How does the SEC's proposed ESG disclosure compare to EU's SFDR? Also, let us track some current events in the United States...

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In recent weeks, we have seen a flurry of very contradictory ESG news coming from the US. On one hand, the US Inflation Reduction Act took an important step in the transition to clean energy and grabbed global headlines. On the other hand, there were anti-ESG sovereign pension mandates in Texas last week, followed by Florida announcing that its $188bn retirement system would not include ESG. Recently, Strive US Energy ETF (DRLL) voted to encourage more drilling and fracking activities by raising $250 million.

In the last 60 days, the SEC had received over 14k comments to its May 2022 proposal to enhance disclosures by investment advisors and investment companies on ESG investment practices. The two proposed rules were that the current 2001 regulation to prohibit companies from putting a label on products that don't use factors in their name as a primary investment strategy, including ESG, be updated and the other proposal was for ESG disclosures for investment companies and advisers in three different groups. The proposed amendments are designed to provide investors clear and comparable information about how a fund considers ESG data factors.

For example, open-end funds would provide an overview of their ESG strategy in the summary section of the prospectus and would provide more details about the strategy in the statutory prospectus, whereas the layered process means that, "Integration Funds" would need to summarize in a few sentences how they incorporate ESG factors and what factors they consider. "ESG-Focused" Funds that use inclusionary or exclusionary screens, funds that focus on ESG-related engagement with the issuers in which they invest, and funds that try to achieve a certain "ESG impact" would be required to provide more detailed information in a tabular format.

There has been criticism of the "ESG integration" category as some fear this will contribute to greenwashing by making funds appear more committed than they are and just providing a summary that the fund considers ESG is not informative to investors. Some fear, providing detailed information, including factors and methodologies, could lead to firms giving away intellectual property to competitors. One of the shareholder advocacy groups asked all funds to disclose the same information to investors to improve comparability. The SEC will be reviewing each of the responses prior to finalizing their rules. This article provides a good overview of the developments (Article Link).

SEC and EU's SFDR:

It is also insightful when we compare the SEC's ESG disclosure requirements to the EU Sustainable Finance regulations. The EU SFDR applies to financial advisers and "financial market participants", which covers a broader market when compared to the SEC, which doesn't cover private equity, private credit, venture capital, and other AIFs. The SEC's ESG Disclosures proposal seems easier to implement than the EU's SFDR because it only asks for a summary and details of the approach used after the fact. In contrast, the EU's SFDR is more prescriptive and gives technical screening criteria to classify and align funds.

Within the proposed SEC and EU SFDR disclosure requirements themselves, certain disclosures have some similarity, such as the requirement to discuss the degree to which any ESG impact was achieved by investment products with such objectives. However, the approach is different. For example, scope 3 emissions are required under SEC, to the extent a company reports this information, but there is no

requirement for modelling of this data. However, SFDR needs Scope 3 as part of Principal Adverse Indicators (PAIs) if the financial market participants offer products that make sustainable financial investments. The EU SFDR uses a lot more metrics and gives more detailed rules about what can be considered "sustainable" in general than what the SEC's proposed rules do.

The EU sets a threshold for environmental sustainability under various environmental objectives, which investors then use to disclose the degree to which their portfolio is in alignment. The EU taxonomy establishes technical screening criteria for economic activities to be considered sustainable. Since the US doesn't have a similar taxonomy, the SEC proposal requires disclosure of certain metrics, which right now are only related to climate, and lets investors decide if they are aligned enough with sustainability or climate goals.

Regulators are demanding more transparency. But the growing number of regulations with different approaches will make it hard for funds and advisors to keep track of everything they need for compliance. Hence, greater alignment in regulatory requirements will substantially harmonize disclosures, investment products, and investor understanding.