

Fund Finance Friday



ESG: Regulatory Reform on the Horizon?

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With ESG (Environmental, Social and Governance) funds on a dramatic incline, an incline expected to continue going forward, it seems inevitable that regulatory reform is on the horizon. Europe has been leading the charge in the incorporation of ESG considerations into its regulatory framework. As we look to gauge what type of regulatory reform might be around the corner for us here in the U.S., specifically in the realm of fund finance, it is useful to look at the regulatory developments in the EU.

Regulatory Reform in the EU

The most relevant EU regulation in this space is the Sustainable Finance Disclosure Regulation (SFDR), which came into effect in March of this year. The SFDR imposes mandatory ESG disclosure obligations on asset managers and other financial markets participants, and is a major milestone in the EU's efforts to ensure a systematic and transparent approach to sustainability within financial markets, thereby preventing greenwashing and ensuring comparability.

By way of background, the SFDR was introduced by the European Commission alongside the Low Carbon Benchmarks Regulation and the Taxonomy Regulation as part of a package of legislative measures stemming from the European Commission's Action Plan on Sustainable Finance.

According to its official wording, the SFDR "lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products."

The SFDR has imposed transparency and disclosure requirements on financial market participants and financial advisers such as banks, insurance companies, pension funds, and investment firms, at both entity and product level, aimed at protecting end investors by enabling them to make informed decisions about their investments. These market participants and advisers are now required to be transparent about:

- (i) their policies on the integration of sustainability risks in their investment decision-making and advisory processes;
- (ii) how they consider the adverse sustainability impacts of their investments (e.g., how the proceeds applied by borrowers have effects on ESG matters);
- (iii) the sustainability of their financial products;
- (iv) how environmental or social characteristics being promoted are met (e.g., if an index has been designated as a benchmark, information on how that index is consistent with those characteristics); and
- (v) where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, information as to how the index is aligned with that objective and, if no index has been designated as a reference benchmark for such objective, an explanation as to how that objective is to be attained.

The disclosure requirements include:

- What firms must disclose and maintain on their websites;
- The information that must be provided to investors; and
- Periodic reporting to investors.

To comply with these obligations, relevant firms in the EU have had to make changes to their internal procedures and policies to comply with the new requirements, including in many cases investing in training staff in relation to the new obligations.

We understand that there has been some regulatory uncertainty regarding certain aspects of the SFDR – for example, with respect to the application of some obligations to entities established outside of the European Economic Area or whether a financial product that includes ESG factors in its decision-making process falls within the scope of SFDR Article 8, which sets criteria for ESG funds. However, guidance is expected to be published in the future to elaborate on certain obligations under the SFDR.

Current Reform in the U.S.

While we await concrete regulatory reform here in the U.S. with respect to transparency and uniformity on ESG matters in the financial markets, there has been some reform by way of published guidance in the U.S. that is relevant to fund finance.

In 2019, the Loan Syndications and Trading Association (LSTA), the Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA) published the Sustainability Linked Loan Principles (SLLP), which were most recently updated in July of this year, and also published the Green Loan Principles, which were most recently updated in February of this year. The goal of this published guidance is to promote the development and preserve the integrity of the sustainability linked loan and green loan product by providing guidelines that capture the fundamental characteristics of these loans, thereby promoting sustainable development more generally. It is interesting to note that in the May 2019 version of the SLLP, engaging an independent third party to verify the borrower's performance against each sustainability target was a recommendation; it is now a “necessary element” pursuant to the latest SLLP.

In addition, in May of this year, the LSTA published an ESG Diligence Questionnaire, which is designed to be completed by the borrower and included with other diligence materials and is aimed at providing greater transparency on the ESG initiatives of the borrower.

Perhaps the biggest driver of change in the market, however, stems from investors themselves. For example, in side letters, we have seen an increasing number of GPs acknowledging investors' commitment to various indexes such as the UN Principles for Responsible Investment (PRI), and we understand that investors have been asking GPs to put those considerations into practice while making investments. We also understand that many investors are insisting on bespoke ESG reporting requirements, which remains challenging since there is no widely adopted standard ESG reporting template.

Things do seem to be progressing at a higher level, too, albeit not as quickly as our European counterparts in this area. Firstly, it has been apparent from the beginning of the Biden administration that it would support various ESG initiatives. Interestingly, the SEC published a regulatory agenda in June 2021 that signaled the SEC Chair's focus on ESG matters, including disclosures regarding climate change, corporate board diversity, cybersecurity risk and human capital management. Finally, it is worth noting that the 26th UN Climate Change Conference is expected to take place in Scotland later this year (November 2021), with many participants gearing up to discuss the progress made since the 2015 Paris Agreement and what steps should be taken next. It is likely we will see some additional guidance stemming from the Conference. These all appear to be positive steps towards reform in this space.

Conclusion

While it remains to be seen in which direction the U.S. will go in terms of regulation, it is abundantly clear that reform is coming. In the absence of harmonized rules on sustainability-related disclosures to end investors, for example, diverging measures will continue to be adopted, different approaches in different financial services sectors will persist, and this will cause significant distortions of competition because of significant differences in disclosure standards.

While there appears to be natural teething issues with the SFDR, this piece of legislation will undoubtedly serve as precedent for other jurisdictions looking to achieve the common goal of ensuring a transparent approach to sustainability within financial markets.

The U.S. does have the advantage of being able to learn from other jurisdictions such as the EU before implementing regulation or additional guidance. One would hope, however, that regulation, if and when it does arrive in the U.S., acts as a way of clarifying and encouraging market participants in ESG matters, rather than as a deterrent.

See also our prior *Fund Finance Friday* articles that are relevant in this context:

[**ESG Loans – The Next Big Wave in Fund Finance**](#), where we review the what, why and how questions related to sustainability-linked loans; and

[**Top 10 Items to Consider When Structuring Your ESG Facility**](#), where we address the credit facility terms that are most relevant in the ESG facility context.

[**The ABCs of ESG**](#), where we review the fundamentals of ESG.