

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on an orange rectangular background. The background of the entire slide features a blurred night cityscape with bokeh lights, overlaid with a digital grid and a world map composed of blue dots. A white line graph with data points and candlestick-style markers is also visible, with some points labeled with values and percentage changes.

K&L GATES

## Live from Boston: A Discussion of Cross-Border ESG Regulations Impacting Global Managers

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# OVERVIEW

- Proposed SEC regulations for registered funds and advisers
- EU: Sustainable Finance Disclosure Regulation (SFDR)
- Practical concerns and challenges of cross-border ESG regulations





# Proposed SEC Regulations for Registered Funds and Advisers



# PROPOSED ESG REFORMS FOR REGISTERED FUNDS

- Proposed ESG reforms for registered funds include:
  - ESG-related disclosure and reporting requirements, the specificity and level of detail of which would depend on the extent to which a fund considers ESG factors in its investment process
  - New fund taxonomy consisting of three categories of ESG funds, each of which will have specific disclosure requirements
  - An environmentally focused fund would be required to disclose its carbon footprint (based in part on its portfolio companies' Scope 1 and Scope 2 GHG emissions) and weighted average carbon intensity (WACI) (also based in part on the fund's portfolio companies' Scope 1 and Scope 2 GHG emissions) in its annual shareholder report - *unless* the fund affirmatively states that it does not consider issuers' GHG emissions as part of its investment strategy



# PROPOSED ESG REFORMS FOR REGISTERED FUNDS

## ■ Proposed New ESG Taxonomy

| Type of Fund      | Definition  |
|-------------------|---|
| Integration Funds | Funds that “ <b>consider</b> ” one or more ESG factors alongside non-ESG factors in their investment decision-making process, but where such ESG factors are not dispositive in the funds’ investment decisions |
| ESG-Focused Funds | Funds that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies  |
| Impact Funds      | Subset of ESG-Focused Funds that seek to achieve one or more specific ESG impacts   |



# PROPOSED ESG REFORMS FOR REGISTERED FUNDS

## ■ Proposed prospectus disclosures

| Type of Fund      | Disclosure Requirements  |
|-------------------|--|
| Integration Funds | <ul style="list-style-type: none"> <li>How the fund incorporates ESG factors into investment selection processes</li> <li>How such ESG factors are considered alongside other factors</li> <li>Methodology and data sources in considering GHG emissions (if applicable)</li> </ul>  |
| ESG-Focused Funds | <ul style="list-style-type: none"> <li>Standardized “ESG Strategy Overview Table” consisting of a “check-box” format for funds to indicate which ESG strategies the fund employs</li> <li>Descriptions of internal methodology or third-party data provider used in selecting investments, identification of indices the fund tracks, and the participation of the fund and its adviser in any third-party ESG frameworks</li> </ul> |
| Impact Funds      | <ul style="list-style-type: none"> <li>All disclosure requirements applicable to ESG-Focused Funds</li> <li>ESG impact the fund seeks to generate with its investments</li> <li>How the fund measures progress toward the stated impact</li> <li>Time horizon used to measure that progress</li> <li>Relationship between the impact the fund is seeking to achieve and the fund’s financial returns</li> </ul>                      |



# PROPOSED ESG REFORMS FOR REGISTERED FUNDS

## ■ Proposed annual report disclosures

| Type of Fund      | Disclosure Requirements   |
|-------------------|---|
| ESG-Focused Funds | <ul style="list-style-type: none"><li>■ Information regarding how the fund voted proxies on particular ESG-related voting matters (if applicable)</li><li>■ Information regarding the fund's participation in ESG engagement meetings (if applicable)</li><li>■ Carbon footprint and WACI (if applicable)</li></ul> |
| Impact Funds      | <ul style="list-style-type: none"><li>■ Summary of progress towards achieving stated ESG impacts</li></ul>  |



# PROPOSED ESG REFORMS FOR ADVISERS

- Would apply to registered *and* unregistered advisers
- Proposed new **Part 2A (Brochure)** disclosures include descriptions of:
  - **Strategy** - ESG factors considered for each “significant” investment strategy or method of analysis, including whether and how the adviser incorporates a particular factor or combination thereof
    - If an adviser considers different ESG factors for different strategies, separate disclosures would be required for each.
  - **Criteria** - Any criteria or methodology used to evaluate, select, or exclude investments based on the consideration of ESG factors, including any:
    - internal methodology or third-party framework,
    - inclusionary or exclusionary screen
    - Any index utilized including the name and a description of how the index utilizes ESG factors
  - **Relationships with Related Persons** – Any material relationship or arrangement with any related person that is an “ESG consultant” or other service provider.
  - **Proxy Voting** - For an adviser that has specific proxy voting policies and procedures to include one or more ESG considerations when voting client securities, a description of the ESG factors that are considered and how they are considered.





# PROPOSED ESG REFORMS FOR ADVISERS

- **Advisers Sponsoring Wrap Fee Programs** – Would require disclosure regarding ESG factors considered in the selection, review, or recommendation of the PM or affirmative statement that do not assess the PM’s application of ESG factors.
- **Proposed new Form ADV Part 1A requirements** include:
  - Advisers managing **separately managed accounts** would be required to disclose:
    - Whether they “consider” ESG factors when managing such accounts
      - Advisers would be required to report if they use an integration, ESG-focused or impact strategy and the specific factors considered (i.e., environmental, social, and/or governance).
    - Whether they follow any third-party ESG frameworks (e.g., UN PRI) in connection with their advisory services, and identify any such frameworks.
  - **Advisers of private funds** (i.e., Section 3(c)(1) or 3(c)(7) funds) would be required to disclose:
    - Information about the use of ESG factors in managing each reported private fund, including the type of strategy and specific factors considered.
    - Whether the adviser conducts other business activities as, or has related persons that are, ESG consultants or other ESG service providers.





# EU: Sustainable Finance Disclosure Regulation (SFDR)



# KEY THEMES – GLOBAL SUSTAINABLE FINANCE DISCLOSURE REGULATION

- **Lack of consistent and comparable information**
  - No common definitions/philosophies of “sustainable finance” or “ESG”.
  - Lack of comparable metrics/methodology.
- **Knowledge gaps**
  - Preference for sustainable investments may not marry up with financial literacy, especially for retail investors.
- **Perceptions of performance and risk**
  - Difficulty comparing sustainable products and conventional investment products.
- **Connecting investors with sustainable products**
  - Key role for asset managers and financial advisors.
  - Importance of financial education for industry participants, especially financial advisors.



## ACTIVE MARKETING OF ESG FUNDS

- **‘Article 8’ Funds** – Funds that “promote, among other characteristics, environmental or social characteristics (or a combination of these) and the investee companies follow good governance practices.” Also known as “E/S Funds.”
- **‘Article 9’ Funds** – Funds that have “sustainable investment as their objective.” Also known as “ESG Funds.”



# EU SFDR and Taxonomy Regulation – A recent timeline

## Taxonomy Regulation

- TR disclosures relating to all environmental objectives (under Articles 5 and 6) start to apply.
- TR disclosures for non-financial undertakings relating to taxonomy-alignment start to apply.

10 March 2021

### SFDR

- Key disclosures become applicable at both entity and product level.
- (Level 1 only)

1 January 2022

### SFDR

- Periodic Reporting (Article 11 SFDR)

### Taxonomy Regulation

- (Level 1 only)
- The Taxonomy Climate Delegated Act, containing Technical Screening Criteria (TSC) in relation to two of the environmental objectives applies.

30 December 2022

### SFDR

PAI at product level, review disclosures (Article 7 SFDR). Only applicable if a financial market participant (FMP) has opted to consider adverse sustainability impacts (under Article 4 SFDR).

### SFDR

- Principle Adverse Impacts (PAI) disclosure requirements for larger participants and required website disclosure
- (Article 4(3) and Article 4(4) SFDR).

30 June 2021

2 August 2022

- Application of sustainability-related provisions under MiFID II & IDD.

1 January 2023

### SFDR RTS

Regulatory Technical Standards (RTS) developed under the SFDR apply.

1 January 2023





# Cross-Border Challenges of ESG Regulations



# CHALLENGES RAISED BY DISPARATE US AND NON-US APPROACHES

- Global managers will need to reconcile U.S. ESG disclosure rules against requirements in non-U.S. jurisdictions in order to market investment strategies globally
- In many cases, regulations governing the same subject matter impose similar requirements
- In others, the requirements are at odds with one another



# CASE STUDY: SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)

| SEC ESG Disclosure Rules  | SFDR  |
|---|---|
| No definition of ESG  | Definition of “Sustainable Investment”                  |
| ‘Integration Funds’   | ‘Article 6 Funds’ / ‘Article 8 Funds’                   |
| ‘ESG-Focused Funds’   | ‘Article 8 Funds’ / ‘Article 9 Funds’                   |
| ‘Impact Funds’  | ‘Article 9 Funds’ / ‘Article 8 Funds’                   |
| Scope: Funds & Advisers   | Scope: Funds & Advisers                                 |
| Focus on incorporation of ‘E,’ ‘S,’ and ‘G,’ into decision-making process | Focus on sustainability and sustainability risk factors |

\* *However, there’s no unambiguous translation from one classification framework to another.*





# DIVERGING PHILOSOPHIES AND APPROACHES TO DISCLOSURE REGIMES

| US  | EU  |
|---|---|
| <p>The proposed SEC regime <b>does not seek to actively promote sustainability</b>. Instead, it is focused on rooting out greenwashing.</p> <p>For example, the SEC's proposed expansion to the names rules, in order to prevent the misuse of ESG orientated fund names.</p> | <p>The EU has focused on <b>actively encouraging sustainable investment</b> and attracting capital into ESG funds.</p> <p>Under what has become a <i>de facto</i> labelling regime, Articles 8 and 9 are now considered 'badges of ESG-ness'.</p> |

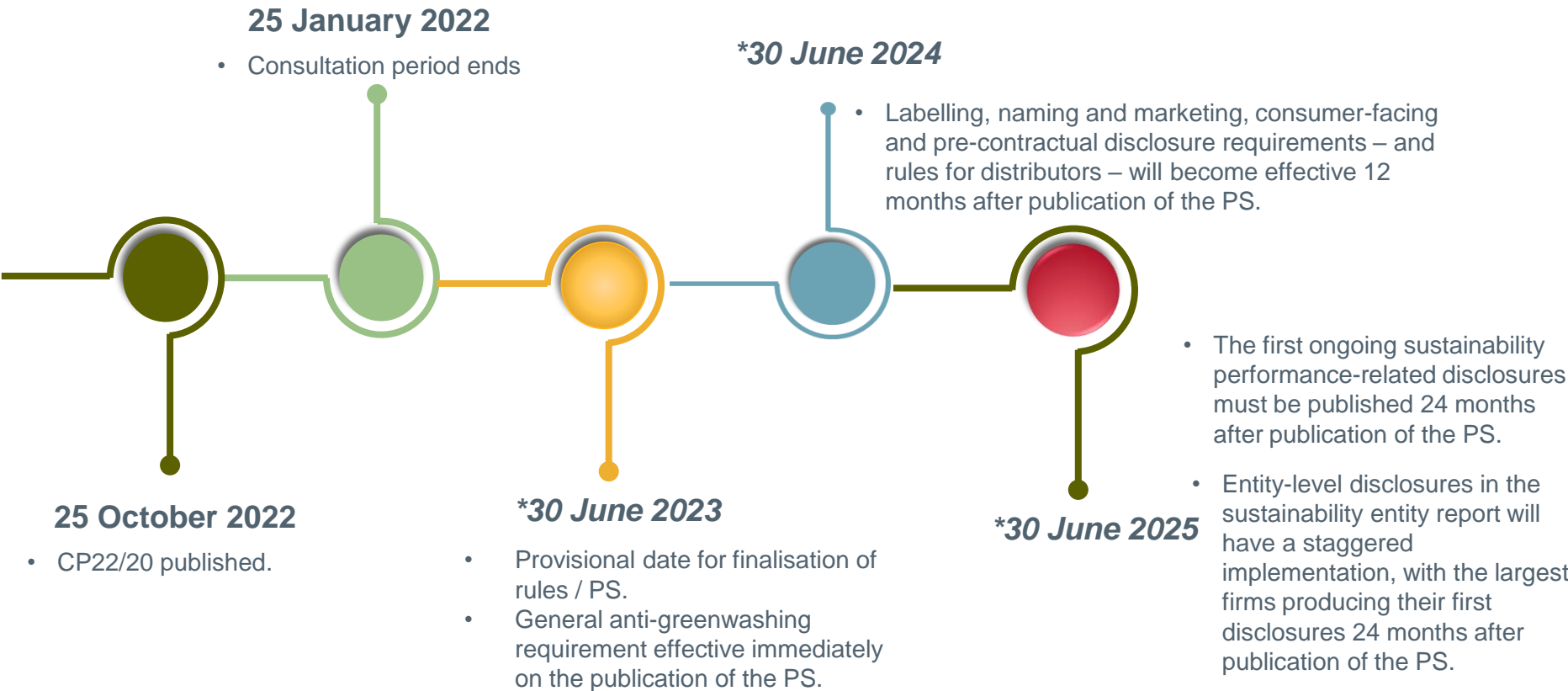


# KEY TAKEAWAYS

- Global asset managers marketing products across jurisdictions will have to grapple with *differentiated*, rather than harmonised disclosure regimes.
- Differences between disclosure regimes are underpinned by diverging philosophies on whether regulators should be actively promoting sustainable investment, or safeguarding against ‘greenwashing’.
- Challenges lie ahead in ensuring that funds marketed globally remain true to their own ESG strategies, rather than being dictated by regulatory intervention and the desire to market as a certain category.



# SDR and investment labels (CP22/20) – Next Steps



\* These dates are **provisional only** and are set by reference to the publication date of the policy statement in 2023 (CP22/20).

