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ESG and debt funds - EU and US status quo

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It is often considered that the EU stance on ESG is regulatory-driven, while the US is pursuing a market-driven approach.

The EU has been steering investments towards sustainable and climate transition activities for several years through its various regulatory frameworks, which has kept fund initiators busy. In the US, after several years of predominantly private sector led environmental, social and governance (**ESG**) integration, the US regulator is now in the process of adopting final rules on ESG disclosures for funds and advisors, underlining the increasing importance of ESG in the US.

Before delving into market tendencies and practices, it is important to address the primary interest of market participants – the ability to use data and disclosures under multiple frameworks. Below, the main elements of the EU and US framework are contrasted.

The EU and US frameworks

In 2022, the Securities and Exchange Commission (**SEC**) issued a proposal on two sets of ESG-related rules with considerable impact for funds and sponsors – one establishing a fund categorisation system based on ESG objectives and the other introducing ESG-related rules in existing fund naming conventions. The latter applied from December 2023, with a 24 or 30-month compliance deadline, depending on the volume of assets under management.

The SEC proposal distinguishes between three fund categories: "ESG-integrated" funds, which consider one or more ESG factors, "ESG-focused" funds with at least significant consideration for one or more ESG factors (including greenhouse gas emissions or a prominent "no-consideration" statement), and funds that pursue "ESG impact" strategies – meaning funds that have a stated goal to achieve a specific impact that generates specific ESG-related benefits. In any of the above categories, data sources and evaluation methodologies will have to be disclosed, as well as their performance against selected criteria to be evaluated, flanked by pre-contractual documentation, annual reports and marketing documents.

Even though website disclosures equivalent to those foreseen in the context of Sustainable Finance Disclosure Regulation (**SFDR**) (for example Principle Adverse Impact (**PAI**) statement or Article 10 SFDR) are not foreseen, the proposed regime is in principle fairly similar to the regulatory framework existing in the EU, notwithstanding any potential changes to come in the near future.

After three years of the application of the SFDR disclosure regime, and given that, practically speaking, Article 8 and 9 disclosures have been functioning more as a labelling regime, the EU is considering whether to keep the existing regime or to conduct an overhaul towards a proper labelling regime. In the latter case, the question remains whether and to which extent labels will be built on existing disclosures and whether a mandatory disclosure will be put in place for all market participants, regardless of their ESG category. Recent trends have shown that alongside the initial "greenwashing" tendency some market players are "greenhushing", that is deliberately not adhering to a specific regulatory ESG category and consequently not publishing sustainability-related information, either due to the belief that this does not bring any additional value to their investors, or in order to avoid the impression that the undertaken efforts are not sufficient.

The EU Commission has recognised the existence of these practices and the burden of overregulation and has expressed the intent to simplify existing regulations and facilitate compliance, especially when it comes to transition finance and small and medium-sized enterprise (**SME**) ESG reporting.

The issue raised by some US-based market participants is the absence of any underlying taxonomy which would categorise the fund's underlying investments and activities. However, as we can see from the experience in the EU regarding Taxonomy Regulation and the current reporting standards for companies under the Corporate Sustainability Reporting Directive (**CSRD**), the existence of such taxonomy will not necessarily render disclosures easier. Research showed that this was, in particular, the case with SFDR entity-level PAI disclosures, where it was found that less than one third of management companies were respecting the comply-or-explain principle, and the majority of published statements was incomplete.

Regarding fund names, the EU watchdog ESMA has abandoned its envisaged double threshold for sustainability-related terms in funds names. From the initially foreseen threshold of 50% of sustainable investments and within this limit an additional 80% threshold of environmental and social investments, it now lowered the requirements to a general minimum threshold of 80% of investments meeting sustainability criteria, alongside the application of Paris-aligned benchmark exclusions and substantial allocation to sustainable investments within the meaning of the SFDR.

The same rules will apply to transition, social and governance, and, as a separate group, environmental and impact-related strategies. Transition and impact-related strategies will have to be underpinned by a measurable path (towards transition), or impact. The SEC naming convention can be considered as aligned to these standards as it will impose a general 80% asset allocation threshold towards the type of investment featured in the name of the fund. This is intended to cover the fund's investment focus, but aims mainly at capturing terms that imply consideration of ESG factors.

Challenges for US investors

The experience shows that US asset managers conquering the EU market are fairly open and interested in the existing regulatory framework around ESG. Over the years the EU ESG regulations have evolved and many US manager have closely followed this evolution and become familiar with the rules. Where initially queries on, for example, the scope of website disclosures, differentiation between entity and manager-level disclosures, or applicability of PAI disclosures had to be addressed, discussions are now much more related to the actual implementation of thorough and ambitious ESG strategies in the day-to-day portfolio management in line with regulations.

This being said, a pragmatic and streamlined approach is often welcomed by US managers, in particular for sophisticated debt fund structures where levered and unlevered sleeves are being implemented, with parallel master-feeder structures including fund vehicles in different EU jurisdictions, most often Luxembourg and Ireland. It is therefore key to ensure a harmonized and integrated approach, with for example SFDR disclosures under Annex II responding to both, the regulatory expectations from the Central Bank of Ireland (**CBI**) and the Luxembourg Financial Sector Supervisory Authority (**CSSF**) in order to avoid a multitude of slightly differing sets of disclosures.

Another challenge currently arising for US managers is the surge of an anti-ESG movement in the US resulting in fragmented policy environment at federal and state levels. Some US institutional investors, for instance, therefore cannot invest in any fund product that imposes ESG related criteria, whereas in the same fund structure other investors will want to see a certain minimum commitment to ESG factors. The same fund structure may then have to integrate differing ESG appetite for different groups of investors.

This dilemma can result in complex structures with separate fund sleeves and portfolios managed by separate portfolio managers, each responsible for investments depending on whether ESG factors are being taken into consideration or not. In parallel fund structures, the provisions governing the functioning between the different sleeves, such as re-balancing clauses, need to be carefully looked at in order to avoid any regulatory or investor policy breach.

In both the EU and the US, the future integration of ESG factors into the regulatory landscape depends on various factors, and not the least political decisions which set the overall direction. The EU needs to show a clear and unambiguous path forward limiting overhauling of existing rules and overregulation in general, in order to remain attractive for US managers. On the other side, the US is becoming more and more fragmented with regard to ESG appetite, and it is to be hoped that the SEC rules are giving rise to a new ESG perception.

Ogier in Luxembourg are working with US asset managers on a daily basis and are very much accustomed to the issues that arise for US managers when reconciling the expectations from investors around the globe and ensuring compliance with different sets of regulations. Our experts in our Luxembourg and Ireland offices, together with our dedicated Sustainable Investment Consulting team, are available to assist you with any project or questions you may have in this field.

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