

U.S., EU Investment Management ESG Rules Diverge

Investment Considerations, Risks and Potential Returns to Differ by Regulatory Regime

- Divergence between U.S. and EU/U.K. pension regulations highlight different interpretations and applications of Environmental, Social and Governance (ESG) investment considerations.
- As one recent example, a DOL rule reiterates that a U.S. pension fund's primary purpose is to provide for workers' retirement security, which must be prioritized above sustainable investing and other non-financial goals.
- EU/U.K. regulators have historically promoted a more holistic approach, allowing investment managers to incorporate broader public non-financial considerations when making investment decisions.
- The disparate regulatory paths toward sustainable investment are unlikely to converge in the near term, given the DOL's historical conservative stance amid the evolution of ESG investing in the EU/U.K.

Regulators Differ on ESG Investing Approach

EU/U.K. regulators have been supportive of environmental, social and governance (ESG) investing, integrating its concepts into financial decision-making processes amid increasing institutional mandates for sustainable investing in Europe.

In certain instances, U.S. regulators have taken a different approach. For example, the U.S. Department of Labor (DOL) has historically prioritized the pension funds' fiduciary duty to beneficiaries and the preservation of retirement funds over larger, non-financial, stakeholder considerations. On the other hand, the U.S. Securities and Exchange Commission's (SEC) regulation of U.S. investment advisors and the U.S. mutual fund industry is moving in a similar direction as EU/U.K. regulators in terms of ESG disclosure.

While these divergent approaches are not expected to immediately impact ratings assigned to investment managers, pension funds and/or the institutions sponsoring such plans, Fitch Ratings expects them to translate into differing investment considerations, risks and potential returns over the longer term.

Overall ESG Demand Continues to Grow

The shift in social and political attitudes that has fueled demand for sustainable investing is accelerating as investors, public institutions and corporations increasingly prioritize ESG measures as part of their investment criteria. Growth has been also driven by the increased belief by market participants that ESG factors can have material impact on long-term investment returns.

Fitch expects the long-term structural trends in favor of ESG investing to persist. Funds that invest in line with ethical principles attracted USD59 billion of inflows globally for the first half of 2020, bringing the total of ESG assets under management to USD2.2 trillion globally, according to Lipper.

Related Research

[Asset Managers: Impact Investing \(August 2019\)](#)

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Total Global Assets Under Management

(USD Bil.)	2015	2016	2017	2018	2019	6/30/20
Ethical Investments	1,281	1,363	1,726	1,632	2,149	2,208
Sequential Change (%)		6	27	(5)	32	3
Non-Ethical Investments	29,009	31,712	39,365	37,940	45,648	44,871
Sequential Change (%)		9	24	(4)	20	(2)

Source: Fitch Ratings, Lipper.

The pandemic has done little to deter the expanding focus on ESG investing, as fund managers increasingly seek to invest in sustainability-conscious assets. Global ESG fund assets have almost doubled since the end of 2015; Europe has a high share of global ESG funds (around 75%), with the U.S. accounting for around 20%.

Fitch believes the growth of sustainability investing could be further accelerated by increased market standardization and transparency in terms of ESG scoring methodologies, common definitions and categorizations.

Near-Term Convergence Unlikely

Fitch believes that the approaches toward sustainable investment are unlikely to converge between the U.S. and EU/U.K. regulators in the near term. The U.S. is not a signatory to the 2015 Paris Agreement and its approach to climate change and environmental issues differs considerably from those outlined in the EU's Green Deal or the U.K.'s drive toward a low carbon economy.

In the EU and the U.K., sustainability goals are increasingly being written into legislation and regulation to achieve net zero carbon emission goals by end-2050 (e.g. the European Insurance and Occupational Pensions Authority incorporates ESG factors into its stress tests). Since the outset of 2018, all EU and U.K. companies have been required to report on their social and environmental challenges. Specifically, for institutional investors and investment managers, disclosure of how ESG risks are integrated into their investment strategies and how ESG issues impact their products, including all investment funds and personal pension products, will come into force in the EU by mid-2021. The U.K. is also well advanced on this front and its financial regulators appear focused on ESG regulatory initiatives.

In Fitch's view, the divergence between U.S. and EU/U.K. rules highlights a different prioritization of the role of investors in addressing ESG-related issues. The DOL's stance appears informed by a classical view on the social responsibility of business, to maximize investors' returns to increase their discretionary spending power. Conversely, EU/U.K. rules appear aimed at crowding in private-sector investments for broader public goals, in line with European policies over the last two decades.

DOL Proposal on ESG Tied to ERISA

On June 23, 2020, the DOL proposed a rule for private pension plans (fiduciaries) governed by the Employee Retirement Income Security Act (ERISA), clarifying investment duties and regulation regarding "non-financial objectives" such as ESG investing.

Approximately USD28.7 trillion of assets were managed under ERISA rules at 1Q20, according to the Investment Company Institute. The DOL regulates the retirement assets of private-sector employer defined benefit and defined contribution plans, as well as employer-sponsored retirement accounts including 401(k) plans, deferred-compensation plans, and profit-sharing plans. Individual Retirement Accounts (IRAs) and public pension funds in the U.S. are not subject to ERISA.

The proposed rule reiterates that private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives. Rather, the singular goal is to provide for retirement security of workers.

The DOL's proposal reflects very specific duties stipulated for fiduciaries under ERISA. These prescribe that fiduciaries must always put the economic interests of an investment first to maximize the funds available to pay retirement benefits. In this context, non-monetary ESG goals may conflict with the fiduciaries' statutory goal if, for example, their pursuit leads to weaker investment returns, additional investment risk and/or higher fees.

The DOL's historical rulings on ESG investments have also questioned if ESG portfolios can meet return/risk objectives of portfolios not screened for ESG investments. Thus, the DOL proposes that fiduciaries should demonstrate that an ESG investment is economically indistinguishable from an equivalent, alternative (non-ESG) product on all "pecuniary" fronts, including diversification, liquidity and risk-return considerations.

On Aug. 31, 2020 the DOL proposed a further rule that would require ERISA-governed fiduciaries to cast shareholder votes only on issues that have an economic effect on a retirement plan, implying they may not vote on ESG-related issues unless they have a measurable financial impact.

DOL New Investment Duties Proposed Rule – Key Principles

- Released on June 23, 2020, the proposal codifies the DOL's position requiring plan fiduciaries to select investments based on financial considerations relevant to the risk-adjusted economic value of investment course of action.
- Compliance with ERISA prohibits fiduciaries from subordinating the financial interests or retirement income of private employer-sponsored pension plans to non-pecuniary goals.
- Provision that requires fiduciaries to consider other available investments to meet ERISA prudence and loyalty duties.
- ESG factors can be considered pecuniary if they present material economic risks or opportunities under generally accepted investment theories; adds new regulatory text on required investment analysis and documentation requirements.
- Provision regarding the selection of investments for 401(k) plans; reiterates that the prudence and loyalty standards apply to a fiduciary's selection of investment alternatives; describes requirements for selecting ESG investment alternatives or mandates.

Considerable Market Feedback

The DOL received over 1,000 public responses to its proposal by the consultation period's end on July 30, 2020. Among the comments and objections, Fitch highlights four key points.

First, a main pushback by market participants was the restriction for any investments labeled as ESG to be considered as a qualified default investment alternative for retirement funds. Default funds are the fallback investments for retirees who do not actively

manage investments and can capture large inflows as a result. Prohibiting ESG funds from becoming a fallback investment option would limit inflows in these products and reduce the growth potential for investment managers and funds specializing in ESG and impact investing.

Second, a number of U.S. investment managers noted the risk that the proposal would lead to worse outcomes for retirees, as investment managers may not otherwise fully consider ESG risks. In these managers' opinion, the proposal may make it more difficult for pension fund managers to earn sufficient returns to pay retirement benefits by restricting access to long-term, value-driven ESG investments.

Third, certain respondents to the DOL's proposal stated it could create an overly prescriptive and burdensome standard for investment managers to ring-fence investment methodologies for funds under ERISA regulations from those for funds falling outside them. This would likely result in moderately higher operating and compliance costs for investment managers, in Fitch's view.

Finally, certain respondents suggested that both the U.S. and EU/U.K. rules conflate ESG integration strategies and economically targeted investments, such as impact investing.

With the public comment period concluded, Fitch expects final rules some time later this year. Earlier this year, the DOL had asked pension plan sponsors and registered investment advisors to provide extensive documentation supporting their decisions to recommend and include ESG products for their ERISA pension funds.

EU Regulators Integrate ESG Considerations

In contrast to the DOL's approach, regulation in the EU and U.K. promotes the integration of sustainability and ESG concepts into financial decision making, which has become a more common and/or formalized consideration for pension fund managers.

In particular, the European Commission's proposed amendment to Markets in Financial Instruments Directive (MiFID) II rules would mandate that investment firms consider the ESG preferences of their retail clients when providing investment advice. This proposal is still under discussion and should be finalized in 2021, coming into force in 2022. The proposed amendment to MiFID II rules builds on the European Commission's recently approved Sustainable Finance Disclosure and Taxonomy Regulations (December 2019 and June 2020, respectively), which define an ESG disclosure regime and a harmonized classification system of environmental objectives, respectively. The Taxonomy Regulation aims to address the issue of "greenwashing" by introducing a common set of standards for ESG classification, which should help ESG investments to become more mainstream.

Still, the proposed amendment to MiFID II rules could increase the cost of regulatory compliance of investment managers and expose them to additional litigation and reputational risk, if investment managers fail to meet or underdeliver both financial and non-financial targets as expected by clients.

Neither regulation will be part of retained EU law in the U.K. as they come into force after Dec. 31, 2020, when the Brexit transition period ends. However, the British government has expressed interest in aligning with these components of EU law afterward.

MiFID II

MiFID II is the EU legislation that regulates companies providing financial services to clients linked to instruments such as equities, bonds, units in collective investment schemes and derivatives, and the exchanges on which those instruments are traded.

The objective of MiFID II, which became effective in January 2018, is to improve the functioning of financial markets following the financial crisis and to boost investor protection.

MiFID II has toughened transparency requirements, altered rules on research distribution and charges, boosted governance requirements for manufacturers and distributors of investment products and strengthened market structure requirements.

SEC More Aligned with EU/U.K.

The SEC recently solicited public comment on the appropriate treatment of funds that use terms such as ESG in their names and whether these terms have the potential to mislead investors.

In this sense, the SEC, which regulates the overall U.S. investment advisor and mutual fund industry, is moving in a similar direction as EU/U.K. regulators in terms of ESG disclosure. On May 14, 2020, a subcommittee of the SEC Investor Advisory Committee issued a series of recommendations aimed at achieving standardization of ESG-related disclosure in the U.S. capital markets.

On Aug. 26, 2020 the SEC finalized an amendment to Regulation S-K regarding required disclosures about a company's business description, legal proceedings and risk factors. The principles-based amendments reflect the changes in the regulatory and business environment, and the increasing demands on the SEC to require ESG disclosures.

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