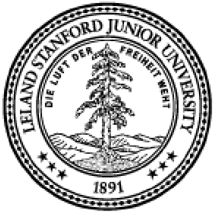

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Sustainable Finance: Regulatory Approaches to ESG Disclosures in the European Union and the United States

Dennis J. Poehland

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Abstract

This paper presents a comparative analysis of disclosure obligations on sustainable finance in the European Union and the United States. First, it examines the European Commission's centralized approach to disclosures on sustainable finance. Most of this analysis is devoted to the EU Taxonomy and Sustainable Finance Disclosure Regulation. Second, the paper contrasts this approach with the U.S. Securities and Exchange Commission's policy, which is largely based on voluntariness and much less comprehensive in its definition of ESG metrics and targets. The paper concludes that for now, the European Commission's framework meets investors' demands more decisively and provides more clarity to managers.

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I. Introduction: ESG and Sustainable Finance

During the past decade, the field of environmental, social, and corporate governance (ESG) has developed from a niche area into a considerable component of investor attention, sparking countless debates among managers and regulators alike. While the recent spike in ESG investing has stunned business executives, corporate attorneys, and regulators, the field's massive growth was not unforeseeable.[1] During most of the Twentieth Century, corporate governance was largely dominated by normative shareholder theories.[2] Efforts to further social or environmental purposes in business were sporadic and usually considered as purely philanthropic.[3] With the emergence of public concerns around climate change, environmental hazards, racial discrimination, gender inequality, and, most recently, a global pandemic, it became increasingly clear that risk emanating from social and environmental issues can bear directly on shareholder interests and can be mitigated in a more nuanced approach to corporate governance.

Therefore, in light of the traditional dichotomy between private and public interests, ESG is often considered as one approach to bridge the gap between the two by integrating environmental, social, and governance metrics in companies' risk calculations and long-term

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[1] Jeff Benjamin, *What Sparked Today's Love of ESG?*, INVESTMENT NEWS (Apr. 19, 2021), https://www.investmentnews.com/what-sparked-todays-love-of-esg-204945.

[2] *See, e.g.,* Milton Friedman, *A Friedman Doctrine—The Social Responsibility Of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, available at https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html (noting that in a "free" society, the exclusive social responsibility of business is "to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game . . . .").

[3] *See id.*

profit motives. The resulting mantra of "doing well by doing good" motivated not only regulators but investors and managers themselves to integrate ESG targets in their operations.[4]

While ESG considerations affect virtually all sectors of the economy, the financial services industry has been a central focus of ESG investors, a broad group ranging from decidedly social activists to alpha seekers.[5] Importantly, the most consequential players in the financial services sector have increasingly embraced and echoed the call to include social and environmental considerations in their decision-making. Larry Fink, CEO of BlackRock, Inc., notably emphasized that as part of its profit motive, "every company must not only deliver financial performance, but also show how it makes a positive contribution to society."[6] At the same time, as ESG has gained in importance, investors have become particularly adamant to counter the notion of "greenwashing," i.e., portfolio management practices that involve false or misleading statements on sustainability—or omissions on unsustainability—vis-à-vis investors.

Meanwhile, regulatory approaches to these disruptions vary dramatically between jurisdictions, ranging from guidance emphasizing the traditional primacy of shareholder value to decided efforts to promote sustainable finance through regulation. Some stakeholders criticize what they perceive as regulatory overreach when ESG disclosures are mandated; others consider voluntary disclosures insufficient. While some academic analyses have examined the current

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[4] Michael Branch, Pete Hand & Lisa R. Goldberg, *A Guide to ESG Portfolio Construction*, 45 J. PORTFOLIO MGMT. 61, 61 (2019).

[5] *Id.*

[6] Laurence D. Fink, *A Sense of Purpose: Larry Fink's 2018 Letter to CEOs* (Jan. 17, 2018), available at https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/ (last visited March 21, 2022). In Fink's 2022 Letter to CEOs, he also emphasized that "[w]e focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients," which reflects the gap-bridging role of ESG. *See* Laurence D. Fink, *The Power of Capitalism: Larry Fink's 2022 Letter to CEOs* (January 18, 2022), available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited March 21, 2022).

state of affairs on sustainable finance disclosures, significant gaps exist for studies that have presented decidedly comparative perspectives on the European Union and the United States on sustainable finance. Given that ESG investing has gained particular traction in North America and Europe, this paper seeks fill some of those gaps and also attempts to assess which regulatory approaches are more promising.

The first part of the analysis examines the European Commission's centralized approach to sustainable finance disclosures and their mandatory nature. It presents an overview of relevant legal instruments proposed or adopted by EU institutions and analyzes their actual or likely impact on capital markets. While several shortcomings are discussed, the analysis finds that the European approach largely represents a clear, comprehensive, and feasible approach to ESG disclosure regulations that is tailored to the financial services industry. The second part of the analysis considers the prevalent approach in the U.S., which is primarily based on voluntariness and much less comprehensive in terms of ESG metrics and targets. It concludes that in the current political climate, the European framework meets investors' demands more decisively and provides more clarity to managers. However, given that the entire ESG field is rapidly evolving, this paper's findings should not be considered as definite.

II. The European Union's Approach to Sustainable Finance

After the adoption of the Paris Agreement on climate change in 2015, ESG regulators across the world began to give particular consideration to the financial services industry. This was in part because the Paris Agreement specifically referenced the private sector and financial

institutions, highlighting their roles in "address[ing] and respond[ing] to climate change."[7] Soon after the Paris Agreement entered into force in 2016, the European Commission established the High-Level Expert Group on Sustainable Finance (HLEG), which was tasked with "recommend[ing] a comprehensive programme of reforms to the EU financial policy framework," among other things.[8] The High-Level Expert Group presented its final report in early 2018 and called on the Commission to prioritize a range of steps to "mainstream" sustainability disclosure across the financial services industry in the EU, including through mandatory obligations.[9] These recommendations were both clear and comprehensive, including specific proposals for a "common sustainable finance taxonomy," "upgrad[ing]" disclosure rules to enhance transparencies on environmental risks, and an "EU omnibus proposal" to clarify investor duties across all investment chains.[10]

Just one month after the HLEG released its final report, the Commission presented its Action Plan on Financing Sustainable Growth (Sustainable Finance Action Plan, SFAP), which was largely based on the HLEG report and set out three broad categories, each including a number of "key actions" to mandate ESG considerations in the financial services industry.[11] The

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[7] U.N. Framework Convention on Climate Change, *Adoption of the Paris Agreement*, art. 133, U.N. Doc. FCCC/CP/2015/L.9/Rev.1 (Dec. 12, 2015); *see also* Christian Thiman, *Foreword*, *in* MAKING THE FINANCIAL SYSTEM SUSTAINABLE (Paul G. Fisher ed., 2020).

[8] European Commission Press Release IP/15, European Commission Establishes an Expert Group to Develop a Comprehensive European Strategy on Sustainable Finance (Oct. 28, 2016).

[9] *Financing a Sustainable European Economy: Final Report 2018 by the High-Level Expert Group on Sustainable Finance*, at 26 (January 31, 2018) [hereinafter HLEG Final Report] https://ec.europa.eu/info/sites/default/files/180131-sustainable-finance-final-report_en.pdf.

[10] HLEG Final Report, *supra* note 9, at 13.

[11] *Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions—Action Plan: Financing Sustainable Growth*, COM (2018) 97 final (March 8, 2018) [hereinafter Sustainable Finance Action Plan]. In contemporary European policy discourse, sustainable finance issues have now been subsumed under the European Green Deal, which was established in December 2019. *See* Directorate-General for Communication, *Overview of Sustainable Finance*, EUROPEAN COMMISSION, https://ec.europa.eu/info/business-economy-

following sub-parts discuss the initiatives that were proposed or adopted to fulfill these key actions.

A. The EU Taxonomy

First, the SFAP explicitly targeted the direction of capital flows toward sustainable investments.[12] To that end, the first initiative was a "clear and detailed EU taxonomy" to define which investments meet the Commission's criteria for sustainability.[13] This taxonomy would serve as a common yardstick for large and listed companies, financial market participants, and financial advisers to maintain and adjust their financial activities. While the taxonomy is considered to be part of the Commission's capital-flow-based initiatives, it can be thought of as a set of procedural metrics underlying the EU's entire regime on sustainable finance.

After trilogues, the so-called Taxonomy Regulation was adopted in June 2020.[14] Article 3 specifically defines an "environmentally sustainable economic activit[y]" as an activity that must "contribute[] substantially" to six positive environmental objectives set out in article 9.[15] These objectives consist of climate change mitigation and adaptation, sustainability pertaining to water and marine resources, the transition to a circular economy, pollution prevention and control, and

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euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en ("[s]ustainable finance has a key role to play in delivering on the policy objectives under the European green deal . . . ."). Indeed, under the European Climate Law of 2019, sustainable finance became a central pillar of the European green deal. *See* Parliament and Council Regulation 2021/1119, 2021 O.J. (L 243) 1, 2. For purposes of this analysis, this did not result in a retroactive change of the SFAP; it much rather built on the SFAP and other pieces of existing legislation.

[12] Sustainable Finance Action Plan, *supra* note 11, at 4–7.

[13] Directorate-General for Communication, *Overview of Sustainable Finance*, EUROPEAN COMMISSION, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en.

[14] Parliament and Council Regulation 2020/852, 2020 O.J. (L198) 13 [hereinafter Taxonomy Regulation].

[15] Taxonomy Regulation, *supra* note 14, at art. 3(a).

the protection and restoration of biodiversity and ecosystems.[16] The application timeline for these objectives is staggered: the climate mitigation and adaption requirements entered into force on January 1, 2022; the remaining objectives are set to apply starting on January 1, 2023, though specific application timelines vary depending on the specific governing regulation.[17] The Taxonomy Regulation cross-references legal definitions contained in prior EU legislation and multilateral agreements; e.g., article 2(5) defines "climate change mitigation" as the process of maintaining an increase in the global average temperature of "well below" 2 degrees centigrade and "pursuing efforts to limit it" to 1.5 degrees above pre-industrial levels, "as laid down in the Paris Agreement."[18] Articles 10 through 16 provide a comprehensive list of factors that can be considered for purposes of articles 3 and 9.[19] These also include enabling and transitional activities that have primarily indirect effects on the objectives of article 9.[20]

In addition to the required "substantial[]" contribution to at least one of the objectives in article 9, an environmentally sustainable economic activity may not "significantly harm" any other of these objectives.[21] For instance, an activity causing "significant greenhouse gas emissions" as defined in the Taxonomy Regulation constitutes significant harm under articles 3(b) and 17(a) and is sufficient to exclude that activity from the scope of article 3. Importantly, Taxonomy Regulation articles 3(c) and 18(2) incorporate as a minimum safeguard the principle

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[16] Taxonomy Regulation, *supra* note 14, at art. 9 (a)–(f).

[17] *See, e.g.,* European Commission Press Release IP/22/711, EU Taxonomy: Commission presents Complementary Climate Delegated Act to Accelerate Decarbonisation (Feb. 2, 2022).

[18] Taxonomy Regulation, *supra* note 14, at art. 2(5).

[19] *See, e.g., id.* at art. 10 (governing climate change mitigation).

[20] *Id.* at art. 16(b) (requiring enabling activities to have a "substantial positive environmental impact, on the basis of life-cycle considerations").

[21] *Id.* at art. 3(b).

of "do no significant harm," which had already been promulgated in the SFDR and is essential to determining which disclosure obligations apply under that regulation.[22]

Crucially, the activity must comply with specific "technical screening criteria" under article 3(d). Article 23(2) in turn empowers the Commission to adopt a series of delegated acts to define these criteria, among other things. The first delegated act, adopted in June 2021, spans nearly 350 pages in the Official Journal and outlines requirements for metrics under articles 3 and 9 of the Taxonomy Regulation in meticulous detail.[23]

The core value of these criteria—and of a stringent taxonomy as a whole—lies in both their comprehensiveness and binding nature.[24] Large and listed companies, financial market participants, and financial advisers alike are considered to be bound by a relatively clear set of definitional rules that can be implemented in regulations governing a wide range of economic and financial sectors. The SFDR—arguably the most significant regulation for sustainable finance—is discussed in sub-part C below. Disadvantages of the EU's top-down approach and potential shortcomings of the Taxonomy Regulation's scope are discussed in sub-part D.

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[22] *See* discussion *infra*, at 14–15.

[23] Commission Delegated Regulation 2021/2139, 2021 O.J. (L 442) 1. The second delegated act was published in the Official Journal in December 2021 and specifies disclosures under article 8 of the Taxonomy Regulation. Commission Delegated Regulation 2021/2178, 2021 O.J. (L 443) 9. The Commission approved the third delegated act in February 2022, but it has not yet been formally adopted. The Commission's draft would allow a limited number of activities in the nuclear energy and gas sectors to qualify under articles 3 and 9 of the Taxonomy Regulation, which has generated public debate across the EU, leading some to accuse the Commission of greenwashing—the very activity it sought to counter. *See, e.g.,* Marina Strauss, *European Commission declares nuclear and gas to be green*, DEUTSCHE WELLE (Feb. 2, 2022), https://www.dw.com/en/european-commission-declares-nuclear-and-gas-to-be-green/a-60614990; Emily Rauhala, *E.U. labels natural gas and nuclear energy 'green,' prompting charges of 'greenwashing*,' WASH. POST (Feb. 2, 2022), https://www.washingtonpost.com/world/2022/02/02/green-energy-gas-nuclear-taxonomy/.

[24] *See* Consolidated Version of the Treaty on the Functioning of the European Union art. 288, May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].

In addition to the mandatory nature of the EU Taxonomy, the Commission also established two new and voluntary low-carbon benchmarks for investors, one of which aligns investment portfolios with the requirements under the Paris Agreement.[25] Both benchmarks are designed to incentivize investors to voluntarily go beyond binding requirements while receiving "additional assurances" that avoid greenwashing.[26] The benchmarks are discussed in sub-part C.

B. Other Capital-Flow-Based Initiatives

In addition to the taxonomy, the SFAP also included specific proposals to reorient capital flows toward sustainable investments, all of which were based on the HLEG's final report. One initiative revolves around a European Green Bond Standard (EUGBS), which would require issuers to demonstrate that all funds raised from these bonds are entirely allocated to projects that are deemed sustainable under Taxonomy Regulation article 3. The EUGBS would also mandate a number of specific disclosure obligations, ranging from a pre-issue "green bond factsheet" to allocation reports and at least one impact report on the bond's overall environmental impact.[27] This proposal was also directly aimed at reducing the risk of greenwashing; conversely, investors' reliance on their investments' sustainability would be enhanced.[28] Compliance and enforcement would be within the mandate of the European Securities and Markets Authority (ESMA).[29] While the Commission proposed the standard as a voluntary approach and as a

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[25] Council and Parliament Regulation 2019/2089, 2019 O.J. (L317) 17.

[26] European Commission Press Release IP/19/1418, Sustainable Finance: Commission Welcomes Agreement on a New Generation of Low-Carbon Benchmarks (Feb. 25, 2019).

[27] *Commission Proposal for a Regulation of the European Parliament and of the Council on European Green Bonds*, at 27–29, COM (2021) 391 final (July 7, 2021).

[28] *Id.*

[29] European Commission Press Release IP/21/3405, Commission Puts Forward New Strategy to Make the EU's Financial System More Sustainable and Proposes New European Green Bond Standard (July 6, 2021).

complement to the International Capital Market Association's (ICMA) Green Bond Principles, the European Parliament's December 2021 proposal included an amendment that would make the standard's application "mandatory . . . to all bonds marketed as environmentally sustainable."[30] In response, several stakeholders noted the high uncertainty caused by the "evolving" nature of the EU Taxonomy[31] and increased cost and liability for issuers, potentially causing "issuer flight."[32] In a general sense, these debates around voluntariness or compulsion resemble the debates in the United States, discussed in Part III below, albeit on a much smaller scale.

Other initiatives within the SFAP framework are aimed at the financial advice that investment firms provide to their clients, mandating "clear advice on the social and environmental risks and their opportunities" to raise investor awareness. Additionally, the Commission included the insurance industry in its ESG considerations. The Commission adopted a delegated regulation in 2021, modifying the delegated act for the Markets in Financial Instruments Directive II (MiFID II). This modification served primarily to ensure the existing MiFID II framework's compliance with requirements under the SFDR. These initiatives highlight the Commission's desire to employ a highly comprehensive approach that includes all virtually all facets of capital markets, including the scope of investment advisers' fiduciary duties

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[30] EUR. PARL. DOC. 2021/0191 (COD), at 26.

[31] Amy Geddes, Louis de Longeaux, Jake Jackaman & Minolee Shah, *The EU Green Bond Standard: Will Compulsion Fragment the Market?* HERBERT SMITH FREEHILLS LLP (Feb. 03, 2022), https://www.herbertsmithfreehills.com/insight/the-eu-green-bond-standard-will-compulsion-fragment-the-market.

[32] INTERNATIONAL CAPITAL MARKET ASSOCIATION, ANALYSIS OF THE AMENDMENTS TO THE EUGB REGULATION PROPOSED BY THE RAPPORTEUR OF THE EUROPEAN PARLIAMENT (Jan. 5, 2022), available at https://www.icmagroup.org/News/news-in-brief/analysis-of-the-amendments-to-the-eugb-regulation-proposed-by-the-rapporteur-of-the-eu-parliament/.

to their clients.[33] On the downside, extensive changes to existing legal regimes increase managerial expenses on legal advice and risk reassessments. However, given the current investor pressure for such legislative enactments, these drawbacks likely have only minor effects on EU asset managers' postures.

The Commission's also targets direct investments in sustainable projects. These initiatives include the European Green Deal's "investment pillar," the Sustainable Europe Investment Plan (SEIP).[34] Given their nature, these initiatives are not primarily regulatory, but they help illustrate how the Commission complements its regulatory function with direct market engagement.

C. The Sustainable Finance Disclosure Regulation

In addition to capital-flow-based initiatives, the SFAP outlines several key actions to mainstream sustainability into risk management. These include updated ESMA disclosure requirements for credit ratings[35] and the introduction of a "green supporting factor" in the EU prudential rules for banks and insurance companies.[36] However, the bedrock piece of legislation

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[33] *Commission Delegated Regulation Amending Delegated Regulation (EU) 2017/565 as regards the Integration of Sustainability Factors, Risks and Preferences Into Certain Organisatorial Requirements and Operating Conditions for Investment Firms*, C(2021)2616 (Apr. 21, 2021); *see generally* TFEU art. 290(1).

[34] EUROPEAN COMMISSION, THE EUROPEAN GREEN DEAL INVESTMENT PLAN AND JUST MECHANISM EXPLAINED (Jan. 14, 2020), available at https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_24.

[35] *See* EUROPEAN SECURITIES AND MARKETS AUTHORITY, FINAL REPORT: GUIDELINES ON DISCLOSURE REQUIREMENTS APPLICABLE TO CREDIT RATINGS (July 18, 2019), available at https://www.esma.europa.eu/sites/default/files/library/esma33-9-320_final_report_guidelines_on_disclosure_requirements_applicable_to_credit_rating_agencies.pdf.

[36] Unlike restrictive policy tools, which include the SFDR, the "green supporting factor" would serve as a liberalization of capital requirements for sustainable financial products. While the Commission hopes that lower capital requirements would incentivize investing in sustainable financial products, some worry that banks will be excessively vulnerable if their investments fail with less loss-absorbing capital. Sini Matikainen, *Green Doesn't Mean Risk-Free: Why We Should Be Cautious About a Green Supporting Factor in the EU*, GRANTHAM INSTITUTE ON CLIMATE CHANGE AND THE ENVIRONMENT (Dec. 18. 2017), https://www.lse.ac.uk/granthaminstitute/news/eu-green-supporting-factor-bank-risk/.

on risk management for sustainable finance is the Sustainable Finance Disclosure Regulation (SFDR).[37] Adopted in 2019, the SFDR aims to enhance transparency by harmonizing rules for financial market participants and financial advisers to "integrate[] sustainability risks . . . in their processes and [provide] sustainability-related information" on their financial products.[38] While the SFAP considers the SFDR's purpose to target risk management, it ultimately serves to re-orient capital towards sustainable investments, which is not inherently different from the initiatives discussed in sub-part A.[39]

Among the most notable aspects of the SFDR is its scope, which includes all financial advisers and market participants subject to EU jurisdiction, including insurance companies, all investment firms and credit institutions providing portfolio management, pension funds, certain venture capital funds, and others.[40]

The disclosure obligations imposed by the SFDR are multi-faceted and can be grouped into two main categories. First, articles 3 through 7 regulate firm-level obligations, mandating all financial market participants and financial advisers within the SFDR's general scope to disclose certain ESG metrics on their websites. For instance, article 3 mandates them to disclose their policies on the "integration of sustainability risks in their investment decision-making process."[41] Under article 4, managers are required to publish a statement detailing "principal adverse

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[37] Parliament and Council Regulation 2019/2088, 2019 O.J. (L317) 1 [hereinafter SFDR].

[38] SFDR, *supra* note 37, at art. 1. The SFDR's disclosure obligations complement obligations under existing regulatory schemes, including MiFID II.

[39] *See* Directorate-General for Communication, *supra* note 11.

[40] SFDR, *supra* note 37, at art. 2(1). The SFDR is distinct from the Non-Financial Reporting Directive and the Corporate Sustainability Reporting Directive, both of which are not targeted specifically at the financial sector and therefore not subject of this analysis.

[41] *Id.* at art. 3.

impacts" of their investment decisions on sustainability factors. These "PAI statements" must take into account the firm's size, nature, and scale of its activities, as well as its role in the market.[42] The regulators' goal of avoiding loopholes is readily apparent here. Under a 'comply-or-explain' approach, managers who do not consider adverse impacts of investment decisions on ESG factors or otherwise fail to comply with disclosure obligations must show "clear reasons" for their noncompliance and state whether they intend to consider adverse impacts going forward.[43] Since June 30, 2021, however, the 'explain' option is unavailable for companies employing an average number of 500 people during the financial year, which reflects the Commission's judgment that attempts to justify noncompliance by larger financial market participants and advisers are futile as a matter of law.[44] The SFDR empowered the European Supervisory Authorities (ESAs) to propose specific requirements for the contents of PAI statements and other legislative details in draft regulatory technical standards (RTS), which are currently scheduled to be adopted by the Commission by January 1, 2023.[45] For purposes of SFDR article 4, the RTS require the PAI statement to include quantitative disclosures, i.e., primarily data on nine environmental indicators and five social metrics,[46] as well as qualitative

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[42] *Id.* at art. 4(1)(a), (2), (5); *see also* SUSTAINABLE FINANCE DISCLOSURE REGULATION: DETAILED RULES ON DISCLOSURES, KIRKLAND & ELLIS LLP (Feb. 11, 2021), https://www.kirkland.com/publications/kirkland-alert/2021/02/sustainable-finance-disclosure-regulation.

[43] SFDR, *supra* note 37, at art. 4(1)(b), (5)(b).

[44] *Id.* at art. 4(4).

[45] *Id.* at art. 4(6)–(7); Letter from John Berrigan, Deputy Director-General for Financial Stability, Financial Services and Capital Markets Union, to Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, and Andrej Šircelj, President of the Ecofin Counsel (Nov. 25, 2021), https://www.esma.europa.eu/sites/default/files/library/com_letter_to_ep_and_council_sfdr_rts-j.berrigan.pdf.

[46] EUROPEAN SECURITIES AND MARKETS AUTHORITY ET AL., FINAL REPORT ON DRAFT REGULATORY TECHNICAL STANDARDS, art. 6 [hereinafter Draft RTS], available at https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf.

disclosures, including the firm's policies to identify principal adverse impacts, data sources, methodologies to select indicators, and a description of the firm's adherence to multilateral standards such as the Paris Agreement.[47]

In addition to these obligations, article 6 requires all financial market participants and financial advisers to describe in pre-contractual disclosures "the manner in which sustainability risks are integrated into their investment [decisions or advice]" and the anticipated effects of sustainability risks on their products' financial returns.[48] In case of non-compliance, a "clear and concise explanation" must be included instead.[49] While the complexity and wide scope of these provisions requires diligence on the part of managers, they are deliberately phrased in relatively clear language and designed to become routine for managers and investors alike.

The second major category of SFDR disclosure obligations are product-level obligations for funds purporting to promote an ESG purpose. These obligations are further classified into funds under articles 8 and 9, respectively.

Article 8 concerns so-called light green funds, i.e., financial products that "promote[], among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices."[50] The draft RTS include more detailed requirements for these pre-contractual disclosures. Unsurprisingly, these include information on the specific ESG metric promoted by the fund and the role of that metric within the fund's general investment strategy

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[47] *Id.* at art. 7–9.

[48] SFDR, *supra* note 37, at art. 6(1)–(2).

[49] *Id.*; *see also* DELOITTE IRELAND LLP, SUSTAINABLE FINANCE DISCLOSURE REGULATION – ARTICLE 6 FUNDS 2, available at https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Audit/IE_SustainableFinanceDisclosureReg_FINAL.pdf].

[50] SFDR, *supra* note 37, at art. 8(1).

and asset allocation.[51] When the Commission adopts the RTS, managers will also be required to disclose whether there is a "minimum proportion" of a product's sustainable investment and how the remaining proportion of the investments will be allocated, which serves as both additional context for investors and a binding commitment for managers.[52]

Article 9 governs funds decidedly committed to sustainable investment instead of ESG metrics being just one element as under article 8.[53] The relationship between articles 8 and 9 was initially subject to some debate, especially since the SFDR's definition of "sustainable investment" includes the 'do no significant harm' test, similarly to the Taxonomy Regulation.[54] Since article 9 expressly governs funds with "sustainable investment as its objective" and article 8 omits the term "sustainable investment altogether," article 8 can be considered a fallback for funds that fail the 'do no significant harm' test but nevertheless promote ESG metrics among other characteristics.[55]

As expected, disclosure obligations under article 9 are even more demanding for these so-called 'dark green funds.' For instance, article 9 itself requires managers who chose to designate

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[51] *Id.* at art. 8(3); Draft RTS, *supra* note 46, at art. 13(3)(a), (c)–(d).

[52] *See* Draft RTS, *supra* note 46, at art. 16(2)(a). The Draft RTS also require managers to disclose whether an investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights. RTS art. 14(3)(b). This, in turn, incentivizes compliance with those regimes despite their legally non-binding nature.

[53] SFDR, *supra* note 37, at art. 9(1)–(2).

[54] *Id.* at art. 2(17); *see* EUROPEAN COMMISSION Q&A ON SUSTAINABLE FINANCE DISCLOSURES REGULATION [sic], DEBEVOISE & PLIMPTON LLP 1, available at https://www.debevoise.com/insights/publications/2021/07/european-commission-qa-on-sustainable] (noting that "the exact scope of article 8 remains unclear"); *see also* discussion *supra* at 5.

[55] *See id.* at art. 9(1)–(2); *cf. id.* at art. 8; *see also* EU SUSTAINABLE FINANCE DISCLOSURE REGULATION: EUROPEAN COMMISSION Q&AS AND IMPLICATIONS FOR NON-EU FUND MANAGERS, SIDLEY AUSTIN LLP (Aug. 5, 2021), available at https://www.sidley.com/en/insights/newsupdates/2021/08/ec-qas-application-eu-sustainable-finance-disclosure-regulation-implications-noneu-fund-managers.

a reference benchmark other than a broad market index to explain how their index is different.[56] This strongly enhances the legal and reputational risk posed by tinkering with indices. The draft RTS propose a range of specific obligations, which include all obligations applicable to article 8 funds and additional requirements, such as disclosure of benchmarks used by funds aimed at reducing carbon emissions and an explanation of whether those benchmarks qualify as low-carbon benchmarks under the Taxonomy Regulation.[57]

Additionally, the draft RTS propose requiring managers of both light and dark green funds to make additional disclosures in their annual reports and maintain sustainability disclosures on their websites.[58] The SFDR's comparative value is assessed in sub-part D and Part III.

D. Transparency and Long-Termism

The final section of the Commission's SFAP is focused on creating synergies between requirements for the financial service industry and disclosure obligations for non-financial service providers.[59] Another element is aimed at factfinding around "undue short-term pressure" on corporations in the financial sector.[60]

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[56] SFDR, *supra* note 37, at art. 9(1)(b).

[57] *See, e.g.,* Draft RTS, *supra* note 46, at art. 21(c); *see also* discussion *supra* p. 6.

[58] *See* KIRKLAND & ELLIS LLP, *supra* note 42 ("Although the requirements on website disclosures are detailed, there are no disclosure or reporting templates, allowing managers some flexibility in crafting their website disclosures").

[59] *See* Sustainable Finance Action Plan, *supra* note 11; Commission Guidelines on Non-Financial Reporting: Supplement on Reporting Climate-Related Information, 2019 O.J. (C 209) 1.

[60] *See,* EUROPEAN COMMISSION, CALL FOR ADVICE TO THE EUROPEAN SUPERVISORY AUTHORITIES TO COLLECT EVIDENCE OF UNDUE SHORT-TERM PRESSURE FROM THE FINANCIAL SECTOR ON CORPORATIONS (Feb. 1, 2019), available at https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/190201-call-for-advice-to-esas-short-term-pressure_en.pdf.

These initiatives are merely ancillary to both the EU Taxonomy and the SFDR. However, their objectives of transparency and long-termism serve as core motivations for the SFAP and its components as a whole. Other core motivations become apparent when parsing through the depths of these regulatory projects. First, as even this general analysis shows, if ESG disclosure in the financial services industry is mandated by a central governing authority in a top-down approach, virtually all facets of capital markets and all relevant forms of financial service providers must be regulated. In order to ensure the effectiveness of these requirements and to avoid loopholes, the legislation will inevitably take on a massive size and complexity. This can have unintended consequences if the legal risk emanating from a new set of regulations is excessively high. If individual components are contradictory or ambiguous, the net effect of such efforts may be to drive away investors and financial services providers altogether, provided that there are more attractive regulatory environments elsewhere. As will be discussed in Part III, this is one of the main arguments proffered against mandatory top-down regulation of sustainable finance in the United States. However, the European Commission's SFAP and its component pieces of legislation manage to mitigate that risk fairly well, given that the entire sustainable finance regime is still in the early stages of its implementation. The Commission was adamant to mitigate the top-down character of its approach in the sense that stakeholders from within the financial sector occupied consultative positions throughout the legislative process. For instance, the HLEG was composed of members and observers from a range of financial services sectors, including the banking, insurance, and asset management industries.[61] That said, the EU's approach remains a highly centralized and comprehensive one, based on mandatory disclosure.

[61] HLEG Final Report, *supra* note 9, at 3.

The Commission also acknowledged in the very structure of the SFAP that adjustments may have to be considered as individual legislation takes shape.[62] This is exemplified by the delegated acts passed by the Commission to substantiate the EU Taxonomy and by the draft RTS developed under the SFDR. As noted above, for the SFAP to retain its competitive attractiveness, definitional gaps under the Taxonomy Regulation and certain ambiguities between SFDR articles 6, 8, and 9 will need to be resolved.[63]

III. Governing Sustainable Finance in the United States

While the regulatory approaches to sustainable finance in the U.S. differ in numerous respects from those in the EU, the pressures from investors and other stakeholders for public companies to disclose their ESG risks, practices, and impacts are similar.[64] Given the analysis of the European approach as a top-down strategy, Part III outlines the bottom-up regulatory approach in the U.S., which is dominated by voluntariness and a less coherent and less comprehensive set of regulations.

A. The Central Role of Voluntariness

One of the most significant differences to the European Commission's approach is the fact that the SEC has not promulgated comprehensive, mandatory regulations aimed specifically at the financial services industry. Indeed, much of the debate around mandatory ESG disclosures in the U.S. is focused on public companies and other companies generally within the SEC's

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[62] Sustainable Finance Action Plan, *supra* note 11.

[63] *See, e.g.,* Franziska Schütze & Jan Stede, *EU Sustainable Finance Taxonomy—What Is Its Role on the Road towards Climate Neutrality?*, at 9 (Deutsches Institut für Wirtschaftsforschung, Discussion Paper 1923, 2020) (identifying gaps in carbon emission-intensive sectors).

[64] SULLIVAN & CROMWELL LLP, THE RISE OF STANDARDIZED ESG DISCLOSURE FRAMEWORKS IN THE UNITED STATES 1 (June 8, 2020), available at https://www.sullcrom.com/files/upload/SC-Publication-Rise-Standardized-ESG-Disclosure-Frameworks.pdf.

jurisdiction.[65] So far, ESG disclosure has been based on voluntariness for all companies under SEC jurisdiction, which has significant effects on the lack of coherence of sustainability frameworks within the United States. The vast majority of this framework rests on a number of non-governmental and private-sector initiatives to enhance and systematize ESG disclosures.

One of the leading non-governmental organizations working to establish ESG metrics in the United States is the San Francisco-based Sustainability Accounting Standards Board (SASB), which has developed a set of so-called SASB Standards. Importantly, SASB recognized the problem of industry-specific requirements and has developed a series of industry-specific ESG metrics.[66] For the financial sector, these are grouped into three main categories: capital markets, corporate and retail banking, and insurance.[67] In an abstract sense, SASB has taken the place of a regulator with an established standard-setting process relying on stakeholder participation and public comments, as well as independent oversight by its Standards Board.[68] Given this structured but voluntary approach to ESG disclosure, many of the most important players in the financial sector have begun to rely on the SASB Standards in their disclosures. For instance, Larry Fink's 2020 Letter to CEOs noted that "we need to achieve more widespread and

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[65] Esther Whieldon, *SEC Acting Head Explains Why Voluntary ESG Disclosure Regime is Not Enough*, S&P GLOBAL MARKET INTELLIGENCE (Mar. 1, 2021) https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/sec-acting-head-explains-why-voluntary-esg-disclosure-regime-is-not-enough-62934422 (noting that the SEC has recently taken "first steps" toward developing a general framework for ESG disclosures).

[66] *Standards Overview*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, https://www.sasb.org/standards/ (last visited April 1, 2022).

[67] *Find Your Industry*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, https://www.sasb.org/find-your-industry/ (last visited April 1, 2022).

[68] *Standard-Setting Process*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, https://www.sasb.org/standards/process/ (last visited April 1, 2022).

standardized adoption" of ESG disclosures and asked companies to publish SASB-aligned disclosures.[69]

In the same letter, Fink called for the adoption of TCFD-aligned disclosures. The Task Force on Climate-Related Financial Disclosures was established by the G20 Financial Stability Board in 2015 and provides climate-related metrics and targets, among other things. Unlike the SASB, however, the TCFD tends to follow a more general, less sectoral approach. While certain "pilot projects" have been launched since 2017 to provide sector-specific guidance to the banking sector, the TCFD framework is not generally tailored to the financial services industry in its current application.[70] A number of other non-profit organizations provide additional guidance and metrics for the financial sector, including the Global Reporting Initiative (GRI). However, although both supply and demand for ESG metrics continue to increase, the functional problem of this decentralized approach is obvious.

In essence, the patchwork of diverse standards creates dynamics that allow loopholes and may encourage greenwashing—the very problem regulators, non-profit organizations, and investors seek to avoid. In this regard, the argument that over ninety percent of S&P 500 companies voluntarily disclose certain ESG data loses some of its power.[71] Indeed, former SEC Acting Chair Allison Lee acknowledged in March 2021 that a voluntary framework with a

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[69] Laurence D. Fink, *A Fundamental Reshaping of Finance: Larry Fink's 2020 Letter to CEOs* (January 14, 2020), available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited March 28, 2022).

[70] *See UNEP FI TCFD Banking Pilot Projects*, U.N. ENVIRONMENT PROGRAMME FINANCE INITIATIVE (2021), https://www.unepfi.org/climate-change/tcfd/tcfd-for-banks/.

[71] *See 2021 Sustainability Reporting in Focus*, G&A INSTITUTE (2021), https://www.ga-institute.com/2021-sustainability-reporting-in-focus.html (finding that ninety-two percent of S&P 500 companies published sustainability reports in 2020).

number of different standards leads to "significant gaps."[72] Acting Chair Lee also remarked that "investors can't really compare across businesses, across the industries . . . and sometimes they can't even compare [a] single business that might choose different things to disclose at different times."[73] Certain initiatives seeking to better align the patchwork of voluntary standards have gained some ground since 2019, but most of their recommendations have not yet been implemented, largely due to a lack of centralized governance.[74] This becomes even more apparent when considering, e.g., that the European Commission encourages voluntary reliance on the TCFD as part of the SFAP's transparency initiatives that *complement* the wide-ranging mandatory framework.[75]

B. The SEC's Approach

Even though a number of arguments are regularly levied to prevent a more stringent and mandatory regulatory regime for the U.S. financial services industry, the insufficiency of the status quo has not been lost on the majority of SEC commissioners.[76] In May 2020, the SEC's Investor-as-Owner Subcommittee called on the SEC to "take the lead" on ESG disclosure under the SEC's governing materiality principles.[77] Notably, the subcommittee warned that in case "the

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[72] Whieldon, *supra* note 65.

[73] *Id.*

[74] *See* SULLIVAN & CROMWELL LLP, *supra* note 64.

[75] *See* discussion *supra* Part II.D; Commission Guidelines on Non-Financial Reporting: Supplement on Reporting Climate-Related Information, *supra* note 59, at 1.

[76] Addisu Lashitew, *The Risks of US-EU Divergence on Corporate Sustainability Disclosure*, THE BROOKINGS INSTITUTION (Sept. 28, 2021), https://www.brookings.edu/blog/future-development/2021/09/28/the-risks-of-us-eu-divergence-on-corporate-sustainability-disclosure/#cancel.

[77] U.S. SECURITIES AND EXCHANGE COMMISSION, RECOMMENDATION FROM THE INVESTOR-AS-OWNER SUBCOMMITTEE OF THE SEC INVESTOR ADVISORY COMMITTEE RELATING TO ESG DISCLOSURE 9 (May 14, 2020), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf.

SEC does not take the lead, it is highly likely that other jurisdictions will impose standards in the next few years that [U.S.] issuers will be bound to follow . . . due to the global nature of the flow of investment . . . ."[78] Of course, this warning was justified, since planning under the European Commission's SFAP had already been well underway in 2020. In December 2020, the SEC's Asset Management Advisory Committee proposed the establishment of a separate ESG Subcommittee but explicitly rejected the "highly prescriptive approach" used in the EU, fearing that it would result in superfluous metrics and unnecessary cost.[79] The Committee considered a "parsimonious approach [as] sufficient" and proposed narrowing the number of metrics and task an independent entity with oversight, specifically suggesting SASB.[80] Given its view that the incoherence problem around ESG disclosure was supposedly smaller than publicly believed, this recommendation stood in some contradiction to the Investor-as-Owner Subcommittee earlier that year. Above all, it highlights the SEC's internal tussle on ESG disclosure issue, which sends mixed signals to markets and the public alike.

Finally, on March 21, 2022, the SEC announced three proposals for a limited number of climate-related disclosures.[81] These proposed rules would require publicly-listed companies in the U.S. to disclose climate-related risks along a limited but fixed range of metrics that meet the SEC's materiality standard. Furthermore, managers would be obligated to disclose qualitative

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[78] *Id.*

[79] U.S. SECURITIES AND EXCHANGE COMMISSION, ASSET MANAGEMENT ADVISORY COMMITTEE POTENTIAL RECOMMENDATIONS OF ESG SUBCOMMITTEE 4 (December 1, 2020), https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf (discussion draft).

[80] *Id.*

[81] U.S. SECURITIES AND EXCHANGE COMMISSION, THE ENHANCEMENT AND STANDARDIZATION OF CLIMATE-RELATED DISCLOSURES FOR INVESTORS, https://www.sec.gov/rules/proposed/2022/33-11042.pdf (proposed rule); *see* SULLIVAN & CROMWELL LLP, SEC PROPOSES EXPANSIVE CLIMATE-RELATED DISCLOSURE RULES (March 28, 2022), https://www.sullcrom.com/files/upload/sc-publication-sec-proposes-expansive-climate-related-disclosure-rules.pdf.

and quantitative metrics on greenhouse gas emissions and a number of climate-related financial metrics.[82] The framework incorporates the TCFD framework discussed above.[83] While these proposals represent a major shift in the SEC's approach to ESG governance, it should be emphasized that they are limited to climate-related risks and unlike the EU Taxonomy and SFDR, do not extend to a broader set of ESG metrics. Given the tensions within the SEC itself, a further centralization of the agency's governance or a dedicated sustainable finance framework seems highly unlikely in the near future.

While the U.S. financial services industry largely approved of the SEC's adjusted approach, others emphasize that the U.S. should retain its decidedly voluntariness-based strategy. Commissioner Hester Peirce criticized that the proposed rules "tell[] corporate managers how *regulators*, doing the bidding of an array of non-investor stakeholders, expect them to run their companies."[84] The argument seems intuitive that investors know best how to make financial decisions and regulators should provide them with an accurate perspective of the managers' views of their companies. However, such types of arguments are undermined by the fact that the overwhelming demand for clear ESG metrics and targets is coming from the investors themselves. Other contentious points, which are primarily based on the "elastic nature of the ESG concept," are arguably more plausible and manifest themselves throughout the European Union's centralized approach.[85] These range from definitional issues in the Taxonomy Regulation to ambiguities in the SFDR.

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[82] *Id.*

[83] *See* discussion *supra* p. 17.

[84] HESTER A. PEIRCE, WE ARE NOT THE SECURITIES AND ENVIRONMENT COMMISSION – AT LEAST NOT YET (March 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.

[85] Lashitew, *supra* note 76.

Contrary to Commissioner Peirce's view, however, a purely voluntary strategy would—and still does—ignore the massive inefficiencies resulting from the SEC's reticence to become more active on ESG disclosures generally, let alone with respect to the financial services industry in particular. Without centralized governance, the problem of "meaningful evaluation" persists for investors, regulators, and managers alike.[86] Indeed, the SEC's contradictory internal deliberations and the resulting lack of clarity have caused some investors to increasingly look to Europe instead.[87]

IV. Conclusion

This paper considered the different approaches employed to govern sustainable finance in the European Union and United States. It found a number of relatively drastic differences between both approaches, with the EU's approach being highly centralized and largely mandatory, and the American approach primarily relying on voluntary disclosures with some adjustments toward mandatory obligations on climate-related metrics. The analysis revealed several shortcomings of the EU's approach, including definitional difficulties due to the fluid nature of many ESG metrics, as well as legislative ambiguities that could lead to legal risk for managers and reputational risk for investors. It noted that the U.S. regime lacks a dedicated governance structure for sustainable finance in particular, relying instead on non-profit regulators

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[86] SULLIVAN & CROMWELL LLP, *supra* note 64.

[87] *See, e.g. The EU's Green-Investing "Taxonomy" Could Go Global*, ECONOMIST (Jan. 8th, 2022), available at https://www.economist.com/finance-and-economics/2022/01/08/the-eus-green-investing-taxonomy-could-go-global. This is not to suggest that internal and transparent deliberations generally cause uncertainty and disincentivize investments. On the European side, the internal deliberations on the EU Green Bond Standard illustrate this. However, when another regulator has already adopted or proposed vast regulations on the same subject matter, the resulting clarity may lead some investors to choose investments in that jurisdiction instead.

and a primarily laissez-faire approach by the SEC. Finally, the analysis reflected on the SEC's policy changes in recent years.

Ultimately, this analysis remains a snapshot in time of a rapidly changing and evolving field. The financial services industry is among the most globally-oriented sectors. Despite differences in corporate structures between the U.S. and EU, the mandatory requirements of both the SFDR and the EU Taxonomy have already had significant impacts in managers' risk assessments on ESG metrics beyond the EU's borders.[88] The centralized and relatively well-developed framework that the EU specifically developed for sustainable finance mitigates some of the impacts of the absence of U.S. regulatory leadership. But regulatory frameworks, too, are subject to competitive dynamics. If managers of companies listed in the U.S. start orienting themselves on a taxonomy defined in Brussels and metrics outlined in an EU regulation, the European Commission's leadership on sustainable finance would likely prove a winning hand throughout the foreseeable future and on a global level. At the same time, while the European approach seems to fit investor preferences more appropriately at the moment, it remains to be seen whether and how the American approach will find its place in sustainable finance as investors, managers, and regulators continue to develop and adjust their preferences.

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[88] *Id.*