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FINDING GOLD IN EUROPE IN GREEN WHILE MAINTAINING REGULATORY COMPLIANCE

In this article, the authors discuss and compare the regulatory regimes in the United States, the European Union, and the United Kingdom governing investment fund products that take into account environmental, social, and governance ("ESG") investing considerations. The authors highlight some of the key regulatory, risk, and other considerations for asset managers in organizing, offering, and managing non-U.S. ESG products while simultaneously managing U.S. retail funds.

By Christopher D. Christian and Katie Carter *

In recent years, environmental, social, and governance ("ESG") considerations have become an increasingly important component in attracting capital to an investment fund product. In Europe, institutional clients and distributors show a strong preference for investment fund products that invest according to ESG criteria.[1] To capture the increased demand from European investors, U.S. asset managers have created and marketed investment funds and strategies that consider ESG factors in investing.[2] While demand for ESG-related products increases in Europe, U.S. asset managers are faced with a maze of legislation as to the meaning of the phrase "ESG" and encounter often competing and inconsistent ESG regulatory frameworks. In an effort to "classify" or "label" ESG-related products outside of the United States to increase distribution, U.S. asset managers may, if not careful, inadvertently increase their regulatory and litigation risk in the United States as well as alienate current clients.

This article will: (1) examine the current ESG classification and labeling regimes for investment fund products in Europe and compare those frameworks with the proposed ESG disclosure regime in the United States for mutual funds and (2) highlight some of the key regulatory, risk, and other considerations for asset managers in organizing, offering, and managing non-

[1] Report from PWC, Asset and Wealth Management Revolution 2022: Exponential Expectations for ESG, pub. *avail. at* https://www.pwc.com/gx/en/industries/financial-services/asset-management/publications/asset-and-wealth-management-revolution-2022.html (discussing the acceleration of ESG-related investments and the demand for ESG-related investment products).

[2] Carlson, Debbie, "ESG Investing Now Accounts for One-Third of Total U.S. Assets Under Management", Market Watch

footnote continued from previous column…

(Nov. 17, 2020), *available at* https://www.marketwatch.com/story/esginvesting-now-accounts-for-one-third-of-total-u-s-assets-under-management-11605626611.

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U.S. products from the United States while simultaneously managing U.S. retail funds.

I. OVERVIEW OF EUROPEAN UNION ESG DISCLOSURE REGIME

When raising capital in the European Union, U.S. asset managers have to be cognizant of the three pillars of the EU's sustainable finance initiative: (1) the EU Sustainable Finance Disclosure Regulation ("SFDR"), which came into effect on March 10, 2021;[3] the Taxonomy Regulation, effective from January 2022, which establishes specific environmental criteria related to economic activities for investment purposes and which forms part of the enhanced disclosure obligations required by the SFDR;[4] and (3) certain point of sale disclosure obligations required by the Markets in Financial Instruments Directive ("MiFID II"),[5] as described more fully below.

A. SFDR Disclosure Regime

SFDR was introduced by the European Commission as part of a package of legislative measures arising from its agenda on sustainable finance and is designed to re-orient capital towards sustainable growth and make it easier for investors to distinguish and compare between the many sustainable investment strategies that are now available within the EU.[6] SFDR aims to assist investors by providing more transparency on the degree to which financial products consider environmental and/or social characteristics, invest in sustainable investments, or have sustainable investment objectives.[7]

SFDR applies to financial market participants ("FMPs") and financial advisers, which are defined to include alternative investment fund managers ("AIFMs"), management companies to Undertakings for Collective Investment in Transferable Securities ("UCITS"),[8] portfolio managers, credit institutions, and pension providers.[9] SFDR also applies to "financial products," which include UCITS, alternative investment funds ("AIFs"), pension products and segregated mandates or separate accounts.[10]

Generally, SFDR requires asset managers and investment advisers to: (1) make certain firm-level disclosures regarding how they consider sustainability (ESG) in their investment process;[11] (2) make certain

[3] Regulation (EU) 2019/2088 of the European Parliament and of the Council of November 27, 2019, on sustainability-related disclosures in the financial services sector ("SFDR"), as amended by Regulation (EU) 2020/852 of the European Parliament and of the Council of June 18, 2020 on the establishment of a framework to facilitate sustainable investment (the "Taxonomy Regulation").

[4] Taxonomy Regulation.

[5] Directive 2014/65/EU of the European Parliament and of the Council of May 15, 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[6] SFDR, Preamble.

[7] SFDR, Art. 8 (Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures) and Art. 9 (Transparency of sustainable investments in pre-contractual disclosures).

[8] Directive 2009/65/EC of the European Parliament and of the Council of July 13, 2009 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast).

[9] SFDR, Art. 2 (Definitions) for the definition of a "financial market participant" and "financial adviser." An AIFM is further defined by reference to Article 4(1)(b) of Directive (EU) 2011/61/EU) (the Alternative Investment Fund Managers Directive ("AIFMD")).

[10] SFDR, Art. 2 (Definitions) for the definition of a "financial product". SFDR could also apply to a private fund or AIF that is sold into the European Union on a private placement basis under Art. 42 of AIFMD (Conditions for the marketing in Member States without a Passport of AIFs Managed by a non-EU AIFM).

[11] SFDR, Art. 3 (Transparency of Sustainability Risk Policies) (requiring FMPs to publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making process and financial advisers to publish on their websites information about their policies on the integration of sustainability risks in their advice).

firm-level disclosures regarding how they consider the adverse impacts of investment decisions on sustainability factors, so-called "Principal Adverse Impacts";[12] and (3) make specific pre-contractual and periodic disclosures for those products that are marketed to investors as incorporating sustainability considerations. SFDR also mandates transparency of remuneration policies in relation to how asset managers integrate sustainability risks.[13] As a result, SFDR requires FMPs to make disclosures at a firm level (*e.g.*, on a firm website)[14] and at the product level with pre-contractual disclosure, periodic reports,[15] and website disclosures.[16]

At product level, the nature of the pre-contractual disclosures and reporting required depends on the extent to which a product promotes environmental or social characteristics or invests a proportion of its assets into "sustainable investments," as described more fully below.

1. *Article 6 Funds*

As a default, Article 6 applies to all financial products. Under Article 6, products are required to disclose either how they integrate financially material sustainability (*i.e.*, ESG) risks into the investment decision-making process or explain why sustainability risk is not relevant. Those products, referred to in the European market as being "Article 6 Funds," do not promote environmental or social characteristics (*e.g.*, Article 8 Funds) or have sustainable investment as an objective (*e.g.*, Article 9 Funds) and are not permitted to market themselves as taking positive ESG-related considerations or opportunities into account.[17] Under Article 6, products are required to include descriptions of the following in pre-contractual disclosures: (1) the manner in which sustainability risks are integrated into their investment decisions and (2) the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.[18] Where an investment manager deems sustainability risks not to be relevant with respect to the fund, the fund disclosure shall include a clear and concise explanation of the reasons why sustainability is not relevant.[19] Article 6 funds are very similar to US mutual funds that "integrate" ESG into their investment process – so-called integration funds, although such integration funds may also refer to ESG opportunities as well as risks, which an Article 6 fund is not permitted to do. Note, Article 8 and Article 9 funds also need to include Article 6 compliant disclosures in their offering documentation.

2. *Article 8 Funds*

Article 8 funds are those that *promote*, among other characteristics, environmental or social characteristics, or a combination of those characteristics, or which undertake to make a certain level of investment in "sustainable investments."[20] Article 8 funds are required to make certain pre-contractual disclosures, website disclosures, and comply with periodic reporting requirements.[21]

3. *Article 9 Funds*

An Article 9 fund has "sustainable investment" as its objective.[22] The term "sustainable investment" means:

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[12] SFDR, Art. 7 (Transparency of Adverse Sustainability Impacts at Financial Product Level); *see also* Art. 4 (Transparency Adverse Sustainability Impacts at Entity Level); see also Art. 10 (Transparency of the Promotion of Environmental or Social Characteristics and of Sustainable Investments on Websites).

[13] SFDR, Art. 5 (Transparency of Remuneration Policies in Relation to the Integration of Sustainability Risks).

[14] SFDR, Art. 4. (Transparency of Adverse Sustainability Impacts at Entity Level) (requiring FMPs with more than 500 employees (or others on a comply or explain basis) to publish and maintain on their websites: (1) information on where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available or (2) 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).

[15] SFDR, Art. 11 (Transparency of the Promotion of Environmental or Social Characteristics and of Sustainable Investments in Period Reports).

[16] SFDR, Art. 10 (Transparency of the Promotion of Environmental or Social Characteristics and of Sustainable Investments on Websites).

[17] SFDR, Art. 6 (Transparency of the Integration of Sustainability Risks).

[18] *Id.*

[19] *Id.*

[20] SFDR, Art. 2(17); *see also* supra note 7.

[21] *Supra* note 7.

[22] SFDR, Art. 9 (Transparency of Sustainable Investments in Pre-contractual Disclosures).

"an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy." The term includes an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration, and labor relations, or an investment in human capital, or economically or socially disadvantaged communities. With the proviso that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff, and tax compliance."[23]

Unlike the proposals in the UK, discussed below, it is important to note that the requirements set out in Articles 6, 8, and 9 of SFDR are not drafted as labels (although many investment firms have treated them as such).

B. Taxonomy Regulation

The Taxonomy Regulation is the European Commission's principal mechanism to address "greenwashing" as it sets out criteria for determining if an activity is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives.[24] The Taxonomy Regulation defines what constitutes a "sustainable economic activity." SFDR requires Article 8 and Article 9 funds to disclose and report the proportion of their investments that constitute environmentally sustainable economic activities under the Taxonomy Regulation, including details on the proportions of enabling and transitional activities.[25]

C. MiFID II: Point of Sale ESG Considerations

A wide range of new EU sustainable finance measures were published in 2021 and have been applied since August 2022 and November 2022. In total, four Commission Delegated Regulations and two Commission Delegated Directives (collectively, the "Delegated Acts") were amended.[26] The Delegated Acts integrate sustainability issues and considerations into a number of EU legislative regimes, including MiFID II, and complement the obligations in SFDR and the Taxonomy Regulation to form part of the European Commission's package of measures to help improve the flow of capital towards sustainable activities across the EU.[27]

Two of the Delegated Acts are Commission Delegated Regulation (EU) 2021/1253 (the "MIFID ESG Org Regulation")[28] and Commission Delegated Directive (EU) 2021/1269 ("MIFID ESG PG Directive")[29] which require integration of sustainability considerations into the suitability assessment and product governance obligations under MIFID II. MIFID II currently provides that when an investment firm (which would include most EU-based distributors) offers "investment advice" or "portfolio management" services to a client, it is first required to obtain information on (among other things): (1) the client's investment objectives (*i.e.*, financial objectives) and (2) the client's risk tolerances, in order to be able to recommend suitable investments.[30]

Under the MiFID ESG Org Regulation, it is now also mandatory to obtain information and assess investment suitability on the basis of the client's sustainability preferences. The MiFID ESG Org Regulation outlines three categories of investment products that it considers

[23] SFDR, Art. 2(17).

[24] Taxonomy Regulation, Art. 3 (Criteria for Environmentally Sustainable Economic Activities).

[25] Taxonomy Regulation, Art 5 (Transparency of Environmentally Sustainable Investments in Pre-Contractual Disclosures and in Periodic Reports); *see also* supra note 14.

[26] Commission Delegated Regulation (EU) 2021/1255; Commission Delegated Directive (EU) 2021/1270; Commission Delegated Regulation (EU) 2021/1253; and Commission Delegated Directive (EU) 2021/1269.

[27] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions Action Plan: Financing Sustainable Growth 2018.

[28] Commission Delegated Regulation (EU) 2021/1253 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks, and preferences into certain MiFID II organisational requirements and operating conditions for investment firms.

[29] *Supra* note 25.

[30] MiFID II Art. 25 (Assessment of Suitability and Appropriateness and Reporting to Clients) and Commission Delegated Regulation (EU) 2017/565 as amended by the MiFID ESG Org Reg Art. 54.

can be recommended or sold to a client that has confirmed that it has sustainability preferences:

- *Environmentally sustainable investments:* Financial instruments that pursue a minimum proportion of sustainable investments in economic activities that qualify as environmentally sustainable under Article 2(1) of the Taxonomy Regulation, where the minimum proportion meets or exceeds that which has been determined by the client or potential client;
- *Sustainable investments*: Financial instruments that pursue a minimum proportion of sustainable investments, as defined in Article 2 (17) of SFDR, where the minimum proportion meets or exceeds that determined by the client or potential client; and
- *Investments that consider sustainability factors:* Financial instruments that consider principal adverse impacts on sustainability factors, where elements demonstrating that consideration are determined by the client or potential client.[31]

Investment firms are required to obtain such information as is necessary for the firm to understand the essential facts about the (potential) client, including whether they have any sustainability preferences. Investment firms will then have to make investment recommendations that meet those preferences. These three sustainability preference categories are separate and distinct.[32]

A financial product that satisfies all three categories will be best placed to be recommended for investment to a wider pool of investors. To add to the complexity, under the MIFID ESG PG Directive, firms that are in the scope of MIFID II product manufacturer obligations will need to consider the sustainability related objectives of clients when identifying a target market for the financial product and will have to communicate this aspect of the target market to the distributors of that product.[33] This will not simply be a case of asking an investor whether they would like to invest in product that is categorized by the investment firm as Article 6, Article 8, or Article 9 under SFDR.[34]

II. OVERVIEW OF UK ESG DISCLOSURE AND LABELING REGIME

In October 2022, the United Kingdom's financial services regulator, the Financial Conduct Authority ("FCA") published Consultation Paper CP 22/20 (Sustainability Disclosure Requirements ("SDR") and investment labels) (the "Consultation Paper") setting out its proposed sustainability-related disclosure rules for UK funds, portfolio management mandates, and the UK firms managing such products.[35] The Consultation Paper was issued in light of the FCA's concerns that firms may be making exaggerated, misleading, or unsubstantiated sustainability-related claims about their products (so-called "greenwashing").[36] To prevent greenwashing and instill trust and consumer confidence in the investment products offered in the UK, the FCA proposed "guardrails" to protect consumers from potential harm.[37]

The proposed UK regime has limited overlap with the perceived EU classification regime under SFDR and amounts to a "labeling" regime for investment funds. As proposed, SDR would not apply to investment managers that are not FCA regulated, nor does it apply to non-UK funds, although the FCA intends to separately consult on how SDR may be applied in respect of non-UK funds in the future (*e.g.*, non-UK funds which are registered for marketing in the UK).[38]

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[31] MiFID ESG Org Regulation, Art. 1 (Amendments to Delegated Regulation (EU) 2017/565).

[32] *Id.* at 30.

[33] *Id.* at 7 and 16.

[34] European legislators also believe criteria are required when naming funds that claim to have sustainability characteristics or goals, and have proposed guidelines on the use of ESG or sustainability-related terms in fund names. *See* Consultation on Guidelines on Funds' Names using ESG or Sustainability-Related Terms, pub. *avail. at* https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related.

[35] Sustainability Disclosure Requirements (SDR) and Investment Labels, Consultation Paper 22/20, pub. *avail.* Oct. 2022, *at* https://www.fca.org.uk/publication/consultation/cp22-20.pdf.

[36] *Id.* at 3.

[37] *Id.* at 17.

[38] *Id.* at 8: The labeling regime applies to the following FCA regulated firms: (1) firms carrying out portfolio management; (2) UK UCITS management companies; (3) investment companies with variable capital ("ICVC") that are regulated as a UCITS scheme without a separate management company; (4) full-scope UK AIFMs; and (5) small, authorized UK

The proposals cover six core elements: (1) sustainable investment labels; (2) qualifying criteria for each label; (3) entity-level disclosures; (4) naming and marketing rules; (5) requirements for distributors to ensure that product-level information (including the labels) are made available to consumers; and (6) a general 'anti-greenwashing' rule applied to all FCA regulated firms, which reiterates existing rules to clarify that sustainability-related claims must be clear, fair and not misleading.[39]

A. Sustainable Investment Labels

The proposed regime distinguishes between three different types of sustainable products according to the primary channel by which each can plausibly contribute to positive sustainability outcomes and how they invest, as noted below:[40]

1. Sustainable Focus Funds. Funds that invest in assets that are environmentally and/or socially sustainable. The features of this category of product are:

— *Sustainability Objective*. Alongside its financial risk/return objective, a 'sustainable focus' product will have an objective of investing in assets that meet a credible standard of environmental and/or social sustainability, or that align with a specified environmental and/or social sustainability theme.[41]

— *Primary Channel for Sustainability Outcomes*. This category of product pursues its sustainability goals primarily *via* the market-led channel of influencing asset prices, thereby reducing the relative cost of capital of sustainable economic activities/projects.[42]

— *Secondary Channel for Sustainability Outcomes*. In addition to the primary channel criteria, products in this category will also typically pursue continuous *improvements* in the sustainability performance of assets through investor stewardship activities.[43]

Further, at least 70% of a 'sustainable focus' product's assets must meet a credible standard of environmental and/or social sustainability or align with a specified environmental and/or social sustainability theme.[44]

2. *Sustainable Improvers Funds*: funds that invest to improve the environmental and/or social sustainability of assets over time, including in response to the stewardship influence of the firm. The features of this category of product are:

— *Sustainability Objective*. Alongside its financial risk/return objective, a 'sustainable improvers' product will have an objective of delivering measurable improvements in the sustainability profile of its assets over time, including through investor stewardship.[45]

— *Primary Channel for Sustainability Outcomes*. This category of product pursues its sustainability goals primarily *via* the channel of investor stewardship. The product's stewardship approach is directed towards encouraging and accelerating improvements in the environmental or social sustainability profile of its assets, including through participation in system-wide initiatives, with flow-on positive implications for environmental and/or social sustainability.[46]

— *Secondary channel for sustainability outcomes*. Portfolio construction and asset selection in 'sustainable improvers' products is geared towards identifying those assets that are best-placed to improve their sustainability profile

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AIFMs. The labeling regime applies to the following investment products: (1) UK authorized funds (excluding feeder funds and funds in the process of winding up or terminating); (2) UK unauthorized AIFs, including investment trusts; and (3) portfolio management services if 90% or more of the value of all constituent products in which they invest qualify for the same label. Irish and Luxembourg-domiciled funds that are authorized as UCITS and passported into the UK are *not* currently subject to the proposed labeling regime.

[39] *Id.* at 5, 6.

[40] *Id*. at 17.

[41] *Id.* at 33, Section 4.29.

[42] *Id.*

[43] *Id.*

[44] *Id.* at 33, Section 4.30.

[45] *Id.* at 33. Section 4.37).

[46] *Id.*

over time. So, a secondary channel would be the market-led channel of influencing asset prices and the relative cost of capital of more sustainable economic activities/projects.[47]

3. Sustainable Impact Fund: Funds that invest in solutions to environmental or social problems, to achieve positive, real-world impact.[48] The features of this category of product are:

— *Sustainability Objective*. Alongside its financial risk/return objective, a 'sustainable impact' product will have an objective of achieving a pre-defined, positive, and measurable environmental and/or social impact.[49]

— *Primary Channel for Sustainability Outcomes*. This category of product pursues its sustainability goals by directing typically new capital to projects and activities that offer solutions to environmental or social problems, often in underserved markets, or to address observed market failures. Products would be expected to have a stated theory of change and to pursue a highly selective asset selection strategy aligned with that theory of change.[50]

— *Secondary Channel for Sustainability Outcomes*. Driving continuous improvements in the sustainability performance of assets through investor stewardship activities would be a secondary channel.[51]

Contrary to the market interpretation of SFDR where there is a perceived hierarchy under which Article 9 products are viewed as being 'greener' than Article 8 products, and which are in turn seen as 'greener' than Article 6 products, there is no hierarchy between the proposed categories. Each type of product is designed to deliver a different profile of assets and to meet different consumer preferences.[52] To qualify for any sustainable investment label, however, the investment fund must meet five overarching principles covering: (1) sustainability objective; (2) investment policy and strategy; (3) Key Performance Indicators ("KPIs"); (4) resources and governance; and (5) investor stewardship (the "Principles").[53] In addition, the fund must also meet a number of other key guidelines associated with the Principles, as described in the Consultation Paper.[54]

The FCA's initial view of how these three labels map across to SFDR categorization is set out in the Consultation Paper.[55] It should be noted that certain funds, which are being marketed as compliant with Article 8 or Article 9 of SFDR, would not fall under any of the FCA's proposed sustainable labels.[56]

B. Consumer Facing Disclosures.

The FCA Consultation Paper also proposed consumer-friendly, accessible disclosures to help consumers understand the key sustainability-related features of an investment product.[57] This includes a fund's sustainability objective, investment approach, and performance against the objective. Consumer-facing disclosure will be required to be produced for products with or without a sustainable investment label, although disclosures will inherently be more limited for products that do not have a label.[58]

C. Detailed Disclosures at Product and Entity Level.

The FCA has proposed that additional, more granular disclosures at the product and entity level be required for institutional investors and retail investors seeking more information, including:

1. *Pre-Contractual Disclosures*: Setting out the sustainability-related features of an investment product (*e.g.*, its sustainability objective, investment policy, and strategy). Sustainability-related information must be disclosed both for products that use a label and for products that do not use a label but which have sustainability-related features that are integral to their investment strategy (*i.e.*, where the product has specific sustainability features and

[47] *Id.*

[48] *Id.* at 17.

[49] *Id.* at 33 (section 4.43).

[50] *Id.*

[51] *Id.*

[52] *Id.* at 17.

[53] *Id.* at 33 (section 4.47).

[54] *Id.* at 33.

[55] *Id.* at 33 (Annex 1).

[56] *Id.*

[57] *Id.* at 19.

[58] *Id.* at 19.

the firm has specific policies and procedures in place in relation to those features).[59]

2. *Sustainability Product Level Report*: The FCA would require that ongoing sustainability-related performance information be produced in a 'sustainability product-level report.' These disclosures must be produced for products that use a label.[60]

3. *Entity-level disclosures*, in a 'sustainability entity report' on how firms are managing sustainability-related risks and opportunities. These disclosures must be made regardless of whether an in-scope firm uses a label.[61]

D. Naming and Marketing Rules

The Consultation Paper includes a general 'anti-greenwashing' rule clarifying that sustainability-related claims must be clear, fair, and not misleading.[62] The FCA is proposing to restrict the use of sustainability-related terms in the naming and marketing of products offered to retail investors that do not use a sustainable investment label. This aims to ensure that product names and marketing align with, and are proportionate to, the product's sustainability-related objectives and strategy.[63]

E. Requirements for Distributors

There are additional requirements for distributors of in-scope UK-domiciled investment products to retail investors to make the sustainable investment label and consumer-facing disclosures available to those investors.[64]

III. OVERVIEW OF U.S. ESG MUTUAL FUND DISCLOSURE REGIME

While there has been increasing demand for ESG products and strategies in the United States, U.S. financial regulators have not previously taken formal steps to implement disclosure requirements specifically relating to ESG investing. The landscape is, however, rapidly changing as described more fully below.

A. Mutual Funds: Overview of Proposed Disclosure Regime

The U.S. Investment Advisers Act of 1940, as amended ("Advisers Act") requires an investment adviser to act in accordance with its fiduciary duty to its clients.[65] This fiduciary duty "means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own."[66] The U.S. Securities and Exchange Commission ("SEC") recognizes that an adviser and its client may shape the advisory relationship by agreement, provided that there is full and fair disclosure and informed consent.[67] It also has previously stated that this means that an adviser can only pursue an ESG-investment strategy if the client expresses a desire to pursue such a strategy after receiving full and fair disclosure regarding the salient features of the strategy, including the strategy's risk and return profile.[68]

Against this regulatory backdrop, the SEC proposed for public comment on May 25, 2022, a framework requiring certain funds registered under the U.S. Investment Company Act of 1940, as amended (the "1940 Act"), certain investment advisers registered under the Advisers Act, and certain advisers exempt from registration under the Advisers Act to disclose their ESG-investment practices ("ESG Proposal").[69] The ESG Proposal, which is a companion to a separate release proposing changes to Rule 35d-1 under the 1940 Act ("Names Rule"),[70] would amend rules and forms

[59] *Id.* at 33 (section 3.2).

[60] *Id.*

[61] *Id.*

[62] *Id.* at 33 (section 6.9).

[63] *Id.* at 33 (section 3.2).

[64] *Id.*

[65] *See*, e.g., Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963).

[66] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)], *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[67] *Id.*

[68] Commissioner Mark T. Uyeda, Remarks at the California '40 Act Groups, Los Angeles, CA, Jan. 27, 2023, *at* https://www.sec.gov/news/speech/uyeda-remarks-california-40-acts-group.

[69] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Rel. Nos. IA-6034 & IC-34594 (May 25, 2022) ("ESG Release").

[70] On September 20, 2023, the SEC, by a vote of four to one, adopted amendments to the current rule regarding registered

under both the 1940 Act and the Advisers Act.[71] The ESG Proposal is subject to comment and no definitive implementation date has been announced.

1. *Proposed Prospectus ESG Disclosure Enhancements*

The ESG Proposal would not define "ESG" or similar terms, and instead, propose to establish a regulatory framework that would require funds to disclose to investors how they incorporate ESG factors into their investment selection process and investment strategy.[72] The disclosure requirements would vary depending upon whether a fund is categorized as an "integration fund," an "ESG-focused fund," or an "impact fund."[73] The SEC is proposing a layered disclosure approach, consisting of a short concise description in the summary prospectus followed by a complementary, more detailed description in an open-end fund's statutory prospectus or later in a closed-end fund's prospectus.[74] The purpose of this layered approach is to seek to ensure that a fund does not overemphasize the role of ESG factors in investment selection decisions, and thereby potentially mislead investors.[75]

— a. *Integration Funds*

An integration fund is a fund that "considers one or more ESG factors along with other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio. Such funds may select investments because those investments met other criteria applied by the fund's adviser (*e.g.*, investments selected on the basis of macroeconomic trends or company-specific factors like a price-to-earnings ratio)."[76]

To the extent that a fund would meet the definition of an integration fund, it would be required to briefly summarize in its summary prospectus how the fund incorporates ESG factors into the investment selection process, including what factors are considered.[77] In addition to this general requirement, the SEC has proposed that if an integration fund considers greenhouse gas ("GHG") emissions in its portfolio investments as part of its investment selection process, the fund is required to describe in its statutory prospectus how it considers such information (including a description of the methodology the fund uses for this purpose).[78] The statutory prospectus would also be required to detail the ESG factors considered in the investment selection process.[79]

The required integration fund disclosures for an integration fund could be made through a brief narrative description or through an illustrative example of how ESG factors are considered alongside other factors.[80] In

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fund names, as well as certain forms and disclosure requirements; Investment Company Names, Release No. IC-3500 (September 20, 2023).

[71] The term "funds" in the ESG Release means management investment companies registered on Form N-1A [17 CFR 274.11A] (*i.e*., mutual funds) or Form N-2 [17 CFR 274 11a-1] (*i.e*., closed-end investment companies), unit investment trusts registered on Form S-6 [17 CFR 239.16], and business development companies ("BDCs"), but not private funds as defined under the Advisers Act. *See* id. at FN 4 at 8.

[72] Press Release, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG-Investment Practices, pub. *avail.* May 25, 20023 *at* https://www.sec.gov/news/press-release/2022-92; the ESG Release clarifies that the SEC is not proposing to define "E" "S" or "G" or related terms (although the SEC is proposing to categorize funds based on the degree to which they incorporate ESG factors); ESG Release.

[73] ESG Release at 4-25.

[74] *Id.* at 23, 24.

[75] *Id.* at 23.

[76] ESG Release at 26.

[77] *Id.* at 25. Open-end funds would provide this information in the summary section of the fund's prospectus, while closed-end funds, which do not use summary prospectuses, would disclose the information as part of the prospectus's general description of the fund.

[78] For example, an integration fund that considers "the GHG emissions of portfolio companies within only certain 'high emitting' market sectors . . . would also be required to describe the methodology it uses to determine which sectors would be considered 'high emitting,' as well as the sources of GHG emissions data the funds relied on as part of its investment selection process." *Id.* at 27.

[79] *Id.*

[80] The ESG Release provides the following example: "an Integration Fund might disclose that it invests in companies consistent with its objective of risk-adjusted return; that it considers ESG factors alongside financial, industry-related and macroeconomic factors; that the specific ESG factors it evaluates are the impact and risk around climate change, environmental performance, labor standards, and corporate

the absence of further guidance from the SEC or its Staff, however, it is not clear whether the integration of any ESG factor (or the general maintenance of an ESG investing policy applicable to funds) would trigger the "integration fund" classification – or if some higher standard instead would apply.

— b. *ESG-Focused Funds*

An ESG-focused fund is a fund that focuses on one or more ESG factors by using them as a significant or main consideration in: (1) selecting investments or (2) in its engagement strategy with the companies in which it invests.[81] ESG-focused funds under the proposed definition would include, for example, funds that track an ESG-focused index or that apply a screen to include or exclude investments in particular industries based on ESG factors.[82] An ESG-focused fund would also include a fund that has a policy of voting its proxies and engaging with management of its portfolio companies to encourage ESG practices or outcomes.[83]

From a disclosure perspective, an ESG-focused fund would be required to disclose in its summary prospectus information in a standardized tabular format, an ESG Overview Table, organized into three broad categories: (1) an overview of the fund's strategy with a "check-the-box" feature; (2) how the fund incorporates E, S, and/or G factors in its investment decisions; and (3) how the fund votes proxies and/or engages with companies about E, S, and/or G issues.[84]

In the statutory prospectus, an ESG-focused fund would be required to describe how the fund incorporates ESG factors into its investment process, including information related to: (1) the index methodology for any index tracked;[85] (2) internal methodologies used and how they incorporate ESG factors;[86] (3) scoring or ratings systems of any third-party data provider used;[87] (4) factors applied in any inclusionary or exclusionary screen;[88] (5) description of any third-party frameworks followed and how they are used;[89] and (6) with respect to engagement, a description of any specific engagement objectives and associated key performance indicators.[90] To the extent that an ESG-focused fund utilizes proxy voting or engagement as a "significant means" of implementing the fund's strategy, the fund would also be required to make additional disclosures in its annual report.[91]

— c. *ESG Impact Funds*

The SEC proposes to define an "Impact Fund" as an ESG-focused Fund that seeks to "achieve a specific ESG impact or impacts."[92] The ESG Release provides the following examples of Impact Funds: (1) "a fund that invests with the goal of seeking current income while also furthering a disclosed goal of financing construction of affordable housing" or (2) a "fund that invests with the goal of seeking to advance the availability of clean water by investing in industrial water treatment and conservation portfolio companies."[93] An Impact Fund's stated goal of pursuing a specific impact is what would distinguish Impact Funds under the proposal from other ESG-Focused Funds.[94]

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governance; and that its consideration of these factors would not necessarily result in a company being included or excluded from the evaluation process but rather would contribute to the overall evaluation of that company." *Id.* at FN 44 at 27.

[81] This would include any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors and any fund whose sales literature or advertisements indicate that the fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. The ESG Release clarifies that mentioning ESG factors in an advertisement or marketing materials – but not as a "significant or main consideration" – would not cause a fund to be an ESG-focused fund (absent other factors). *Id.* at 33, 34.

[82] *Id.* at 35. The SEC is not suggesting any ESG-related minimum characteristics that such index or screen would have. Can an ESG-focused fund that uses the index or screen to focus on one or more ESG factors by using them as a significant or main consideration in selecting investments be required to provide disclosure about the index or screen under the proposal. *Id.*, FN 58 at 33.

[83] *Id.* at 33.

[84] *Id.* at 36-38.

[85] *Id.* at 48.

[86] *Id.* at 46.

[87] *Id.*

[88] *Id.* at 36, 41.

[89] *Id.* at 36, 41.

[90] *Id.* at 35.

[91] *Id.* at [-].

[92] *Id.* at 35. Impact funds are a sub-set of ESG-focused funds.

[93] *Id.* at 35.

[94] *Id.* at 35.

An Impact Fund would be required to provide all of the disclosures for an ESG-Focused Fund.[95] Additionally, an Impact Fund would have additional disclosure requirements, including how the fund measures progress towards the stated impact; the time horizon used to measure that progress; and the relationship between the impact the fund is seeking to achieve and the fund's financial returns.[96]

B. Registered Investment Advisers: Disclosure Regime

The SEC also proposed to amend Form ADV Part 2A to require registered investment advisers that consider ESG factors as part of their advisory business to disclose information similar to that required in fund registration statements and annual reports.[97] Specifically, the ESG Proposal would require registered advisers to disclose: a description of the ESG factors considered in providing advisory services and how they are incorporated; and, if ESG factors are considered when selecting, reviewing, or recommending portfolio managers, a description of the factors considered and how they are incorporated. The new disclosures would appear in Items 8, 10, 17 and Appendix 1 (Wrap Fee Brochure).

C. Private Funds

A "private fund" by definition is a fund that relies on an exemption from registration as an investment company under the 1940 Act by virtue of qualifying for an exemption under Section 3(C)(1) or Section (3)(C)(7) of the 1940 Act. Private funds are not subject to the ESG Proposal.

IV. KEY RISK CONSIDERATIONS FOR U.S. ASSET MANAGERS

As U.S. asset managers attempt to attract more assets from European investors by creating products that satisfy the appetite of distributors and end investors for "green" products, it is important for asset managers to "do what they say and say what they do." Firms claiming to be conducting ESG investing need to explain to investors clearly what they mean by ESG investing no matter what classification or label that a manager puts on a European product. To the extent that managers create "clones" of U.S. mutual funds in the form of UCITS that are marketed as being compliant with Article 8 or Article 9 of SFDR or otherwise labeled in the UK, the disclosure documents for the U.S. fund should be consistent with any documents used by the UCITS. Any inconsistency in the disclosure could lead to unintended consequences, including regulatory enforcement risk, litigation risk, and shareholder risk, as described more fully below.

A. SEC Examination Risk

In April 2021, the SEC's Division of Examinations published a risk alert,[98] describing the areas on which the SEC Staff is focusing in examinations of registered investment advisers' and funds' ESG offerings.[99] The SEC has noted that examiners will be looking for consistency between disclosure claims and actual practices. The Staff also will review advisers' proxy voting processes.[100] In its examinations, the SEC staff has reviewed U.S. mutual fund disclosure documents and questioned whether the documents are consistent with those of European fund disclosure documents where the portfolio management team, investment strategy, and portfolio securities are similar.

B. SEC Enforcement Risk

In 2021, the SEC launched its Climate and ESG Task Force within the Division of Enforcement to identify potential violations under existing disclosure rules of

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[95] Investment Advisers registered with the SEC must deliver a brochure and one or more brochure supplements to each of their clients or prospective clients, which advisers may use to help them with their disclosure obligations as fiduciaries. The adviser brochure is designed to provide a narrative, plain English description of the adviser's business, conflicts of interest, disciplinary history, and other important information to help clients make more informed decisions about whether to hire or retain that adviser. The ESG Proposal would require ESG-related disclosures from registered investment advisers that consider ESG factors as part of their advisory businesses. *Id.* at 127.

[96] *Id.*

[97] *Id.*

[98] SEC, Division of Examinations, "Risk Alert: The Division of Examinations' Review of ESG Investing" (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

[99] SEC, Division of Examinations, "2021 Examination Priorities" (Mar. 3, 2021), https://www.sec.gov/files/2021-exam-priorities.pdf.

[100] Hester M. Peirce, Commissioner, SEC, Statement on the Staff ESG Risk Alert, pub. *avail*. April 12, 2021, *at* https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert.

material gaps or misstatements in issuers' disclosure of climate risks and ESG strategies; the latter being of special focus in the case of investment advisers and funds.[101]

In 2022, the Task Force was involved in pursuing several high-profile enforcement actions, all charging companies with fraudulently misleading investors on ESG-related matters. Violations noted in these enforcement actions were primarily in three areas: (1) exaggerated disclosures involving ESG goals, (2) failure to disclose material information relevant for assessing the reasonableness of and/or progress towards meeting publicly disclosed ESG goals, and (3) failure to establish effective controls around ESG-related policies and reporting.

For example, in November of 2022, the SEC charged Goldman Sachs Asset Management, L.P. ("GSAM") with failing to establish and to follow policies and procedures relating to ESG-related investments.[102] The SEC further charged that GSAM disclosed information about its ESG-related policies and procedures but failed to follow such policies and procedures consistently. To settle the charges, GSAM agreed to pay the SEC a $4 million penalty. The action against GSAM reinforces the idea that investment advisers must develop and adhere to policies and procedures regarding their investment processes, including ESG research, to ensure investors receive the advisory services such investors would expect to receive from an ESG investment.

In another suit, the SEC charged BNY Mellon Investment Adviser, Inc. ("BNY") for misstatements and omissions regarding the ESG considerations that BNY uses for investment decisions for certain mutual funds managed by BNY.[103] The SEC contended that BNY did not follow through with ESG quality reviews that it represented that it undertook for investments in the relevant funds. BNY agreed to settle the case with the SEC and pay a $1.5 million penalty. The action against BNY shows that the SEC will hold investment advisers accountable when such investment advisers do not accurately describe their incorporation of ESG factors into their investment selection process.

[101] SEC, Press Release, pub. *avail*. March 4, 2021, *at* https://www.sec.gov/news/press-release/2021-42.

[102] *In re* the Matter of Goldman Sachs Asset Management, L.P., Investment Advisers Act Release No. 6189 (Nov. 22, 2022).

[103] *In re* the Matter of BNY Mellon Investment Adviser, Inc., Investment Advisers Act Release No. 6032 (May 23, 2022).

C. U.S. State Regulatory Risk

Since 2022, the U.S. asset management industry has received numerous formal inquiries from state officials into their ESG practices. Attorneys general and state treasurers from over 21 "red states"[104] have sent various letters to US asset managers over their consideration of ESG factors in their investment or proxy decisions.[105] The letters broadly cite federal and state legal regimes and in some cases contractual duties, that the state officials claim potentially are being breached by financial organizations, insurers, managers, and boards when they advance climate change mitigation or other ESG goals.

These state officials have questioned the use of ESG factors on several fronts. A central theme of the state letters is whether ESG practices (including proxy voting in line with ESG considerations) represent a conflict of interest and a breach of fiduciary duties. Other letters have questioned whether there are antitrust concerns arising from financial entities' commitments to develop investment practices addressing climate change and the de-carbonization goals of the Paris Agreement.

To date, the state officials have requested information, and in some cases sent civil investigative demands or subpoenas, on the mechanics of calculating ESG factors, whether the implementation of such factors was coordinated within the financial sector, and whether the financial industry is specifically aligning with particular groups or policy positions, among other details. While none of the letters formally threaten litigation or investigation, statements by various attorneys general have suggested the possibility of future formal action related to the use of ESG factors in investment decisions and financial activity. Some states have also adopted blacklists in certain circumstances.

D. Alienating Current Investors: Private Litigation Risk

Meanwhile, private litigants have filed complaints in state and federal courts challenging the ESG-related

[104] The term "red states" commonly refers to US states that traditionally vote for Republicans. *See* Josh Peters, Here's Why Republicans are "red" and Democrats are "blue"; Pub. *avail*. Nov. 3, 2020, *at* https://www.usatoday.com/story/news/politics/2020/11/03/heres-why-republicans-red-and-democrats-blue/6144842002.

[105] Ross Kerber, US Republicans Challenge More Fund Managers on SEC, Reuters, pub. *avail*. March 31, 2023, *at* https://www.reuters.com/business/sustainable-business/us-republicans-widen-challenge-fund-managers-esg-2023-03-31.

decisions made by companies and investment funds. A recurring theme in these matters is that ESG practices allegedly run counter to the duties of fiduciaries to maximize the profit-taking goals of investors.

For example, in *Utah, et al. v. Su*, the U.S. Department of Labor (the "DOL") was sued by 25 states and certain oilfield exploration interests challenging the DOL's December 2022 rule relating to the management of retirement investment accounts and ESG.[106] The plaintiffs alleged that the DOL's rule subverts fiduciary duties required by the Employee Retirement Income Security Act ("ERISA") and exceeds the authority granted to the DOL by Congress.

In another case, a class of current and former American Airlines pilots filed a lawsuit against American Airlines, its Employee Benefits Committee, its retirement plan administrator, and its financial advisors for alleged breaches of fiduciary duty under ERISA relating to the consideration of ESG principles in the management of the class plaintiffs' 401(k) plan.[107] The plaintiffs allege that the selection and inclusion of investment options that pursue ESG policy goals via investment strategies, proxy voting, and shareholder activism is inconsistent with the defendants' fiduciary duties under ERISA. The plaintiffs further allege that the inclusion of ESG funds in the American Airlines 401(k) plan breaches fiduciary duties because, purportedly ESG funds are more expensive, do not perform as well as their peers, and engage in shareholder activism in the pursuit of goals beyond the maximization of financial benefits.

In a third case, members from the New York City Qualified Pension Plans (the "Plans") sued their respective pension administrators for breaches of fiduciary duty relating to the Plans' decision to divest from fossil fuel investments in an effort to combat climate change.[108] The plaintiffs allege that the divestment from fossil fuel companies breached the Plans' fiduciary duties by placing ESG considerations over returns of the Plans. The plaintiffs are also seeking an injunction that would require the Plans to rescind their divestment policy and make decisions going forward "exclusively on relevant risk-return factors."[109] Not only should a U.S. asset manager be cognizant of private litigation but also alienating its largest client base in the U.S. while chasing assets in Europe with "green" products.

V. CONCLUSION

As U.S. asset managers look to find gold in Europe in offering green products, it is important to consider the cost of raising capital and whether the requirements in a jurisdiction to "label" or "classify" a product that may use ESG factors create unintended consequences and material risks in the United States. ■

[106] *Utah, et al. v. Su*, et al., Case No. 2:23-cv-00016 (N.D. Tex. 2023).

[107] *Spence v. American Airlines, Inc., et al.*, Case No. 4:23-cv-00552 (N.D. Tex. 2023).

[108] *Wong et al. v. New York City Employees' Retirement System et al.*, Index No. 652297/2023 (N.Y. Sup. Ct. 2023).

[109] *Id*.