29 June 2022

Ecofin Editorial: From the desk of Ecofin's Sustainability Strategist

Anny Giavelli
Sustainable Investment Strategist

What should investors know about the SEC and EU's focus on ESG investing?:

The U.S. has seen substantial growth within sustainable investing. The Global Sustainable Investment Alliance has estimated that the total US-domiciled assets under management using sustainable investing strategies reached $17.1 trillion at the start of 2020.[1] In accordance with such tremendous growth, an increase in demand for regulation has surfaced as various products have been targeted for greenwashing. The Biden administration has followed suit and demonstrated a shift in focus towards eliminating greenwashing. Further, the SEC formed a climate and ESG task force last year and has also issued substantial penalties on various corporations, such as those faced by BNY Mellon Investment Adviser for misstatements relating to ESG.

The SEC has also had a busy Spring regarding the proposal of ESG related rules. Back in March, the regulator launched a landmark proposal for corporates regarding climate-related disclosures.[2] Then in May, the SEC issued another two proposals increasing standardisation and transparency for ESG products. The first proposal attempts to prevent disingenuous fund naming practices while the second expands on further ESG disclosures for investment funds. There will be a comment period for 60 days.

What do these proposals recommend?

The first SEC proposal; amendments to the "Names Rule" [3]:

- Most notably, the rule expands to include "particular characteristics" such as "growth," "value," and "ESG" factors within the 80% requirement. The requirement states that if particular characteristics such as "ESG" are used in the fund name, then 80% of assets are required to be investments having those suggested naming characteristics.

The second SEC proposal regarding enhanced ESG disclosures, recommends funds be categorized into three types:[3]

- **Integration funds** incorporate ESG factors in conjunction with non-ESG factors. These funds do not generally prioritize ESG factors over non-ESG factors.
- **ESG-focused funds** have a "significant or main consideration" for ESG factors.
- **Impact funds** a subcategory of ESG-focused funds, aim to achieve a "particular ESG impact."

How does the SEC's ESG disclosure compare to EU Sustainable Finance regulations?

We believe that the enhanced ESG disclosures are more intuitive and would be easier to implement, compared to the EU Sustainable Finance ("SFDR") regulation, but they are also less prescriptive and granular: The SEC proposal acts as a general post-mortem summarization exercise, while the SFDR is more proactively formulaic with specific technical screening criteria to classify and align funds accordingly. The SEC's less detailed manner of classifying funds differs from the EU's "green Taxonomy", which provides more detailed technical screening criteria to define the "greenness" of investments.

Further, the usage of the ESG acronym is used quite frequently within the SEC's proposal, while that is not the case for the EU SFDR and Taxonomy. This difference demonstrates the EU's more prescriptive approach to sustainability, while the SEC approach is employing a more general scope.

Potential implications for investors

Expansion on reporting tools and engagement: Under the SEC proposal, environmentally focused funds would be required to disclose their emission data. This may pose a reporting challenge for some funds due to a lack of data availability; however, some asset managers have begun to report such data as a common practice. We believe this would allow investors to be able to compare emission profiles between different products and track progress toward emission reduction goals. Nonetheless, we would encourage regulators to provide further tools in conjunction with emission data to help investors analyse various other climate trajectories that may help channel additional capital to high emitters on a transition journey. We would also welcome any disclosure of saved energy efficiency and avoided emission metrics that express climate impact for the overall economy. Additionally, while the expansion of ESG disclosures emphasizes engagement initiatives to increase transparency and accountability, Ecofin believes a more defined scope of engagement is needed to include a broader range of stakeholder engagement activities.

Confusion in a fragmented regulatory world: The SEC's ESG disclosure rules' slight departure from SFDR may cause confusion, misalignment and economic burden amongst investors, particularly funds that invest in both U.S. and EU markets. Further, Ecofin believes the SEC's three categorizations of funds may need to be contemplated further; for example, the placement of thematic investing within the three is not abundantly clear.

Ecofin is pleased to see the SEC supporting the acknowledgement and inclusion of ESG related rules within the U.S. securities markets. These rules may help inform and protect investors by increasing standardization, transparency and accountability of data disclosure.

It is clear governing bodies are getting serious in their approach to not only monitoring asset managers, but are also pushing companies to align with sustainable factors. We are unlikely to see an international harmonisation of ESG regulation; however, the development of these rules may inform the market that the SEC is contemplating ESG earnestly and ESG data disclosure is no longer a choice. These disclosures will help level set the U.S. amongst other regulatory regimes focused on advancing transparency. This could enhance the US's position in ESG and attract further capital flow.

[1]http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf

[2]Please see the following link for Ecofin's response to the proposal: https://www.sec.gov/comments/s7-10-22/s71022-20132185-302698.pdf

[3]www.sec.gov