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Compliance Corner
April 15, 2024

Compliance Considerations for Investment Advisers Using ESG Strategies in the US and EU

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Implementing an effective compliance structure can be particularly challenging for advisers utilizing environmental, social and governance (ESG) investment strategies that have clients across the globe, as the legal and regulatory requirements applicable to ESG differ and at times are inconsistent. The ESG-related regulations, guidance, and enforcement activities (collectively, "regulatory regimes") of global authorities continue to change at a rapid pace, obligating advisers to remain aware of applicable updates and the need to modify their ESG-related policies and procedures in response to such updates. While ESG regulation is a priority for many regions, this article highlights certain compliance considerations for advisers seeking to abide by the regulatory regimes of the United States and European Union.

Implementing an ESG Compliance Program for an Advisory Business in the US and EU

When considering adopting new policies and procedures or amending existing ones to address ESG, advisers should consider which regulatory regimes apply to their business and any particular compliance requirements contained therein. While the SEC has not adopted any specific ESG-related compliance program requirements for investment advisers, in the EU, following the implementation of the Sustainable Finance Disclosure Regulation (SFDR)[i], management companies[ii] – which delegate investment advisory services to investment advisers – to European funds (UCITS[iii] funds or alternative investment funds[iv]) must implement a specific ESG compliance framework. These management companies must also look closely at the compliance program an appointed adviser has adopted to ensure that the adviser's compliance program aligns with each fund's respective SFDR classification (*i.e.,* Article 6, Article 8, or Article 9[v]) and that the adviser can effectively implement the investment strategy in accordance with that classification.

Advisers should carefully consider the following when implementing an ESG compliance program appliable to the funds they advise:

- **Framework** – Does an adviser with U.S. and EU clients want to maintain a distinct compliance framework (*i.e.*, compliance program) for each region (*i.e.*, one designed for the adviser's business in the U.S. and one designed for the adviser's business in the EU) or implement a single framework, utilizing the more restrictive aspects of each regulatory regime to help ensure compliance with both regulatory regimes? Regardless of the approach taken, when establishing a new – or enhancing an existing – compliance framework, advisers may wish to consider addressing how the adviser (i) considers sustainability risks and factors when conducting investment due diligence, and (ii) takes sustainability risks into account in their organizational procedures, resources, management of conflicts of interest, and risk management policies.[vi] They should also consider whether policies and procedures relating to offering document and marketing disclosures account for ESG-related strategies and the discussion thereof in such materials.

- **Administration of the Framework** – Does the adviser wish to select a member of its personnel to be responsible for ESG-related compliance across the entire business, or have a dedicated ESG compliance officer for each region? For advisers that do not identify the need for a specific ESG compliance officer, or do not have sufficient personnel resources to maintain such a role, can the adviser's existing chief compliance

officer effectively oversee ESG policies and procedures across the global business, or would the adviser benefit from having an ESG committee oversee ESG practices in both the U.S. and EU? Advisers may also wish to consider how to effectively assess and test their policies and procedures, such as by evaluating third-party data providers and reviewing disclosures against schedules of portfolio investments.

- **Monitoring and Responding** – How will the adviser track regulatory regime developments (e.g., new enforcement actions that provide insight into a regulator's expectations) and consider necessary compliance framework updates? Advisers should consider how to train personnel regarding any updates to policies and procedures, particularly when some updates may result from an event in another region (e.g., training for U.S. personnel regarding a compliance program update resulting from a change to SFDR).

Each of these considerations will need to account for the adviser's size, nature, business complexity, and its use of ESG strategies. For example, an adviser with a significant number of ESG-related products offered on a global basis may decide to have a dedicated ESG compliance officer or maintain an ESG committee.

Addressing Specific Compliance Elements

As previously noted, regulatory regimes currently differ, and are expected to continue to vary in a variety of ways. Highlighted below are some key factors for advisers to consider when designing and implementing a compliance framework that addresses ESG-related issues and/or ESG products.

- **Labels/Categories/Classifications**
    - In light of the inconsistent labeling/categorization/classification ("classification") rules either adopted or proposed by the U.S. and EU, advisers should review substantially similar products and strategies and identify which classification – and related disclosure or reporting requirements – apply for the relevant regulatory regime. For example, the SEC's proposed rules for advisers and registered investment companies[vii] would create three specific ESG classifications for funds[viii] and three specific ESG classifications for strategies used by investment advisers.[ix] Similarly, as noted above, the EU has adopted classifications under SFDR based on how a fund incorporates sustainability considerations in its investment program.

- Regulatory filings, marketing materials, and offering documents should be reviewed to ensure that the appropriate classification is attached to the fund or strategy, and that any related requirements are satisfied.

- **Disclosure and Marketing**
  - Advisers should ensure that offering and marketing documents applicable to their managed funds or the advisers' business satisfy the appliable regulatory regimes' requirements. Accordingly, advisers should consider whether they can practically utilize one set of documents or would benefit from creating custom documents for each regulatory regime. While the latter may require more time, the former may be more difficult to implement in practice in light of the various approaches of the regulatory regimes. In either case, advisers should bear in mind that both the U.S. and EU regulatory regimes share a common prohibition: advisers and funds may not engage in "greenwashing"; their disclosures must align with their actual practices.
  - Advisers should consider how their compliance program will scale as regulations develop. For example, the SEC has not yet adopted final rules mandating ESG-specific disclosures. However, if the proposed rules are adopted, advisers and the funds they manage will be required to include certain disclosures in their offering documents and marketing materials, many of which will be based on the applicable ESG classification that applies to the fund or strategy. For example, under the proposed rule for advisers, an adviser that utilizes "impact" strategies will be required to provide certain disclosures not necessarily required for non-impact strategies. In addition, certain of the proposed U.S. disclosure requirements could be inconsistent with, or otherwise differ from, those mandated under SFDR.

- **Portfolio Management**
  - In the U.S., there are currently no ESG-specific SEC rules dictating how advisers must invest client assets (*e.g.*, there is no minimum percentage that must be invested in a particular asset), except that such investment must be consistent with the applicable marketing materials, offering documents, any investment objectives or restrictions established by or for the client, and, in the case of registered investment companies, a fund's name. In that regard, advisers should ensure that all offering documents, marketing materials, and other disclosures or communications are consistent with actual investment practices, and they should consider whether and how such checks should be documented. In addition, advisers should consider the use of vendors and other third parties,

    including ongoing diligence of such third parties and the information they provide, and whether disclosure of such use is appropriate and accurate.
  - In the EU, advisers developing investment strategies around SFDR classifications must consider the following factors when designing their ESG strategies to achieve an Article 8 or Article 9 classification: sustainability characteristics, sustainability factors, sustainable investments, sustainability risks, principal adverse impacts, and taxonomy alignment.

- **Reporting**
  - The SEC has not yet adopted ESG-specific reporting requirements for advisers or funds. However, if the SEC's proposed rules are adopted, registered investment companies and advisers will need to report, as applicable, certain ESG-related information in their reports on Forms N-CEN and N-CSR, and Form ADV Part 1A, respectively. In addition, in September 2023, the SEC adopted rule amendments that introduce new requirements for funds with names suggesting an "investment focus" and specifically identified the consideration of ESG factors as an element suggesting an "investment focus."
  - The EU reporting framework comprises two key elements: adviser level reporting and fund/product ("fund") level reporting. Advisers must disclose on their websites (i) the potentially negative impacts an investment decision may have on ESG factors; (ii) whether they consider such ESG risks in their investment decision-making process; and (iii) how compensation policies align with the integration of sustainability risk. Funds must disclose (i) how sustainability risk might impact financial performance; (ii) whether and how the fund considers potentially negative impacts on sustainability risk; and (iii) how products labeled as "sustainable investments" monitor, measure, and assess their sustainability impact.
  - Advisers should take appropriate steps to ensure they understand their reporting obligations and any changes thereto. Advisers may also wish to consider appropriate reporting to boards of directors/trustees and others in their organizational structure.

Conclusion

Adhering to the range of global regulatory regimes presents continual challenges for investment advisers. Advisers looking to launch ESG-related funds will be expected by investors and fund boards to demonstrate their awareness of the applicable regulatory regime and to maintain an appropriate program designed to ensure compliance with such requirements.

While the demands on compliance teams are sure to increase with regulatory obligations, enforcement actions in the U.S. and EU have reflected that regulators will scrutinize compliance frameworks, including their providing for effective oversight of disclosure, marketing, portfolio management and reporting practices, and making appropriate updates.

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[i] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

[ii] The UCITS Management Company or Alternative Investment Fund Manager ("AIFM"), as relevant. A UCITS Management Company is a company whose regular business is the management of UCITS (defined as including investment management, fund administration and distribution). An AIFM may carry out all of these functions, but this must include investment management (defined as encompassing portfolio management and risk management). In the context of Luxembourg and Ireland, the management company is domiciled in either Luxembourg or Ireland and portfolio management is typically fully delegated to a U.S. investment adviser.

[iii] Undertakings for Collective Investment in Transferable Securities, the legislative framework for which is set out at EU level in Council Directive 2009/65/EC, Commission Directive 2010/43/EC and Commission Directive 2010/44/EC.

[iv] Alternative Investment Fund as provided for in Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulation (EC) No 1060/2009 and (EU) No 1095/2010.

[v] Article 6 is the default classification for financial products that do not have sustainable investment as their objective nor invest in assets that promote environmental or social characteristics. Article 8 applies to a financial product that "promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices." Article 9 applies to a financial product that "has sustainable investment as its objective."

[vi] Advisers are generally expected to appropriately manage financially material sustainability risks arising from fund investments and should consider how they manage such risks as they consider management of other relevant fund risks, such as market, interest or credit risk.

[vii] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, File No. S7-17-22, https://www.sec.gov/files/rules/proposed/2022/33-11068.pdf.

[viii] Under the proposed rule for funds, (i) an "Integration Fund" is a fund that considers one or more ESG factors alongside 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; (ii) an "ESG-Focused Fund" is a fund that focuses on one or more ESG factors by using them as a significant or main consideration (a) in selecting investments or (b) in its engagement strategy with the companies in which it invests, and includes (1) any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors; and (2) any fund whose advertisements or sales 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; and (iii) an "Impact Fund" is an ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts.

[ix] Under the proposed rule for advisers, (i) an "integration" strategy involves the consideration of one or more ESG factors alongside other, non-ESG factors in the adviser's investment advice, but such ESG factors are generally no more significant than other factors in advising clients with respect to investments, such that ESG factors may not be determinative in providing advice with respect to any particular investment; (ii) "ESG-focused" strategies focus on one or more ESG factors by using them as a significant or main consideration in advising clients with respect to investments or in the adviser's engagement strategy with the companies in which its clients invest; and (iii) "impact" strategies or methods of analysis are those ESG-focused strategies or methods of analysis that seek to achieve a specific ESG impact or impacts.