclosure requirements will fall on Art. 9 funds. It is likely that many funds may fall into the light green category, because they are promoting ESG objectives in their marketing material. For funds that are marketed from March 10, 2021 onwards, relevant disclosures should be included in the offering documentation such as the private placement memorandum or the AIFMD disclosure addendum, summarizing, among other things, how sustainability risks are integrated into investment decisions, including how ESG characteristics are met and how any index is compatible or consistent with those characteristics.

These pre-investment disclosure requirements also apply to U.S. managers marketing under the private placement regime as they already had to comply with the AIFMD disclosure obligations and were required to prepare a disclosure supplement under Article 23 AIFMD.

Much of the detail behind the disclosures is further specified in the Level 2 framework and regulatory technical standards that are expected to apply from Jan. 1, 2022. The initial disclosures from March under Level 1 Disclosure Regulation will be therefore fairly high level at first, though managers should each consider their product classification in light of the Level 2 measures, to ensure they are ready and able to meet the additional disclosure requirements when they become effective.

At this stage, managers should assess whether they are in scope of the new requirements, review what products are marketed in the EU and classify these products. Even if there are no ESG or sustainable investment objectives, firms still need to prepare language on the firm's website to disclose this is the case. For firms that market funds that fall into the scope of Art. 8 or Art. 9 products, the high level statements and disclosure need to be integrated onto firm websites and their Article 23 AIFMD disclosure documents.

It has been confirmed that the U.K. will not be adopting the Disclosure Regulation since it becomes effective after the U.K. has left the European Union. This means that non-EU fund managers that only market into the U.K. have not to comply with the new EU regime. Nevertheless, it is expected that the U.K. will implement its own sustainability regime in due course for the financial sector. Non-EU firms that are marketing in the EEA as well as the U.K. are likely to adopt one set of disclosures for U.K. and EU investors and disclosing the same information to U.K. investors.

ESG Developments in the U.S.

The Securities and Exchange Commission (SEC) under former Chairman Jay Clayton had been skeptical of uniform ESG disclosure regimes and considered the existing securities laws and general materiality disclosure standards as sufficient. Developments in the space have been driven primarily by investor demand. For example, the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee recommended in May 2020 that the SEC establish ESG disclosure requirements for publicly traded issuers and urged the SEC to create a principles-based framework.

With changes under the Biden administration, it is expected that the SEC will be more focused on ESG, as environmental factors have been at the forefront of his campaign. Although there may not be a short-term imposition of detailed mandatory regulatory requirements, particular areas, such as human capital and disclosures on climate risks may be expected. For fund managers, avoiding “greenwashing,” a strategy for marketing purposes, will be a key focus from a regulatory standpoint.

How the Current U.S. Regulatory Framework Captures ESG Factors

When thinking about fund managers, U.S. regulators will primarily focus on SEC registered investment advisers (RIAs). Existing regulatory requirements under the Investment advisers act of 1940, as amended (the Advisers Act), that are relevant when considering ESG disclosures include Section 206 and the Compliance Rule.

Section 206

Advisers have a fiduciary obligation to avoid deceptive conduct under the general anti-fraud provisions. This concept applies to any firm marketing a fund in the U.S., whether as an RIA or foreign investment adviser relying on an exemption from registration. The U.S. regulatory regime is a disclosure-based regime that is focused on providing material information to prospective investors.

Compliance Rule

RIAs must comply with the Compliance Rule, Rule 206(4)-7 under the Advisers Act, requiring policies and procedures to be reasonably designed and implemented to prevent violations of the securities laws.

SEC's ESG Examination Priorities

The SEC's Division of Examinations (DoE) noted that ESG disclosures were part of its 2020 Exam Priorities and in some cases conducted examinations requesting detailed information on the state of ESG investing across the industry. In the examination context, the SEC staff may be educating itself about firms' approach to ESG and has the authority to issue deficiency letters or refer matters to the SEC's Division of Enforcement. From a deficiency standpoint, the SEC has been focused on disclosures to investors regarding the ESG-focused investment process and strategy, and whether firms have sufficient internal procedures to make sure those disclosures are accurate in comparison to the investment strategy ultimately employed. The DoE's document requests included the following items:

- Use of ESG scoring and benchmarks, such as whether firms are signatories to the UN Principles for Responsible Investment.
- Overview of particular made or recommended ESG investments and their ESG score.
- Internal ESG process and compliance with policies by the firm and its services providers, such as compliance evaluations or internal audits that cover the implementation of the ESG investment process.
- Returns on ESG investments, such as lists of the most or least profitable ESG investments, financial performance metrics, and investment returns from ESG investment,
- All marketing materials on a firm's ESG program.

Outlook for ESG Development in the U.S.

It is expected the ESG will continue to be mostly an investor-driven subject in the U.S., with many large investors pushing for a framework for ESG disclosures. Politically however, there has been a divide between some concerned that client assets or pension funds are being used to support a political agenda, compared with those that believe ESG is an important part of responsible investing. Focusing on operational and strategic consistency with disclosures to investors sits between the two extremes.

The SEC has also traditionally shied away from providing guidance on ESG topics, especially regarding social and governance aspects of ESG, unless specifically mandated by legislation. However, the SEC staff has been thinking about whether there should be better disclosure from asset managers under general materiality standards. Hence, if a manager claims they have an ESG-focused fund, they should be prepared to explain what environmental, social, and governance mean for their ESG program and how sustainable factors are considered in the investment decision making process.

In this respect, recent revisions to the Advisers Act's advertising rule prohibit a registered adviser from including certain statements in an advertisement. The first prohibition is against any material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC. Further, advertisements must not include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser.

There is also potential for further scrutiny and enforcement under certain theories, as mentioned above, primarily regarding the adequacy of disclosures to investors under general fiduciary concepts. Finally, on Feb. 1, 2021, the SEC announced that Satyam Khanna will serve as Senior Policy Advisor for Climate and ESG in the office of Acting SEC Chair Allison Herren Lee. In this new role, Khanna will advise the agency on environmental, social, and governance matters and advance related new initiatives across its offices and divisions.

What Firms Should Consider in Light of New EU Requirements

Firms will need to consider the importance of certain ESG issues and decide which should be elevated to the top of their board agenda. Questions firms may want to contemplate include:

- Does a firm consider itself as having an ESG objective as a priority?
- What is the long-term ESG strategy and how would investors perceive the firm's decision, given how the thinking has changed in this space?
- Does a firm have a sustainability policy and does it have to be reviewed in light of the upcoming EU requirements?
- What additional documents or disclosure requirements have to be factored from March 2021 and what is on the horizon when the Level 2 framework and regulatory technical standards will apply from Jan. 1, 2022?

ESG requirements have only expanded in recent years, and this trend can be expected to continue. Staying abreast of new and developing trends in ESG is essential to a firm's success.