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# 2024 Asset Management ESG Roadshow: New York

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## Welcome

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# Navigating ESG Issues During the Private Fundraising Process

## Today’s presenters

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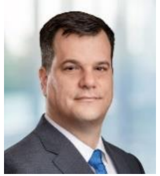

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# Enforcement and Examinations

## Today’s presenters

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# Planning in Dynamic Regulatory Environments

## Today’s presenters


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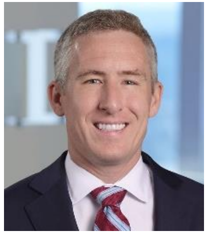


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# Agenda

- Navigating ESG issues during the private fundraising process
- Enforcement and examinations
- Planning in dynamic regulatory environments

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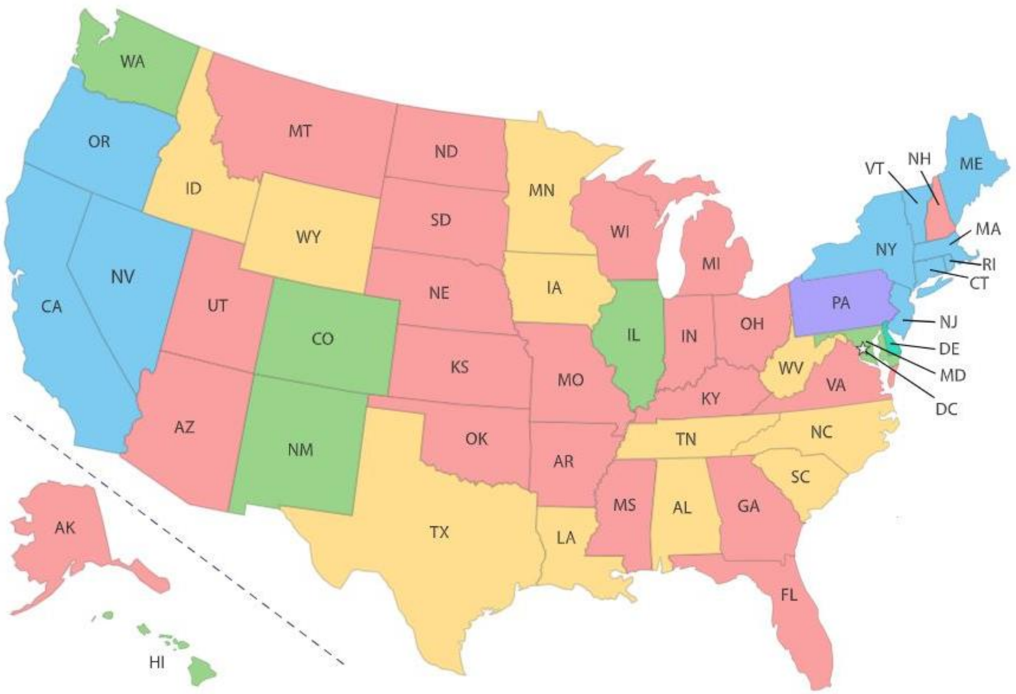
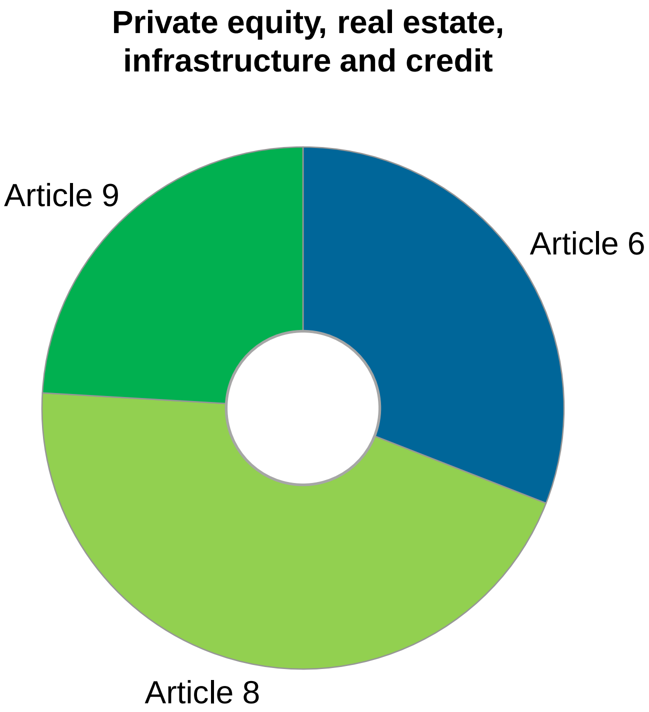
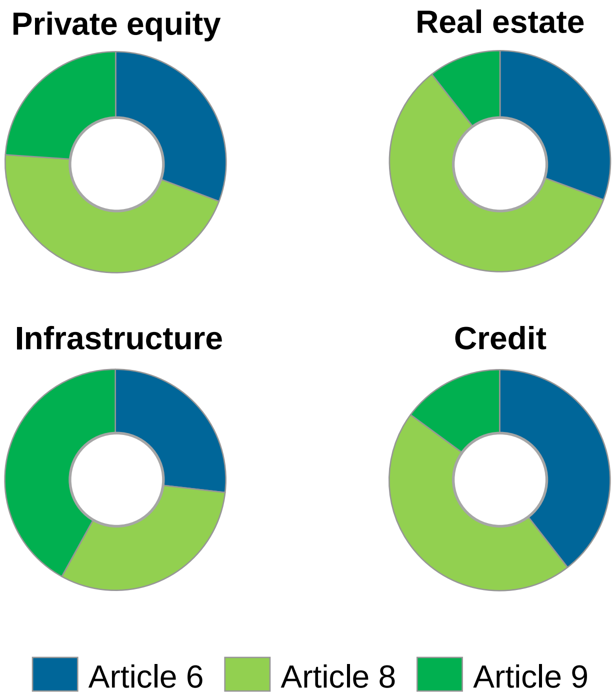
- **Navigating ESG issues during the private fundraising process**
- Enforcement and examinations
- Planning in dynamic regulatory environments

# Navigating state regulation of ESG investments




# SFDR classification



# Categories of ESG side letter provisions

## Acknowledgment of investor's ESG policies

- Example: Adviser acknowledges that it has read investor's internal ESG policies, which often are attached as an exhibit to the side letter

## Agreement to take into account certain widely recognized ESG frameworks

- Example: Adviser acknowledges that it is a signatory to the UNPRI, UN Global Compact Principles or IFC Performance Standards and in some cases agrees to consider such principles when making investment decisions

## Representations and covenants regarding adviser's ESG policies

- Example: Adviser makes reps as to its own policies and/or undertakes to encourage fund's portfolio companies to pursue certain ESG-related goals (e.g., diverse board membership)

## Reporting / notices

- Example 1: Adviser agrees to provide regular reporting on the ESG metrics at the portfolio company level. Can be driven by regulatory requirements (e.g., SFDR) or commercial factors
- Example 2: Adviser agrees to notify investor of material changes to ESG policies or negative ESG-related incidents

## Opt-out rights

- Example: Adviser agrees to excuse investor from participating in fund investments in oil / gas sector

# ESG and fundraising: practical considerations

| | |
|---|---|
| ✓ | Engage with ESG at an early stage with all relevant stakeholders |
| ✓ | Think about ESG holistically – consider different regulatory regimes and investor demands |
| ✓ | Manage side letter requests carefully to ensure that they don’t cut across regulatory / investor requirements / demands |
| ✓ | Include robust risk factors and reps in subscription agreements acknowledging the regulatory uncertainty and obtaining confirmations that investors are not investing because of a fund’s ESG status |
| ✓ | Ensure marketing materials reflect your ESG disclosure category |
| ✓ | Ensure that all ESG-related claims are accurate and reflect what you are able to do / commit to |

# Agenda

- Navigating ESG issues during the private fundraising process
- **Enforcement and examinations**
- Planning in uncertain regulatory environments

# SEC examinations

## The SEC examines compliance with ESG disclosure

- Client disclosure
- Adviser disclosure

## Disclosures

- Can be found anywhere a firm makes statements to investors or potential investors (e.g., PPMs / prospectuses, DDQs, websites, marketing decks, side letters, etc.)
- Ensure that all investor-facing communications are consistent with ESG standards and application (and each other)
- Disclosures should be clear and precise and tailored to actual practices
  - Consider including definition of what the adviser means by “ESG”
  - Disclose how ESG is used
- Consider careful disclosure of internal or third-party standards or scoring
- Do not overstate the extent to which the firm may consider ESG – be aware of vague laudatory statements
- Review current disclosures and representations line by line

# SEC examinations

## Policies and procedures

- Requires coordination across IR, legal and compliance, investment, and ESG teams
- Tailor policies to specific business lines (e.g., PE v. RE v. credit v. public equity v. fund of funds)
- Service providers
- Two sets of policies
  - ESG policy
  - Compliance with ESG disclosures
    - For example, voting securities consistent with policies
    - Red state vs. blue state

# SEC examinations

## Documentation

- Ensure that documentation regarding the consideration of ESG factors is created and preserved throughout the investment process, consistent with any standards established by disclosures and policies / procedures
  - Create contemporaneous disclosure demonstrating that disclosures align with actual practices during investment process, including at investment (e.g., investment committee memos), monitoring, voting and exit
  - Demonstrate adherence to scoring / standards

## Oversight

- Ensure that investment teams are aware of policies, procedures and disclosures
- Enforce and provide regular training to employees on all ESG policies
- Develop controls and consensus over ESG frameworks and memberships
- Perform annual reviews and mock ESG reviews to test adherence to policies and procedures

# SEC enforcement: BNYM and GSAM

## These actions arose out of the SEC's 2021 and 2022 examination priorities

| BNY Mellon Investment Adviser, Inc. (May 23, 2022) | Goldman Sachs Asset Management, L.P. (Nov. 22, 2022) |
|---|---|
| ▪ BNYM was charged with material misstatements and omissions concerning ESG considerations used in making investment decisions for certain mutual funds (ESG integration strategies)<br>▪ First ESG enforcement action relating to ESG disclosures made by a registered fund<br>▪ BNYM settled and agreed to pay $1.5 million penalty<br>▪ Timing coincided with SEC ESG proposals | ▪ Goldman was charged with policies and procedures violations involving two mutual funds and a separately managed account strategy marketed as ESG investments<br>▪ Similar to BNYM with focus on statements by adviser about the specific implementation of ESG factors<br>▪ Goldman settled and agreed to pay a $4 million penalty<br>▪ A handful of small mutual funds had rebranded as "ESG" |

# Current SEC enforcement approach and its impact on ESG

## Gensler's enforcement focus

- Sweeps
- Large dollar awards
- Message cases

## Focus on compliance programs

- Practical application of policies
- Discipline

## UK developments

## Impact on ESG advisers

# Litigation and enforcement threats from the right

## Multistate Attorney General investigation

- Theories: antitrust, consumer protection
- Coordinated subpoenas / CIDs issued to multiple asset managers

## Private action against NYC pension plans

- Theory: fiduciary duty breach due to fossil fuel divestment policy
- Filed June 2023, funded by conservative activist organization

## Tennessee AG action against BlackRock

- Theory: consumer protection
- Filed Dec. 2023, allegations based solely on public statements

## U.S. House Judiciary Committee investigation

- Theory: antitrust
- Focus on climate initiative membership and “decarbonization” targets

# Legal theories

## Consumer protection claims

- State consumer protection laws prohibit “unfair and deceptive acts and practices”
- AGs have broad discretion to define what is “unfair and deceptive”

## Fiduciary duty claims

- **Duty of loyalty**: Sole objective must be maximizing client’s financial returns
  - Other objectives reflect inappropriate “mixed motives”
  - Social or “political” goals such as climate and diversity gains (NYC pension plan action)
  - Joining pro-ESG initiatives shows manager’s mixed motives, including in ostensibly non-ESG products
- **Duty of care**: No reasonable basis to believe ESG investing maximizes financial returns, as underlying assumptions are factually unsupported

## Antitrust claims

- Group boycott / concerted refusal to deal
- Anticompetitive standard setting
- Anticompetitive information sharing

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# The different regulatory regimes for asset managers

| U.S.: SEC Proposed Rules | EU: Sustainable Finance Disclosures Regulation (SFDR) |
|---|---|
| **ESG Integration** | **Article 6 (conventional funds)** |
| ▪ Integrates ESG factors alongside non-ESG factors in investment decisions<br>▪ ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be dispositive with respect to any particular investment | ▪ Funds that are neither Article 8 nor Article 9 (i.e., conventional funds)<br>▪ Cannot promote environmental and/or social characteristics nor have a sustainable investment objective<br>▪ Must integrate ESG risks into the investment decision making process |
| **ESG Focus** | **Article 8 (funds promoting environmental/social characteristics)** |
| ▪ ESG factors are a significant or main consideration in selecting investments or in engaging with portfolio companies (e.g., screens for carbon emissions, board or workforce diversity and inclusion, or industry-specific issues) | ▪ Binding investment strategy which promotes environmental and/or social objectives<br>▪ Any exclusion screening requirements should be part of the binding investment strategy and be meaningful to it<br>▪ Investee companies (i.e., portfolio investments) must follow good governance practices<br>▪ May also make 'sustainable'[1] investments<br>▪ Currently no minimum threshold although this may change |
| **ESG Impact** | **Article 9 (funds with sustainable investment objectives)** |
| ▪ Seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits (e.g., financing the construction of affordable housing units or advancing the availability of clean water) | ▪ Makes exclusively 'sustainable' investments (a small proportion of other investments may be available for hedging or liquidity purposes)<br>▪ Investments must do no significant harm to any other environmental or social objectives by reference to the principal adverse impact indicators<br>▪ Investee companies must follow good governance practices |

[1] **Sustainable investments**' means an investment in an economic activity that contributes to an environmental objective or an investment in an economic activity that contributes to a social objective provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance. Managers also need to disclose how these investments align with OECD Guidelines for Multinational Enterprises and UN Guiding Principles of Business and Human Rights.

# UK SDR

| | Scope | Requirements | Implementation timetable |
|---|---|---|---|
| **Labelling regime** | UK fund managers that manage UK funds | Four opt-in sustainable labels focusing on various ESG investment strategies, comprised of “sustainable focus”, “sustainable improvers”, “sustainable impact” and “sustainable mixed goals”. | 31 July 2024 |
| **Customer disclosures** | UK fund managers that manage UK funds | Consumer-facing disclosures (summarising how the product will pursue and measure the sustainability objectives) and pre-contractual disclosures (with more detailed information on the product’s sustainability profile. | 31 July 2024 |
| **Sustainability reporting** | UK fund managers that manage UK funds which meet certain AUM thresholds (see “implementation timetable”) | Entity-level report focusing on the manager’s sustainability-related risks and opportunities, focusing on governance, strategy, risk management, and metrics & targets (as under the TCFD framework). | December 2, 2025 (largest managers: £50bn or more AUM)<br>December 2, 2026 (smaller Managers: £5bn-50bn AUM) |
| **Anti-greenwashing rule** | All FCA-authorised firms; all products and services (both retail and professional) | All claims made about the sustainability characteristics of a product or service must be clear, fair and not misleading. | 31 May 2024 |
| **Distributor rules** | FCA-authorised firms distributing recognized funds to retail investors | Disclosures when distributing UK funds that have a sustainable label or notices for certain overseas funds that use ESG terms. | 31 July 2024 (labelled funds)<br>2 December 2024 (overseas funds) |

# Federal climate regulation

## SEC Corp. Climate Rules Adopted (Finally)

- Largely a win for issuers
- A mixed bag for investors
- Robust voluntary disclosures will continue
- Investors will still want what they want
- Now the real fun begins!

THE WALL STREET JOURNAL.

**SEC Approves Weakened Climate Disclosure Rule**

- Scope 3 gone; Scope 1 and 2 subject to materiality
- Other disclosures expressly tied to materiality, including scenario analysis, targets, goals, transition plans and internal carbon price
- Board oversight disclosures less prescriptive
- Assurance pushed out; reasonable assurance limited
- Financial statement footnote disclosures limited to severe weather events/other natural conditions

# State climate regulation: the states are becoming climate disclosure leaders

| California adopts landmark climate disclosure laws | Other states are entering the fray |
|---|---|
| ▪ GHG emissions<br>▪ Climate Risk<br>▪ Net zero and emissions reduction claims; voluntary carbon offsets | ▪ GHG emissions and climate risk disclosure bills introduced in **New York** in 2023<br>▪ GHG Emissions Disclosure Bill introduced in **Illinois** in 2024 |

# Membership in ESG-related initiatives has its challenges

- Attribution of statements by climate initiatives to all of their members
- Net Zero Asset Managers Initiative (NZAMi)
- Climate Action 100+ and its defectors
- Possible processes and controls for joining, managing, monitoring and exiting different initiatives

PRI Principles for Responsible Investment | NET ZERO ASSET MANAGERS INITIATIVE | Ceres | Climate Action 100+

# Compliance challenges in uncertain regulatory environments

Which regulatory proposals do we need to pay attention to?

How do we address ambiguities and white space in regulations?

How should I think about the risk of enforcement?

What best practices can help keep me in the middle of the pack?

How will elections change ESG regulation?

How do we balance current rules and future ones?

# Drawing together compliance themes for global firms

## Coordinating Documentation Across US + Non-US Jurisdictions

- Parallel products may be reviewed for consistency
- Global firms create expectations of global compliance
- Challenging to “ringfence” products sold into different jurisdictions (research, proxy voting, engagement, investment process)

## ESG policies vs. guidelines

- What are the pros and cons of adopting a formal Advisers Act Rule 206(4)-7 ESG policy?
- Ways to differentiate compliance policies v. statements

## Critical and Skeptical Approach to “Say What You Do and Do What You Say”

- Recordkeeping is a critical risk area – how do you prove what you do?
- Skeptical regulator demands a counterintuitively heightened level of inquiry
- Compliance and legal functions are critical to marshalling defenses in advance of regulatory scrutiny (face off with investment terms, investor relations, marketing, etc.)

ROPES & GRAY

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