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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING CONSIDERATIONS IN THE U.S. AND THE EU

ESG investing appears to be increasingly popular in the U.S., with investment advisers introducing new ESG-related products and modifying existing investment strategies to include ESG-elements. In this article, the authors begin by giving an overview of factors in an ESG-approach, and existing standards and frameworks. They then discuss the U.S. regulatory framework, focusing on the Advisers Act, the Investment Company Act, and ERISA. Next, they turn to the EU regulatory framework, addressing new EU regulations and other ESG-related legislative activity in the past two years. They close reminding asset managers of the need to develop a clear internal view of the ESG investment process.

By Julien Bourgeois, Nicholas Di Lorenzo, and Christopher Dotson *

Environmental, social, and governance ("ESG") investing, is a growing priority for issuers, investors, asset managers, and regulators. Investors' consideration of the social, governance, and environmental impacts of their investments is not only transforming the proposition offered by many asset managers and the ways in which those asset managers operate, but is also affecting the way that issuers and asset managers think about performance and disclosure. Therefore, understanding the legal and regulatory considerations and requirements that apply and are likely to come to ESG investing is of vital importance.

After having been a focus of some European institutional investors and asset managers for several years, ESG investing appears to be having a breakout moment in the United States. ESG investing is increasingly present in U.S. asset management media, and it is widely perceived as being popular with U.S. millennial investors and many other groups. SEC-registered investment advisers are currently introducing new ESG-related products and modifying existing investment strategies to include ESG elements at an unprecedented pace. Both the nature and volume of ESG-related regulatory developments in the United States can and should be expected to accelerate in the

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FORTHCOMING

- ***THE EFFECTS OF COVID-19 ON NEGOTIATED M&A TRANSACTIONS***

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near term. Among other factors contributing to this trend are indications that the new U.S. Presidential administration will pursue a broad climate-related agenda, including, among other things, causing the United States to rejoin the Paris Agreement (commonly referred to as the Paris Climate Accord) and seeking to implement new regulations related to the disclosure of climate-related financial risks and greenhouse gas emissions by corporate issuers. The current phenomenon of ESG investing in the United States can be traced back to a decades'-long history of responsible investing in the U.S., but comes with many new and old complexities.

However, the absence of regulatory frameworks in certain jurisdictions, the proliferation of competing ESG standards and frameworks from industry or other organizations, and the lack of a uniform definition of what constitutes ESG or ESG investing present a number of potential challenges for U.S., European, and other globally oriented asset management firms. In light of the rapid evolution of ESG and ESG investing in recent years, this article seeks to provide an overview of the current state of ESG and ESG investing, as well as to identify certain core legal and compliance considerations for asset managers when developing new or enhancing existing ESG investing processes. The article begins by providing an overview of the development of ESG investing over time; it then summarizes existing ESG frameworks and standards before reviewing the current U.S. and EU regulatory frameworks governing ESG investing.

OVERVIEW OF ESG INVESTING

In some ways, ESG investing is not new. In fact, some scholars have concluded that iterations of ethical and responsible investing have been in existence for centuries.[1] However, the idea of ESG investing in the U.S. can be traced back to the early 1960s. While ESG investing has continued to evolve since that time and is now entering into mainstream parlance, there is still no uniform definition for either what constitutes ESG investing or the various practices that fall under its umbrella.[2] However, ESG investing can broadly be described as a set of criteria that are used to evaluate a company or business by assessing the company or business's performance along environmental, social, and governance factors. Thus, many view ESG investing as an investment process or strategy *rather than* a specific asset class.

Background

No list of ESG factors is exhaustive, and investors and managers will consider and weigh factors differently based on their individual priorities and values. However, for example:

- *Environmental* factors can include effects on climate change, greenhouse gas emissions, use of renewable or non-renewable resources, waste generation, and approach to recycling, pollution, deforestation, and treatment of animals.

- *Social* factors can include working conditions, effect on local communities, approach to health and safety, human rights, and child labor.

- *Governance* factors relating to operations and accountability can include executive pay, bribery and corruption, diversity and equal opportunities, tax strategy and transparency, board-level oversight and independence, and shareholder rights.

Even after an institution has developed clear criteria for the types of factors involved in their ESG investing approach, the implementation of these factors can take — and often have taken — a wide variety of forms. Early techniques often used simple negative screens. For example, companies that act in violation of certain standards would be excluded from the portfolio. Over

[1] Mateo Bidoggia, et al., "*SRI ESG Investments*," SIPA Columbia University, at 3 (2016) (explaining that socially-responsible investing's ("SRI") origins can be traced back to biblical times. The organization traces SRI to the Torah and Quran in directing those of Judaism and Islam on how to invest.); *see also* Blaine Townsend, From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing, at 3 (2016).

[2] For example, "socially responsible investing," "sustainable or responsible investing," and "impact investing."

time, new techniques have been developed and employed. For example, firms might take a proactive approach to identify and invest only in companies that meet their specified ESG criteria (positive screen). Other ESG approaches focus on leveraging power held through existing investments to influence better behavior by current holdings (voting shares/shareholder activism). Further, some firms conduct portfolio reviews to assess ESG risk exposure or discuss in annual reports the specific criteria applied.

In light of the complexity and potential subjectivity associated with implementing ESG investment principles, many investors rely on ESG criteria developed by other organizations. In the absence of clear regulatory action, non-governmental organizations ("NGOs") and bodies have become key standard-setters driving how asset managers, investors, issuers, and the markets think about ESG. However, the standards and principles advanced are often specific to each NGO or other body and, as a result, do not provide market participants with a uniform or consistent basis for comparison when considering multiple standards contemporaneously. Certain institutional investors, such as sovereign wealth funds and state public pension funds, have also developed their own ESG investment principles and methodologies. In addition, investors and managers are increasingly turning to private for-profit and non-profit organizations' ESG investment ratings and indices.

Overview of Existing Standards and Frameworks

The existing ESG standards and frameworks can generally be classified in two categories: (1) principles-based standards or (2) reporting and disclosure frameworks. These two categories often operate in parallel. Principles-based standards serve as a set of standards to which an investment company will hold itself in its implementation of ESG principles; reporting and disclosure frameworks allow investors to obtain information regarding ESG performance on a consistent basis across investment products or sponsors claiming compliance with such frameworks.

Globally, the Principles for Responsible Investment ("PRI") are the most commonly used responsible investing standard.[3] The PRI is an initiative developed in partnership with the United Nations Environment Program Finance Initiative and the United Nations Global Compact. The PRI's overarching philosophy is reflected in the affirmation required to be made by each PRI signatory:

> As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance ("ESG") issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes, and through time). We also recognize that applying these Principles may better align investors with broader objectives of society.

In light of this affirmation, a PRI signatory is asked to consider integrating responsible investing into the signatory's investment decisions through consideration of six core principles: (1) to incorporate ESG issues into investment analysis and decision-making processes, (2) to be active owners and incorporate ESG issues into ownership policies and practices, (3) to seek appropriate disclosure on ESG issues by the entities invested in, (4) to promote acceptance and implementation of the PRI principles within the investment industry, (5) to work together to enhance effectiveness in implementing the PRI principles, and (6) to report on activities and progress towards implementing the PRI principles. Importantly, the PRI ─ through its principles ─ provides a suggested framework for responsible investing. It does not, however, identify specific criteria that should or are required to be part of an ESG strategy utilized by a signatory (*e.g.*, no investments in tobacco companies) and also does not identify companies that should be excluded for ESG-related reasons.

The Sustainable Development Goals, adopted as part of the 2030 United Nations Sustainable Development Agenda, are also often used as the influence or basis for existing frameworks, standards, and initiatives applicable to ESG investing.[4] In addition, the Sustainable Accounting Standards Board ("SASB") is an independent standard-setting organization that develops reporting standards to enable businesses to communicate financially material sustainability information to their investors. The SASB standards identify the ESG factors that SASB believes are most likely to materially impact

[3] UNPRI, ABOUT PRI, https://www.unpri.org/pri/about-the-pri.

[4] SDRG, THE 17 GOALS, https://sdgs.un.org/goals. The Sustainable Development Goals include, among other things, the goals of ending poverty and hunger, combating climate change, ensuring responsible consumption and production, promoting sustainable economic growth, full and productive employment, and decent work for all.

the financial condition or operating performance of companies in which funds invest. Finally, the Global Reporting Initiative ("GRI") set forth the first global standards for sustainability reporting. The standards are divided into economic, environmental, and social categories, and can be used by reporters as the basis for preparing publicly available sustainability reports.

Outside of these global standard-setting organizations, institutional investors (including sovereign wealth funds and state public pension funds) have also developed ESG principles and methodologies, and private for-profit and non-profit organizations have developed ESG investment ratings and indices that investors increasingly rely on. These ESG standards and frameworks should not be underestimated, as they often form the basis for investment restrictions, investor reporting, and evidence of ESG integration. In fact, ESG criteria published by certain European asset management organizations, ESG consultants, and national pension funds take a more directed approach than those suggested by the global standard-setting organizations. These sources set forth specific criteria that should be used in ESG-driven investment decisions, and many identify particular companies that should be excluded from investments as a result of violating such criteria. More than 100 companies presently appear on these exclusion and observation lists due to their alleged involvement in coal-based energy production, promotion of tobacco, weapons sales, and human rights abuses. Advances in the development of specific European ESG criteria parallel the proposal and implementation in recent years of concrete regulatory developments in the EU addressing ESG investing.

Efforts to Develop Uniform Standards and Frameworks

As discussed above, the absence of either a clear definition of what constitutes ESG investing or uniform standards related to such investments has led to the development of numerous standards and frameworks being utilized by market participants in the ESG space. While the frameworks or standards advanced by NGOs or other bodies are often clear in isolation, the proliferation of such standards and frameworks has come at the expense of uniformity. However, recent developments suggest a growing industry consensus for the need for such uniformity to allow for effective comparison among issuer disclosures and investment adviser processes. For example, in September 2020, five leading ESG standards organizations issued a joint statement expressing their intent to work together to develop a comprehensive corporate reporting framework.[5] Separately, in the asset management space, the Investment Company Institute, a leading industry trade group representing the U.S. mutual fund industry, issued a white paper in July that seeks to develop a uniform framework through which to describe registered funds' use of ESG factors.[6] Under that framework, ESG funds would be classified into one of two categories with each category having its own definition. Although these developments would not have the effect of substantive regulation, each is important in that they seek to develop uniformity in both the nomenclature used to discuss ESG and ESG investing, as well as uniformity in practices to facilitate investor understanding and comparative capabilities in the ESG space.

U.S. REGULATORY FRAMEWORK

Unlike the EU (discussed below), neither the SEC nor its staff has yet adopted any rule or regulation, or provided guidance that would establish specific requirements for an investment adviser's use of ESG principles. As a result, existing U.S. regulations and guidance ─ adopted or provided outside the ESG context ─ currently govern the integration of ESG principles in a U.S. investment adviser's investment process.

Existing Laws and Frameworks

A U.S. investment adviser's integration of ESG principles for U.S. mandates is governed by existing requirements under the Investment Advisers Act of 1940, the Investment Company Act of 1940, and the Employee Retirement Income Security Act of 1974 (ERISA).

Advisers Act Considerations – Regulatory Framework. At the outset, it is important to note that a U.S. investment adviser's incorporation of ESG principles is subject to the fiduciary duty owed by the adviser to its clients under the Advisers Act.[7] The SEC has historically interpreted Section 206 of the Advisers Act to impose on an investment adviser a fiduciary

[5] Statement of Intent to Work Together Towards Comprehensive Corporate Reporting, https://www.sasb.org/blog/progress-towards-a-comprehensive-corporate-reporting-system/. The five organizations that issued the joint statement are the CDP, the Climate Disclosure Standards Board, the Global Reporting Initiative, the International Integrated Reporting Council, and the Sustainable Accounting Standards Board.

[6] *Id.*

[7] 15 U.S.C. § 80b-6(1), (2), (4).

duty.[8] Under this interpretation, an investment adviser has an affirmative duty to act solely in the best interests of its clients, and to make full and fair disclosure of all material facts.[9] However, in 2019, the SEC issued interpretive guidance related to the scope of this duty that codified the SEC's interpretation of the fiduciary duty owed under Section 206 of the Advisers Act. Specifically, under the 2019 Interpretation, the SEC reiterated that an investment adviser owes a duty to act in the best interests of each client at all times.[10] Importantly, the 2019 Interpretation reflects the SEC's view that a client and adviser may shape the nature of their relationship (including the scope of the duty owed) by agreement.[11] As a result, as discussed below, it is crucial that U.S. investment advisers structure their ESG investing programs to be reasonably sure that the use of ESG principles is consistent with the client's best interests as these could be reasonably understood from any client agreements, offering documents, disclosures, and marketing materials.

Advisers Act Considerations – Compliance Considerations. To seek to ensure that the use of ESG principles comports with an investment adviser's fiduciary duties to its clients, the adviser should generally (1) evaluate the client's investment objectives for both new and existing mandates and (2) codify the intended use of ESG principles and associated risks in the applicable agreements and other documents that shape the contours of the adviser's relationship. In broad terms, this could require an investment adviser to:

- Clearly articulate the ESG investment strategy or strategies used and the extent to which such strategies will be used in the investment process. Only by doing so can an adviser accurately disclose *all material aspects* of the use of ESG principles in the adviser's investment strategy, as well as any related risks or potential conflicts of interest and, as a result, be reasonably assured that a client has provided informed consent to the use of ESG principles.

- Establish processes to oversee the incorporation of the adviser's ESG strategies, including consideration of new or enhancements to existing Rule 206(4)-7 compliance policies and procedures. This may include policies, procedures, or protocols related to: (1) ESG investment oversight and governance protocols, (2) accuracy of disclosures, and (3) applicable recordkeeping requirements.

- In circumstances where the adviser retains a sub-adviser to assist with the day-to-day portfolio management activities of the vehicle, assess whether processes are in place to oversee the implementation of ESG considerations by the sub-adviser.

- Evaluate and understand the potential differences in methodologies, assumptions, and approaches used by issuers in reporting ESG data, and consider developing internal frameworks or other guidelines to seek reasonably to assure that the data is incorporated into the investment process in a uniform way and, by extension, to seek reasonably to assure that differences in data reporting do not result in unintended investment decisions. This could include, among other steps, implementing a process for conducting due diligence by third-party service providers (for example, ESG data, ratings, and index providers) who prepare and package ESG data for purchase or use by investment advisers and other financial industry participants.

Investment Company Act Considerations. Neither the SEC nor its staff has adopted, or has yet proposed to adopt, any rule or regulation, or provided formal guidance, regarding the use of particular ESG factors by regulated funds in the United States. However, similar to the Advisers Act context, the existing regulatory framework applicable to registered fund disclosures, board of director/trustee responsibilities, and proxy voting are informative and could be considered by U.S. fund sponsors.[12]

[8] Commission Interpretation Regarding Standard of Conduct for Investments Advisers, Investment Advisers Release No. IA-5248 (June 5, 2019); *see also SEC v. Capital Gains Res. Bureau, Inc*., 375 U.S. 180, 189–91 (1963).

[9] 2019 Interpretation, 15 U.S.C. § 80b-6(1), (2), (4).

[10] *Id.* at 5, 29 (noting that while the 2019 Interpretation contains additional detail on certain matters not included in prior SEC statements, it is intended to reaffirm and clarify certain aspects of an adviser's fiduciary duty under the Investment Advisers Act and not to establish new fiduciary duties).

[11] Specifically, the 2019 Interpretation stated that an adviser's "fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, *provided that there is full and fair disclosure and informed consent*." *Id.* at 9 (emphasis added).

[12] Registered investment companies are typically organized under applicable state law and authorized to conduct their business pursuant to organizational documents that set forth the purposes for which the investment company may be operated. Modern state corporation statutes afford significant flexibility in

Although the Investment Company Act does not directly regulate an investment adviser's use of ESG principles, the existing disclosure regime may require a registered fund to disclose such principles. As a general matter, a registered investment company that incorporates ESG principles in its investment strategy is required to disclose information about the use of those factors in the fund's registration statement to the extent that the factors would have a material impact on the investment company and its investments. In this regard, in reviewing registration statements filed by investment companies that use ESG factors, the SEC staff's disclosure review office often provides comments that focus on a fund's ESG criteria,[13] compliance with Rule 35d-1 under the Investment Company Act (referred to as the "names" rule), the use of ESG data in the investment process,[14] ESG risk disclosure,[15] and proxy voting.[16] As a result, it is important to consider the content, relative mix, and accuracy of ESG-related disclosures prior to incorporating ESG factors into a registered fund's investment strategy. This may include, among other things, verifying any material facts related to the fund's use of ESG principles or standards, and disclosing any material facts that might conflict with a fund's stated ESG standard or position.

Rule 35d-1 under the Investment Company Act requires a registered investment company with a name suggesting that the company focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name. Terms that describe investment strategies, rather than types of investments or asset classes, are excluded from the scope of Rule 35d-1. Notwithstanding the view taken by many U.S. asset managers, the SEC staff appears to sometimes argue that ESG investing is a type of investment ─ rather than an investment strategy ─ that requires a fund that includes "ESG" or similar terminology in a fund's name to adopt an 80% policy pursuant to Rule 35d-1. On March 2, 2020, the SEC published a request for comment on Rule 35d-1 in which the SEC requested comment on investment funds that include qualitative criteria such as ESG investment mandates.[17] Whether and to what extent the March 2020 request for comment results in specific guidance regarding the relationship between Rule 35d-1 and ESG investing is yet to be seen. However, U.S. asset managers should be aware of the potential disconnect between the industry view of ESG investing as an investment strategy and the SEC staff position that ESG investing represents a type of investment subject to Rule 35d-1.

Increasing U.S. Regulatory Focus on ESG Investing

Irrespective of any formal rulemaking or guidance issued by the SEC or its staff regarding investment advisers' use ESG factors, the SEC and its staff *have* expressed a clear intention to prioritize oversight of ESG considerations in general and the use of ESG factors in the investment process more specifically. This focus has been evidenced in recent years by the examination priorities issued by the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the formation of the ESG Subcommittee of the SEC's Asset Management Advisory Committee ("AMAC").

OCIE Examination Priorities. Among other things, the 2020 OCIE examination priorities indicate that OCIE will continue to review registered investment adviser

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delineating the purposes and authorities of a registered investment company. However, before implementing an ESG investment strategy, fund managers should confirm that the authorizations and purposes provided in the fund's organizational documents are sufficiently broad to capture the ESG investment process being considered.

[13] These comments relate to the type of ESG information a fund or adviser uses, and where that information comes from. For example: "Please add disclosure regarding . . . any specific criteria for evaluating what constitutes an 'ESG' company."

[14] Staff comments focus on where ESG factors are integrated into the financial investment process, for example, through screens, affirmative weighting, etc. For example: "Please clarify how each Fund utilizes ESG factors in implementing the Fund's investment strategy."

[15] Staff comments relating to risk disclosure focus on the risks of ESG investing. Funds that listed ESG in their name or as a strategy were asked to include a discussion of ESG investment risk when they did not already do so. For example: "Revise the ESG Strategy Risk to more fully disclose the risks of such strategy including limiting the number of companies in which the Fund can invest and potential impact to the Fund's performance relative to Fund's that do not utilize an ESG strategy."

[16] Comments relating to the use of proxy voting focus on whether the fund or adviser will vote proxies to advance ESG goals. Many of the staff comments are focused on whether the fund or the adviser will use the same or different/tailored proxy voting guidelines for ESG funds. For example: "Explain whether the Fund envisions using tailored proxy voting guidelines consistent with its socially responsible investing philosophy and if not, why not."

[17] Request for Comment on Fund Names, Investment Company Act Release No. 33,809 (Mar. 2, 2020).

compliance programs with a focus on "the accuracy and adequacy of disclosures" related to strategies "focused on sustainable and responsible investing, which incorporate" ESG criteria.[18] Consistent with the discussion above, these enforcement priorities indicate that OCIE intends to focus its examination efforts in this area on whether (1) an investment adviser's practices conform to its disclosures to clients and (2) investment advisers who claim to use ESG principles have established policies and procedures reasonably designed to assure that any investment decisions are made consistently with those claims. However, even prior to the publication of the 2020 OCIE examination priorities, OCIE had already begun conducting a series of examinations to review the ESG practices of registered investment advisers.[19] As part of these reviews, the SEC and its staff have signaled a focus on whether an adviser claiming to incorporate ESG principles does so consistent with applicable disclosures and regulatory filing and consistent with the adviser's fiduciary duty to clients. Most significantly, consistent with their approach to investment adviser regulation in other areas, the SEC and its staff have not expressed an intent to review ─ nor have they in practice reviewed ─ the merits of an ESG investment view.

SEC ESG Subcommittee. The SEC formed the ESG Subcommittee of the AMAC in response to the increasing incorporation by asset management industry participants of ESG principles in their investment processes and product offerings.[20] The ESG Subcommittee, like the AMAC more broadly, is comprised of a group of industry professionals (rather than SEC staff members) and is tasked with providing a diverse set of perspectives on the development of potential rulemakings and/or other SEC or staff guidance, which may be helpful as ESG investing continues to grow in prominence in the U.S. asset management industry. As of the date of this article, the ESG Subcommittee is evaluating preliminary recommendations for regulatory action in five core areas affecting ESG investing: (1) seeking to define whether ESG investing focuses on alignment with investor preferences or the generation of economic value, and the associated disclosure implications (including the appropriate treatment of ESG products under Rule 35d-1 under the Investment Company Act), (2) quantifying and disclosing ESG performance attribution, including in the selection of appropriate ESG benchmark indices, (3) consideration of proxy voting in ESG strategies,[21] (4) enhancements to ESG issuer disclosures, and | (5) ESG rating systems and benchmark indices.

It is not possible to predict whether or to what extent the SEC or its staff will provide rulemaking or guidance on ESG investing in the future. The nature of any such rulemaking could also be impacted by the relative mix of the SEC Commissioners in office, as well as the Chairman of the SEC ─ who, under the new U.S. Presidential administration, is more likely to pursue ESG-related initiatives. However, although the SEC and its staff would not be bound by the ESG Subcommittee's recommendations, the topics being evaluated by the Subcommittee should be viewed as directional indicators of potential future areas of regulatory action by the SEC in the ESG investing space.

U.S. PENSION PLAN DEVELOPMENTS

A large amount of global investment capital is held under private U.S. pension and other employee benefit plans governed by ERISA. ERISA is a comprehensive and complex regulatory scheme and the fiduciary responsibilities imposed by ERISA are extremely strict.[22]

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[18] OCIE, 2020 EXAMINATION PRIORITIES (Jan. 7, 2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[19] Among other things, OCIE's prior examinations focused on: (1) the adviser's process for defining and making investment decisions related to ESG-related investments, (2) adherence to any ESG standards or frameworks with which the adviser claims compliance, (3) adherence to client guidelines, (4) use of third-party data providers (if any), including due diligence of the provider and the data acquired, and (5) accuracy of disclosures, including with respect to the presentation of performance-related information and retention of associated supporting documentation.

[20] In May 2020, the Investor Advisory Committee of the SEC separately issued recommendations regarding whether ESG disclosures are material facts that should be incorporated into applicable disclosures for SEC-registered corporate issuers pursuant to the existing disclosure regime applicable to such issuers.

[21] At its September 2020 meeting, the ESG Subcommittee indicated that it would not proceed with this workstream in light of recent regulatory action taken by the SEC and its staff in the proxy voting context more broadly.

[22] *See e.g.*, *Henry v. Champlain Enters*., 334 F. Supp. 2d 252, 270–72 (N.D.N.Y. 2004) (citations omitted), vacated and remanded, 445 F.3d 610 (2d Cir. 2006); *Henry v. U.S. Trust Co. of Cal.,* 569 F.3d 96, 100 (2d Cir. 2009); *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982), cert denied, 459 U.S. 1069.

In the past the U.S. Department of Labor (the "DOL") developed guidance for ERISA plans on economically targeted investments ("ETIs"), defined as "any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor."[23] This guidance stated that ERISA's prudence and other general fiduciary principles do not prevent plan fiduciaries from investing in ETIs, as long as the expected rate of return is commensurate with alternative investments that have similar risk characteristics and are otherwise appropriate.[24]

Evolution of DOL Views over Time

The tone of the DOL on these issues has fluctuated over time, including as a result of changes in U.S. presidential administrations. Specifically:

- *2008:* A Republican administration noted that ERISA "does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan" and that a fiduciary investing in an ETI would first have to conclude "that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the economic impact on the plan."[25]

- *2015:* A Democratic administration indicated that ESG considerations "may have a direct relationship to the economic value of the plan's investment," and that in such instances, ESG issues "are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices." That same Democratic administration also noted that "fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors."[26]

- *2016-17:* After the 2016 election, the DOL, under a Republican administration, issued Field Assistance Bulletin ("FAB") 2018-01. On its face, FAB 2018-01 is intended to provide guidance to national and regional DOL offices to assist in addressing questions they may receive from plan fiduciaries and other interested stakeholders about Interpretive Bulletin ("IB") 2015-01 and IB 2016-01. More generally, though, FAB 2018-01 arguably signaled yet another shift in tone regarding the interpretation and application of underlying ERISA principles.[27]

- *2018:* A Republican administration in 2018 warned that fiduciaries "must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision," and that "[i]t does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors."[28]

Recent Developments in the Treatment of ESG under ERISA

FAB 2018-01 provides some insights regarding shareholder-engagement as addressed in IB 2016-01. Specifically, the DOL noted that IB 2016-01 was "not intended to signal that it is appropriate for an individual plan investor to routinely incur significant expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors." IB 2016-01 was similarly "not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues relating to such companies." Rather, only in limited circumstances would it be prudent to expend plan assets to actively engage with company management about "important corporate governance reform issues or other environmental or social issues," where such issues pose "significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders," including "important corporate governance reform issues or other environmental or social issues."

Within the past year the DOL has proposed two new regulations dealing with ESG investing, marking the first time that the DOL has sought to codify the proper treatment of ESG considerations in regulatory language.

[23] 80 Fed. Reg. 65135 (October 26, 2015).

[24] *Id.*

[25] 29 CFR § 2509.08-01.

[26] 29 CFR § 2509.2015-01.

[27] FAB 2018-01.

[28] *Id.*

The first regulation, which has now been finalized, relates to the consideration of non-pecuniary factors that will likely have a pointed impact on the use of ESG factors in the context of investment decisions by fiduciaries of employee benefit plans subject to ERISA.[29] The final regulation, makes clear that ERISA plan fiduciaries "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives," and that fiduciaries "are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals."

The second regulation, proposed in August 2020, would apply to how fiduciaries under ERISA consider decisions with respect to the voting of proxies and other exercises of shareholder rights associated with investments made by plans subject to ERISA.[30] The regulation states that a plan fiduciary must vote on matters it determines would have an economic impact; and must not vote on matters it determines would not, and further reinforces the DOL's belief that the consideration of non-pecuniary factors, including ESG-related matters, can result in breaches of ERISA fiduciary duty.

While shifts in regulatory tone and emphasis under ERISA surrounding ESG considerations have been and may continue to be significant, it may be expected that ERISA's fundamental emphasis on investment performance will remain. Whereas in the past ERISA fiduciaries may have felt comfortable selecting strategies that included ESG factors so long as those factors would not be harmful to economic returns, the final ESG-related regulation likely places more emphasis on requiring fiduciaries to justify the positive economic benefits of such strategies. A possible effect of this regulatory initiative will arguably be to increase the focus of ERISA plan fiduciaries and investment managers alike on affirmatively identifying the positive economic benefit of ESG-type thinking, as opposed to proceeding on the basis that considering ESG may not be harmful to economic returns. Fiduciaries interested in considering ESG factors may want to consider focusing on proper process, and on being able to show that due consideration has been given to appropriate investment-related factors, before embarking on any ESG-included approach.

[29] 85 Fed. Reg. 72856.

[30] 85 Fed. Reg. 55219.

EUROPEAN REGULATORY FRAMEWORK

The European Union ("EU"), its member states, and other jurisdictions outside the U.S. have already made significant strides in developing and implementing ESG standards through new regulations and amendments to existing directives and regulations.

Regulatory Standards

Historically, EU-level regulations have focused on either the environmental, social, or governance prong of ESG generally or ESG investing in particular. A commonly cited EU regulation in this regard ─ the Shareholder Rights Directive ─ focused on governance matters by encouraging long-term shareholder engagement and transparency.[31] However, as ESG investing gained priority on the EU's regulatory agenda and as EU member states increasingly commit to implementing the Sustainable Development Goals, EU-level regulations have correspondingly broadened in focus.

In 2018, the EU issued an "action plan" for sustainable finance. Central to this plan are two new EU Regulations ─ (1) the Taxonomy Regulation (a unified classification system of sustainable economic activities)[32] and (2) the Disclosure Regulation (regulation governing sustainability-related disclosures in the financial services sector).[33] In relevant part, the Taxonomy Regulation is intended to provide a common language to identify which activities and financial instruments can be considered as environmentally

[31] The final text of the Shareholder Rights Directive II, as published in the Official Journal of the European Union, can be found *at* https://eur-lex.europa.eu/eli/dir/2017/828/oj. In relevant part, the Shareholder Rights Directive established (1) requirements designed to facilitate identification of an issuer's shareholders and the exercise of shareholder rights and (2) specific requirements intended to encourage shareholder engagement, such as through requirements related to information exchanges between issuers, the exercise of shareholder rights, cost transparency, public disclosures, remuneration of directors, and related party transactions.

[32] 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.

[33] Regulation (EU) 2020/852 of the European Parliament and Council for the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector.

sustainable to be used by investors, financial institutions, companies, and issuers. Similarly, the Disclosure Regulation intends to create a unified understanding of what constitutes "sustainable investment," and a uniform set of disclosure and reporting obligations on issues of sustainability relating to investment activities. However, the Shareholder Rights Directive, the Taxonomy Regulation, and the Disclosure Regulation represent only a small portion of the ESG-related legislative activity being conducted in the EU during the past two years. Specifically, among other actions:

- The EU published draft amendments to MiFID II in the form of a delegation regulation that would require asset managers to consider ESG factors when providing investment advice to clients.[34]

- The European Securities and Markets Association ("ESMA") published technical advice on integrating sustainability risks and factors into the Alternative Investment Fund Managers Directive 2011/61/EU (also known as "AIFMD") and the Undertakings for Collective Investment in Transferable Securities Directive 2009/65/EC (also known as the "UCITS Directive").[35]

- The EU amended the existing Benchmarks Regulation[36] through the adoption of new Low Carbon Benchmark Regulations[37] which, among other things, seeks to improve the transparency of methodologies in preparing ESG benchmark indices and to advance standards used in preparing low carbon benchmark indices.

- The European Commission launched a public consultation in February 2020 regarding the Commission's review of the Non-Financial Reporting Directive.[38] The Commission's review is intended to encourage companies to develop a responsible approach to business while ensuring that companies required to disclose non-financial information on social and environmental impact do so in a manner that provides appropriate access to relevant information.

Impact of European Union Regulatory Developments

Recent regulatory developments affecting ESG investing in the EU should be expected to impact both the EU and U.S. asset management industries. Although the specific impact varies by regulation, the recent ESG-related regulatory developments potentially impact a wide range of market participants. This includes a variety of financial market participants ─ such as alternative investment fund managers, portfolio managers, and UCITS management companies – and financial products – such as UCITS, segregated mandates, pension products, and alternative investment funds.

Increasingly, asset managers operate globally integrated businesses. As a result, regulatory developments may also impact ─ both directly and indirectly ─ U.S. investment advisers. For example, one or more of the above-referenced EU regulatory developments could *directly* impact a U.S. investment adviser if the investment adviser either: (1) has an EU affiliate, (2) offers a product in the EU, or (3) manages accounts for EU clients. In addition, these EU regulatory developments could also *indirectly* impact U.S. investment advisers to the extent that EU-based investors become accustomed to advisers responding to ESG-related requests in foreign jurisdictions. These considerations are, of course, specific to EU ESG-related

[34] The text of the delegation regulation can be found *at*: https://eur-lex.europa.eu/legal-content/GA/ALL/?uri=PI_COM:Ares(2018)2681500. This could include, among other things, a requirement to conduct a mandatory assessment of a client's ESG preferences, integrate those preferences into the management of the client's account, and provide reporting regarding how a specific product meets a client's ESG preferences.

[35] Specifically, ESMA recommended that (1) organizational procedures and the management of conflicts of interest take into account sustainability risks and that (2) "alternative investment fund managers" and management companies assess their level of resources and expertise for integrating sustainability risks and that such managers and companies specifically consider sustainability risks when selecting and monitoring investments.

[36] The final text of the existing Benchmarks Regulation, as published in the Official Journal of the European Union, can be found *at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN.

[37] The final text of the Low Carbon Benchmark Regulation, as published in the Official Journal of the European Union, can be found *at* https://eur-lex.europa.eu/legal content/EN/TXT/PDF/?uri=CELEX:32019R2089&from=EN.

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[38] The text of the Non-Financial Reporting Directive, as published in the Official Journal of the European Union, can be found *at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095.

regulatory developments and supplement — rather than supersede — other considerations for operating a globally-integrated asset management business, such as coordination of disclosures, compliance policies and procedures, and other matters.

CONCLUSION

ESG is not a new phenomenon, but its significance for asset managers is growing and should be expected to continue to grow in the future, particularly under a Democratic administration. The continued media scrutiny of sustainability and environmental pressures, "millennials" forming a greater proportion of the investing population and more vocal demands for a fairer society, have made ESG an increasing priority for investors and, particularly in Europe, a key consideration in asset allocation. As ESG investing increases in popularity, advisers will need to consider the best way to reconcile preferred ESG investment processes with applicable fiduciary and other regulatory standards. In some cases, compliance with such standards will not be required by law but, instead, imposed upon asset managers by clients who have become acclimated to regulatory norms in other parts of the world.

While this article provides an overview of certain core considerations regarding the use of ESG factors in the management of U.S. and European investment products, asset managers must remember that effectively incorporating ESG factors or principles first requires the development of a clear, easily-elaborated statement of the ESG process utilized. Only by first developing a clear internal view of the ESG investment process can an asset manager — whether in the United States or elsewhere — seek to comply with applicable regulatory standards currently in effect and effectively pivot to address the future regulatory changes that are certain to occur both in the U.S. and abroad. ■

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