KEYNOTE INTERVIEW

Navigating US and EU regulatory differences

Diverging sustainability regimes present challenges for GPs, particularly when raising capital from both LPs in Europe and those in US 'anti-ESG' states, say Debevoise & Plimpton's Ulysses Smith and Patricia Volhard

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Q Let's talk about the US first. What are the so-called 'anti-ESG' bills currently being debated and how likely are they to become law?

Ulysses Smith: ESG legislation impacting private markets falls into two broad categories: 'anti-boycott' laws, and legislation that limits the consideration of ESG factors in investment decisions.

States like Texas, Oklahoma and West Virginia have passed laws that direct state entities, including pension funds, to divest from or refuse to contract with firms that exclude certain industries, such as oil and gas, coal, firearms and the like. Those fall into the 'boycott' category.

Florida, for example, fits in the second category, as the state requires any manager investing public funds to make their investment decisions based solely on 'pecuniary factors' defined as those having a material impact on risk and return.

Concern about greenwashing and mislabelling, renewed interest in fossil fuel investments given rising prices, and US political dynamics have fuelled these bills. Interestingly though, most of the draft legislation targeting ESG has not been successful. Of the roughly 160 or so bills or resolutions proposed this year, only six have passed.

There have also been significant court challenges to successful legislation. In 2023, Missouri passed legislation that required asset managers to request written consent from their clients before considering and incorporating what the law deems 'non-financial objectives' in securities recommendations or investment advice. That was recently struck down by the federal court. Anti-ESG legislation in Oklahoma has also been successfully challenged in court.

Q How does ESG-related legislation passed in states such as California, New York and Illinois fit into this picture?

US: This highlights the complexity of the US landscape. California, for instance, has introduced three climate-related disclosure laws that are similar to the stayed US Securities and Exchange Commission's Climate-Related Disclosure rules and the EU's Corporate Sustainability Reporting Directive (CSRD). They require companies above a certain revenue threshold doing business in the state to disclose information on climate risks and greenhouse gas emissions, for example. These laws target greenwashing and

encourage companies to be explicit and accurate in what they communicate about their climate impact, commitments and strategy.

Looking to the future, whether states like those mentioned above diverge from the federal agenda will be influenced by the upcoming US election in November. Should Kamala Harris win and build on Biden-administration initiatives such as the Inflation Reduction Act – which seeks to channel investment into energy transition opportunities by offering tax incentives and subsidies – we can expect federal ESG-related legislation to run in parallel to legislation in places like California, New York and Illinois.

On the other hand, if you imagine a second Trump administration, those federal developments will likely come to a stop, and in some cases, may be reversed, while pro-ESG states go their own way.

Q What complexities does the varied US regulatory landscape create for global funds?

Patricia Volhard: For global fund managers operating in Europe and subject to Sustainable Finance Disclosure Regulation (SFDR) requirements – where qualifying as an Article 8 fund that promotes ESG has become the de facto standard – it is challenging to raise capital from both European investors and US LPs in so-called 'anti-ESG' states at the same time. The demands of these two investor bases differ.

Driven by legislation, European LPs are much more focused on ESG factors than their US counterparts and require more ESG disclosure and transparency from fund sponsors. So, while they are not directly asking managers to change behaviour, there is an expectation that GPs will meet certain ESG criteria. As mentioned, in some US states, this is actively discouraged. One way to align opposing perspectives is to argue that ESG is a value driver, and that ignoring ESG risks and impacts can lead to financially negative outcomes.

It is also challenging at the asset level. Global managers whose funds qualified as Article 8 'dark' or 9 funds under SFDR (which means they are committing to make sustainable investments) are required to monitor and engage with their portfolio companies to ensure certain ESG standards are met.

Under the upcoming Corporate Sustainability Due Diligence Directive (CSDDD) and CSRD, which still have to be implemented into national laws of the EU Member States, some of these requirements also apply to EU companies and, to a certain extent, also to non-EU, including US, companies generating revenues above a certain threshold in Europe. However, while CSRD will improve data availability in Europe, in some US jurisdictions this level of monitoring and engagement will remain difficult. There will be a data gap.

Q In the EU, SFDR is under review. How has the regulation been received by private markets participants, and what do sponsors want to see amended?

PV: Opinions are so diverse on this. One criticism of SFDR is that it was intended to be a disclosure regime that introduced consistent and precise terminology to improve transparency and support ongoing reporting obligations.

However, from this perspective, it has effectively evolved into a labelling regime where investors focus on meeting minimum requirements to qualify as Article 8 or 9 funds. This view advocates for developing an actual labelling regime mirroring the one being implemented in the UK. This would include specific labels that describe a particular investment strategy and include product regulation.

Even if it means being more rigid, supporters of such a label regime argue that clearer rules would reduce a lot of legal uncertainty around how to comply, and fear of being accused of greenwashing.

On the other hand, there is a concern that fund managers that have at large expense established systems and procedures to comply with SFDR will have to change their procedures again. Also, not all favour a label regime and argue that reporting their ESG commitments and activities through the disclosure regime may be just as efficient. They are willing to be more specific on that reporting, but don't want to be squeezed into specific labels where suddenly they can only pursue a limited type of investment when their investment strategy is much broader. This may even prevent fund sponsors from being more ambitious on the ESG side.

Q Looking forward, do you expect greater alignment between US and European sustainability disclosures?

PV: From a global corporate sustainability perspective, at the regulatory level there are the European Sustainability Reporting Standards (ESRS) under CSRD as we've discussed, but there is also the International Sustainability Standards Board (ISSB) model, which regulators around the world are looking at, including the US. While CSRD and ISSB standards differ – notably CSRD takes a double materiality approach – there is significant overlap, and they are pointing in the same direction. There is some alignment there.

US: There will continue to be some divergence, but on a practical level, because of the significant reach of CSRD and CSDDD beyond Europe's borders, these regimes will apply to a number of US entities and influence the US market in due course. And even if the SEC's Climate Rule doesn't survive legal challenge, climate-related legislation in California – where the thresholds are relatively low and which aligns with CSRD – will reach a large percentage of the US business community, including private equity.

Even if firms and companies aren't required to disclose from a regulatory perspective, investor expectations and the demands of the marketplace are moving in such a clear direction that many entities will choose to disclose on a voluntary basis, recognising that this is the price of doing business today. Stakeholders expect transparency. ■

Ulysses Smith is a US-based ESG senior adviser and Patricia Volhard is a Europe-based partner at law firm Debevoise & Plimpton