

**International  
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Legal Guides**



Practical cross-border insights into ESG law

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Contributing Editors:

**David M. Silk & Carmen X. W. Lu  
Wachtell, Lipton, Rosen & Katz**

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## ESG for Asset Managers

Dechert LLP



Julien Bourgeois



Mikhaelle Schiappacasse



Tyler Payne



Stanley Tiu

### Introduction

The role of environmental, social and governance (ESG) matters in the operations and investment management activities of asset managers has been a subject of discussion for many years. In recent years, however, the conversation has become more urgent and focused, driven by the growing evidence of the global impact of climate change. These concerns underly the United Nations 2030 Agenda for Sustainable Development and 2015 Paris Agreement on Climate Change (**Paris Agreement**), the latter of which seeks to combat climate change and to direct finance flows towards low greenhouse gas emissions and climate-resilient development. The Paris Agreement has been the impetus for a growing body of law and regulation in the European Union (EU) focused on ESG concerns and, in particular, sustainable investment. In the United States (US), the Securities and Exchange Commission (SEC) has proposed rules that would dictate ESG disclosure related to climate change for reporting companies and impose ESG reporting requirements on certain funds and US investment advisers.

### European Union

The EU has been leading the way in adopting rules and regulations focused on sustainable investment – with the EU Commission taking the decision in 2016 to make sustainable development a political priority – and ESG has remained front and centre of legal and regulatory developments ever since.

For the EU, sustainable finance is about reorienting investment towards sustainable technologies and businesses, recognising that major public and private investment is needed to make the EU's financial system sustainable and ensure Europe is climate-neutral by 2050. To achieve this, in 2018 the EU launched its Action Plan on Sustainable Growth (**Action Plan**),<sup>1</sup> which set out 10 action points<sup>2</sup> with the key objectives of: (i) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth; (ii) managing financial risks stemming from climate change, environmental degradation and social issues; and (iii) fostering transparency and long-termism in financial and economic activity.

Based on the Action Plan, the EU Commission set out three building blocks as the foundation for building a sustainable financial framework in the EU: (1) a classification system, or “taxonomy”, of sustainable activities; (2) a disclosure framework for non-financial and financial companies; and (3) investment tools, including benchmarks, standards and labels, which are discussed below in detail.

Since 2018, the EU Commission's position with regard to what is needed to meet the sustainability goals has evolved, and the global context has changed. In July 2021, the EU Commission

launched a new phase of the EU's sustainable finance strategy,<sup>3</sup> which identified four main areas where additional actions are needed for the financial system to support the transition of the economy towards sustainability. These are: (1) financing the transition of the real economy towards sustainability; (2) developing a more inclusive sustainable finance framework; (3) improving the financial sector's resilience and contribution to sustainability (the “double materiality perspective”); and (4) fostering global ambition as global efforts are key to tackling the financial stability implications of climate and environmental risks.

Other notable developments include the EU Commission's launch in December 2020 of the Green Deal,<sup>4</sup> described as a “*new growth strategy. It will help us cut emissions while creating jobs*”.

In April 2021, the EU Commission reached a provisional agreement on the European Climate Law,<sup>5</sup> which “*enshrines the EU's commitment to reaching climate neutrality by 2050 and the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 level*”.

On 11 February 2022, the European Securities and Markets Authority (ESMA) published its sustainable finance roadmap for 2022–2024<sup>6</sup> (dated 10 February 2022), which identifies three priorities for its sustainable finance work: (1) tackling greenwashing and promoting transparency; (2) building national competent authorities' and ESMA's capacities in the sustainable finance field; and (3) monitoring, assessing and analysing ESG markets and risks. These priorities are likely to drive the ESG agenda in the financial services sector in Europe for the immediate future.

#### But what does this mean in practice?

The focus of recent years has been to integrate (i) ESG considerations into the investment processes of EU-based investment managers and investors, and (ii) ESG factors into the non-financial data that is tracked and reported on by European businesses. The most significant measures adopted to date are the following building blocks:

- The Taxonomy Regulation,<sup>7</sup> which entered into force on 12 July 2020. It essentially created a classification system for sustainable economic activities, and the majority of its operative provisions took effect on 1 January 2022. This regulation establishes the concept of a “taxonomy-aligned investment”, which in essence is an investment that contributes substantially to certain specified environmental objectives, does not significantly harm those objectives and complies with certain minimum safeguards and technical criteria.
- The Sustainable Finance Disclosure Regulation (SFDR),<sup>8</sup> which came into effect on 10 March 2021, and was subsequently amended by the Taxonomy Regulation. It seeks

to provide for (i) a harmonised understanding of what constitutes “sustainable investment”,<sup>9</sup> and (ii) a uniform, mandatory set of disclosure and reporting obligations relating to sustainability issues in connection with investment activity, including in the offering documentation and annual accounts for investment products. The EU views it as a tool that will trigger changes in behavioural patterns in the financial sector, discouraging greenwashing, and promoting responsible and sustainable investments. At a more granular level, it requires in-scope entities to radically change the way they act and how they assess and document their approach to sustainability.<sup>10</sup> It also provides for the designation of green investment products, including dark-green or “Article 9” products, which pursue a sustainable investment objective, and light-green or “Article 8” products, which promote, amongst others, environmental and social characteristics, provided those companies in which they invest follow good governance. The SFDR is supplemented by regulatory technical standards (RTS)<sup>11</sup> that specify the content, methodologies and presentation of information to be provided pursuant to various provisions of the SFDR. These RTS apply from 1 January 2023.

- The new Corporate Sustainability Reporting Directive (CSRD), which was approved by the EU Commission on November 28, 2022. The CSRD will be published in the Official Journal of the EU and enter into force 20 days after its publication. Member States will have 18 months to implement its provisions into national law. The application of the CSRD will take place on a phased basis, commencing in 2024. The CSRD aims to ensure that companies report reliable, comparable and consistent sustainability information that investors and other stakeholders need in order to, for example, comply with the SFDR and the Taxonomy Regulation. The CSRD revises and strengthens rules introduced by the Non-Financial Reporting Directive,<sup>12</sup> significantly expanding the scope of EU listed and established entities that are in scope of the reporting obligations. The intention is that the CSRD will increase transparency and the disclosure of sustainability information, making the comparison of different financial products easier.

The Taxonomy Regulation, SFDR and CSRD complement each other and cannot be viewed in isolation. While the obligations imposed by the Taxonomy Regulation are limited, the implications of its text are broad, as it establishes the vocabulary underlying the EU’s sustainable development agenda and, in this context, informs the content of the disclosure obligations under the SFDR. The CSRD is an important mechanism for ensuring that the data needed to report on the degree of sustainability is available.

Some other important measures introduced to make the financial sector even more sustainable include:

- The Climate Benchmarks Regulation,<sup>13</sup> in force since 23 December 2020, which introduced two new types of benchmarks:
  - an EU Climate Transition Benchmark, with a “decarbonisation trajectory” evidenced by a measurable, science-based and time-bound movement towards alignment with the objectives of the Paris Agreement (e.g., the 2°C limit on global warming); and
  - an EU Paris-Aligned Benchmark, where the resulting reference portfolio’s carbon emissions are aligned with the objectives of the Paris Agreement (e.g., in essence, the carbon emission savings of each underlying asset exceed its carbon footprint).

In August 2022, ESMA voiced<sup>14</sup> support for the introduction of an EU ESG benchmark label, stating that ESG-labelled benchmarks should be subject to supervision

in order to ensure that benchmark administrators comply with regulatory requirements. This may result in changes to the existing regulations.

- The EU Taxonomy Climate Delegated Act<sup>15</sup> that classifies which activities best contribute to mitigating and adapting to the effects of climate change for the purpose of the Taxonomy Regulation. Subsequent delegated acts will cover other environmental objectives set out in the Taxonomy Regulation, namely: the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems. It has applied since 1 January 2022.
- The Complementary Climate Delegated Regulation<sup>16</sup> (CCD Regulation) that sets out the conditions under which nuclear and natural gas energy activities can be included in the list of economic activities covered by the Taxonomy Regulation (amending the EU Taxonomy Climate Delegated Act). The CCD Regulation also amends the EU Taxonomy Article 8 Delegated Regulation (see below) to require large listed non-financial and financial companies to disclose the proportion of their activities linked to natural gas and nuclear energy. Its provisions will apply from 1 January 2023.
- The EU Taxonomy Article 8 Delegated Regulation<sup>17</sup> that specifies the content and presentation of information to be disclosed by non-financial undertakings, asset managers, credit institutions, investment firms, and insurance and reinsurance undertakings, as well as common rules relating to key performance indicators. It entered into force on 30 December 2021 and has applied since 1 January 2022 with a phased application.
- Amendments to existing legislation (the Alternative Investment Fund Managers Directive (AIFMD),<sup>18</sup> the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive<sup>19</sup> and the Markets in Financial Instruments Directive (MiFID)<sup>20</sup>) to:
  - ensure that sustainability factors and sustainability-related objectives are considered in the product oversight and governance process for products/instruments;
  - require the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms;
  - ensure sustainability risks and sustainability factors are taken into account by alternative investment fund managers and for UCITS; and
  - ensure a client’s sustainability preferences are taken into account in managing their investments or selling them an investment product.

While the entities in scope of the various Regulations and Directives are essentially financial firms active in the EU or the EU entities in which they invest, the impact is already being felt much more broadly, not only because financial firms are frequently global or operate across borders into the EU, but because the EU has moved first to define regulatory parameters in a space that is of growing global importance and relates to issues such as global warming, which does not obey national boundaries.

## United Kingdom

Although a great deal of existing EU legislation was “on-shored” into the United Kingdom (UK) statute book following the UK’s exit from the EU on 31 January 2020, this has not been the case for legislation taking effect after this time. In the context of ESG, this includes the Taxonomy Regulation, the SFDR and the CSRD, as well as the amendments to existing legislation (i.e. the AIFMD, UCITS Directive and MiFID). In fact, regulating sustainable finance is an area where the UK and EU are following divergent paths.

Although it is not taking the same direction of travel as the EU, the UK government has repeatedly stated its commitment to fighting climate change. The UK Chancellor stated that the government's economic policy objective “remains to achieve strong, sustainable and balanced growth”<sup>21</sup> and that the government aims to deliver a “financial system which supports and enables a net zero economy by mobilising private finance towards sustainable and resilient growth and is resilient to the physical and transition risks that climate change presents”<sup>22</sup>. To date, this has meant a focus on climate change.

More specifically, the UK government endorsed the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)<sup>23</sup> in 2017 and made implementation of the TCFD proposals a central part of its 2019 Green Finance Strategy,<sup>24</sup> the principal objective of the strategy being to “align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by Government action”. In promoting the TCFD's recommendations, the UK Taskforce (described below) aims not only to improve the flow of information, but also to foster a step change in how organisations think about climate-related risks and opportunities.

In November 2020, a UK government and regulator-led taskforce – including the two principal financial regulators, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (together, the **UK Taskforce**) – published an Interim Report<sup>25</sup> and Roadmap<sup>26</sup> setting out a strategy towards mandatory TCFD-aligned disclosures across the UK by 2025 and an indicative path for the introduction of regulatory rules and legislative requirements over the next five years, with most to be implemented in the first three years. The UK Taskforce recognises the global nature of the asset management industry and its interactions with related international initiatives, including those that derive from the EU's Sustainable Finance Action Plan. Most encouragingly, the Interim Report states that the proposed TCFD-aligned requirements would, as far as possible, be consistent with and complementary to these initiatives.

The FCA has developed its own ESG strategy<sup>27</sup> that sets out its target outcomes and the actions it expects to take in order to deliver these. The FCA states that “ESG matters are high on the regulatory agenda” and that its aim is to support the financial sector in driving positive change, including the transition to net zero. The FCA's work is based on five core themes:

- Transparency – promoting transparency on climate change and wider sustainability along the value chain.
- Trust – building trust and integrity in ESG-labelled instruments, products and the supporting ecosystem.
- Tools – working with others to enhance industry capabilities and support firms' management of climate-related and wider sustainability risks, opportunities and impacts.
- Transition – supporting the role of finance in delivering a market-led transition to a more sustainable economy.
- Team – developing strategies, organisational structures, resources and tools to support the integration of ESG into FCA activities.

The FCA has undertaken a programme of work to deliver the outcomes it has set out in its business plan for 2021/2022 and in its ESG strategy, some of which are discussed below.

New disclosure rules for companies with a UK premium listing were finalised in December 2020 and since 1 January 2022, the application of the TCFD-aligned Listing Rule for premium-listed commercial companies has been extended to include issuers of standard-listed equity shares.

The FCA has also introduced climate-related disclosure requirements, aligned with the TCFD's recommendations, for asset managers, life insurers, and FCA-regulated pension providers. The disclosures are: (i) “entity-level disclosures”, meaning firms are required to publish annually an entity-level TCFD report on

how they take climate-related risks and opportunities into account in managing or administering investments on behalf of clients and consumers, with these disclosures being made in a prominent place on the main website for the firm's business, and covering the entity-level approach to all assets managed by the UK firm; and (ii) “product or portfolio-level disclosures”, meaning firms are required to produce annually a baseline set of consistent, comparable disclosures in respect of their products and portfolios, including a core set of metrics.

These new disclosure rules have applied to in-scope UK asset managers with assets under management (AUM) of £50 billion or more since 1 January 2022 and will apply from 1 January 2023 for smaller firms above the £5 billion exemption threshold. The publication deadline for the first entity and product-level disclosures is 30 June 2023 for firms with AUM above £50 billion and 30 June 2024 for smaller firms above the £5 billion exemption threshold. The FCA's rules and guidance are set out in a new ESG Sourcebook that will be expanded to cover additional sustainability topics over time.

In November 2021, the FCA issued a discussion paper on sustainability disclosure requirements (SDR) and investment labels (DP 21/4). The FCA envisages entity and product-level disclosures by asset managers and asset owners in respect of investment products in relation to governance, strategy, risk management, metrics and targets. DP 21/4 specifically looks at the extent to which the proposed rules can remain consistent with the disclosure requirements under the SFDR while reflecting the needs of the UK market.

The FCA is expected to consult in Q4 2022 on proposed rules to implement SDR disclosure requirements and provide for sustainable investment labels. The FCA has suggested that classifying and labelling investment products according to objective criteria, and using common terminology, could help combat potential greenwashing and enhance trust. It notes that classification and labelling of sustainable finance products have become increasingly common internationally, albeit with differences in terms of policy aims and practical implementation. Accordingly, the FCA is taking a different approach from the EU, which has declined to consider Article 8 and Article 9 products under SFDR as product labels.

To date, the UK has predominantly focused on climate change, rather than the broader ESG concerns that are the focus of the EU regulators and legislators, although the FCA has stated that it will “leverage the extensive work we have already done recently, and over the years, on governance, diversity, culture and purpose” and that it is “working actively with our international partners to develop robust and commonly agreed international standards on ESG that can serve global markets effectively”.

In summary, both the EU and UK legislative and regulatory bodies continue to focus on ESG. However, their divergent approaches mean that it will become increasingly complex to navigate the overlapping but distinct legal and regulatory requirements as they evolve.

## Hong Kong

Hong Kong's regulatory framework with regard to climate change and sustainable investment has gradually taken shape in recent years. Although the Climate Action Plan 2030+ published by the Hong Kong Environmental Bureau in January 2017 originally centred on green finance, the Hong Kong Securities and Futures Commission (SFC) and Hong Kong Exchanges and Clearing Limited (HKEX) have taken cues from international bodies and Mainland China to develop a regulatory agenda that goes beyond this initial focus.

There are three key drivers underlying Hong Kong's regulatory agenda with respect to sustainable investment: (i) Mainland

China's status as a signatory to the Paris Agreement, the provisions of which apply to Hong Kong; (ii) the conviction of key regulators (including the SFC and HKEX) that climate change is a real threat and a source of financial risk to investors; and (iii) Hong Kong's position as an international financial centre, which necessitates proactive engagement with financial participants on climate risk-related issues.

In light of these drivers, the SFC's and HKEX's efforts have been directed at: (1) disclosure of listed companies' environmental information and climate-related risks; (2) integration by asset managers of climate change factors into their investment and risk management processes; and (3) ensuring accurate product disclosure of green investments, consistent with international standards, and avoiding greenwashing.

So far, similar to the regulations in the EU, the rules are far from being in their final form. At the time of writing, the following are the key measures that have been taken:

- the Hong Kong Stock Exchange published guidelines on mandatory reporting on ESG,<sup>28</sup> which came into effect on 1 July 2020 and replaced the voluntary ESG reporting regime that was first introduced in 2012. The guidelines largely emphasise climate-related disclosure, aligning with recommendations of the TCFD;
- the SFC released a circular to management companies of SFC-authorized unit trusts and mutual funds on "green" or "ESG" funds on 11 April 2019,<sup>29</sup> which was subsequently amended on 29 June 2021.<sup>30</sup> The circular sets out the SFC's expectations on the "product-level" disclosure obligations of SFC-authorized funds that incorporate ESG factors as their key investment focus with the goal of improving their comparability, transparency and visibility. To accompany the circular, the SFC also set up a dedicated website to list all SFC-authorized funds that categorised themselves as ESG funds; and
- on 20 August 2021, the SFC published its consultation conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers,<sup>31</sup> which sets out amendments to the existing SFC Fund Manager Code of Conduct. The document followed a month-long consultation in which the SFC proposed high-level principles setting out the governance, investment management, risk management and disclosure obligations of fund managers with respect to climate risks. The proposals largely reference the recommendations of the TCFD – and notably allow for a two-tier approach (i.e. with baseline requirements for all fund managers and enhanced standards for fund managers with AUM exceeding a threshold of HK\$8 billion). The effective date for all fund managers to fully comply with the new requirements was 20 November 2022, although large fund managers should have already complied with baseline requirements by 20 August 2022.

## Singapore

While initially lagging behind the EU and Hong Kong, Singapore's development of a sustainable investment regulatory framework has accelerated. In 2021, the Singapore government set out its five-pillar climate ambitions for Singapore to achieve by 2030 in its "Singapore Green Plan 2030" (**Green Plan**).<sup>32</sup> The Green Plan makes reference to the Monetary Authority of Singapore's (MAS) own initiatives, as set out in their 2019 annual report, to "green" the financial system by: (i) developing Singapore's green finance markets and solutions; (ii) building a financial system that is resilient to environmental risks; and (iii) building the requisite capabilities and encouraging green fintech innovation.

In a short timeframe, the MAS has consulted the industry and taken measures to facilitate its green initiatives. At the time of writing, the following are the key measures that have been taken:

- (a) the Singapore Exchange (**SGX**) has published its guidelines for sustainability reporting,<sup>33</sup> to which listed companies have been required to adhere on a "comply or explain" basis since the financial year ending 31 December 2017. There are five primary components in the guidelines, which comprise: (i) selection of a sustainability reporting framework; (ii) identification of material ESG factors; (iii) policies, practices and performance of the company against material ESG factors; (iv) ESG targets; and (v) board statement on its oversight of material ESG factors;
- (b) on 8 December 2020, the MAS released the final Guidelines on Environmental Risk Management for asset managers (**Guidelines**)<sup>34</sup> which were further supplemented by information papers on environmental risk management for asset managers (see below) on 31 May 2022. The Guidelines aim to address environmental risks, which are broader than climate risks alone, and are defined as risks that arise from the potential adverse impact of a change in the environment on economic activities and human wellbeing. The Guidelines are largely aligned with the recommendations of the TCFD and cover the areas of: (i) governance and strategy; (ii) research and portfolio construction; (iii) risk management; and (iv) stewardship and disclosure;
- (c) on 31 May 2022, the MAS published information papers<sup>35</sup> on environmental risk management for asset managers, setting out a thematic review resulting from the MAS's survey of certain asset managers in 2021 with reference to their implementation of the Guidelines. The information papers highlight what the MAS considers good and bad practices in asset management and areas where further work is expected to be made, and is likely to serve as a reference point for asset managers as they implement measures for the management of environmental risk; and
- (d) on 8 July 2022, the MAS published a circular on the disclosure and reporting guidelines for retail funds, setting out the MAS's expectations on how retail ESG funds should disclose their investment strategy, investment selection criteria and risks, as well as the enhanced reporting standards applying to such funds. The circular will take effect on 1 January 2023.

The expectation is that these measures will be further developed over time.

It is worth noting that the MAS is itself taking climate change seriously as an institution. In the words of Ravi Menon, its managing director, the MAS aims to lead by example, hoping that financial institutions in Singapore and Asia will follow suit. The MAS, as the guardian of Singapore's official foreign reserves, will also integrate climate risks and opportunities into its investment framework by implementing climate risk mitigation strategies for its equity portfolios and allocating more investments to actively managed strategies that seek out climate change-related opportunities. At the level of infrastructure, the MAS is monitoring its own carbon footprint, tracking usage of electricity, water and paper.

## United States

As of September 2022, neither reporting companies nor asset managers in the US are subject to ESG-specific regulatory requirements at the federal level. However, the SEC, under Chair Gary Gensler, has proposed a set of rules that would establish uniform ESG climate risk disclosure standards for reporting companies, impose ESG disclosure requirements on certain funds and

certain US investment advisers, and standardise naming conventions for US-registered investment companies (**retail funds**). The proposed rule amendments are subject to a public comment period and final rulemaking. These proposals, if adopted, could significantly expand both the nature and comparability of the climate risk disclosure available to financial market participants. Some state governments are attempting to prohibit the investment of state funds with managers or funds that boycott certain industries, such as fossil fuels and firearms, while other states will choose to only invest in managers that limit their exposure to fossil fuels.

#### Climate change reporting proposal

On 21 March 2022, the SEC proposed rules for the enhancement and standardisation of climate-related disclosures for reporting companies (the **Climate Change Proposal**). The Climate Change Proposal would require new climate-related disclosures in a registrant's registration statements and annual reports, in a separately captioned "Climate-Related Disclosure" section, and in the notes to financial statements. The proposed rules would mandate the disclosures summarised below:

- *Board and management oversight* – The proposed rules would require a registrant to disclose, as applicable, certain information regarding the board's oversight of climate-related risks and management's role in assessing and managing those risks.
- *Climate-related risks* – The proposed rules would require disclosure of climate-related risks that have had or are likely to have a material impact on a registrant's business and consolidated financial statements, which may manifest over the short, medium or long term.
- *Climate-related impacts on the business* – Having disclosed the material climate-related risks to the business, a registrant would be required to describe the actual and potential impact of those risks on its strategy, business model and outlook.
- *Risk management* – Registrants would be required to disclose their internal processes for managing climate-related risks, including how the registrant:
  - assesses the significance of climate-related risks in comparison to other risks or regulatory requirements, such as greenhouse gas (**GHG**) emissions limits;
  - considers changes in customer or counterparty preferences, technological changes, or changes in market prices in assessing transition risks;
  - decides whether to accept, mitigate, or adapt to a certain risk; and
  - prioritises climate-related risks and mitigates high-priority climate-related risks.
- *Transition plans* – If the registrant has adopted a transition plan in the context of its climate-related risk management, it must describe the plan along with the relevant metrics and targets used to identify physical and transition risks (e.g. reduction of GHG emissions, mitigation of risk related to extreme weather events, adaptation to the imposition of a carbon price, or adaptation to changing demands or preferences of consumers, investors, employees and business counterparties).
- *Carbon offsets or renewable energy credits (RECs)* – If, as part of its net emissions reduction strategy, a registrant uses carbon offsets or RECs, the proposed rules would require it to disclose the role that carbon offsets or RECs play in the registrant's climate-related business strategy.
- *Maintained internal carbon price* – Under the SEC's proposed definition, an internal carbon price is an estimated cost of

carbon emissions used internally within an organisation. If a registrant uses an internal carbon price, the proposed rules would require it to make various pricing disclosures, including the rationale for selecting the applied internal carbon price and how it uses its internal carbon price to evaluate and manage climate-related risks.

- *Scenario analysis* – A registrant must describe the resilience of its business strategy in light of potential future changes in climate-related risks.
- *GHG emissions* – A registrant must describe the resilience of its business strategy in light of potential future changes in climate-related risks.

If adopted in its current form, the Climate Change Proposal can be expected to impose significant disclosure burdens and related expenses on issuers, particularly those that do not yet have processes in place to gather the information necessary to provide the required disclosures.

#### SEC proposal to enhance ESG disclosures by certain investment advisers and investment companies

On 25 May 2022, the SEC proposed a framework requiring retail funds and certain US-registered investment advisers to disclose their ESG investment practices (the **Proposal**).<sup>36</sup> The Proposal comes in the wake of substantial scrutiny of disclosure practices involving ESG investment by the SEC and its staff. The Proposal is intended to promote the provision of "consistent, comparable, and reliable" information to investors, to facilitate informed decision-making related to ESG investment product and strategy offerings.

In particular, the Proposal would seek to change existing disclosure practices by (among other provisions): expressly requiring ESG-related disclosures in fund prospectuses and annual reports and investment adviser regulatory filings (where funds and strategies use ESG investment techniques); implementing a standardised approach for certain types of ESG funds to disclose their ESG investing processes; and, for the first time, requiring disclosure of GHG emissions data in certain circumstances.<sup>37</sup>

The Proposal would require retail funds<sup>38</sup> that consider ESG factors in their investment process to disclose additional information regarding their investment strategies in registration statements and in the "management discussion of fund performance" section of annual reports. The disclosure requirements would vary depending upon whether a fund is categorised as an "integration fund", "ESG-focused fund" or "impact fund".

An integration fund is defined as a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio. If ESG factors are part of the integration fund's principal investment strategy, the fund would be required to include disclosure in the summary prospectus as to how the fund incorporates ESG factors into the investment selection process, including which factors are considered.

All integration funds would be required to describe how the fund incorporates ESG factors into the investment selection process, including: the ESG factors considered and whether the fund considers the GHG emissions of its portfolio investments; and how the fund considers such information (including the methodology the fund uses) in the fund's statutory prospectus.

An ESG-focused fund is defined as a fund that focuses on one or more ESG factors by using them as a significant or main



consideration in selecting investments or in its engagement strategy with the companies in which it invests. This includes any fund whose name includes terms indicating that the fund's investment decisions incorporate one or more ESG factors, and any fund whose sales literature or advertisements indicate that the fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. The Proposal indicates that it would also capture funds that track an ESG-focused index and funds that apply inclusionary or exclusionary screening based on ESG factors.

Impact funds are a subset of ESG-focused funds. Impact funds are defined as ESG-focused funds that seek to achieve specific ESG impact(s). ESG-focused funds and impact funds would be required to disclose information in the summary prospectus in tabular format related to three broad categories: Overview of the Fund's Strategy; How the Fund Incorporates ESG Factors in its Investment Decisions (specific requirements apply with respect to impact funds); and How the Fund Votes Proxies and/or Engages with Companies about ESG Issues.

ESG-focused funds and impact funds would also need to describe in the statutory prospectus how the fund incorporates ESG factors into its investment process, including information related to: the index methodology for any index tracked; internal methodologies used and how they incorporate ESG factors; scoring or ratings systems of any third-party data provider used; factors applied in any inclusionary or exclusionary screen; description of any third-party frameworks followed and how they are used; and, with respect to engagement, a description of any specific engagement objectives and associated key performance indicators.

ESG-focused funds would need to disclose in their annual reports, to the extent applicable based on certain responses to Form N-CEN (primarily whether proxy voting or engagement is a "significant means" of implementing its ESG strategy), information related to: the percentage of ESG proxy voting matters where the fund voted in favour of the initiative; the fund's progress on engagement strategies; and/or GHG emissions data for portfolio investments (carbon footprint and weighted average carbon intensity).

Both methodologies would require Scope 1 and Scope 2 emissions to be included in the emissions calculation but would not require Scope 3 emissions. The GHG emissions requirements would leverage newly available information under the SEC's proposal in March 2022 related to rules for the enhancement and standardisation of climate-related disclosures for reporting companies.

The SEC also proposed to amend Form ADV Part 2A to require registered investment advisers who consider ESG factors as part of their advisory business to disclose information similar to that required in fund registration statements and annual reports. Specifically, the Proposal would require registered advisers to provide: a description of the ESG factors considered in providing advisory services and how they are incorporated, and – if ESG factors are considered when selecting, reviewing or recommending portfolio managers – a description of the factors considered and how they are incorporated.

The Proposal also contains guidance related to fund and adviser compliance policies, as well as marketing materials, in the ESG context.

#### SEC proposal to prevent misleading or deceptive fund names related to ESG

On the same day, 25 May 2022, the SEC released a companion rule proposal to amend Rule 35d-1 (the **Names Rule**) under the Investment Company Act of 1940, to update rules and forms

under both the Investment Advisers Act of 1940 and the US Investment Company Act to require disclosure related to ESG for certain funds (the **Names Rule Proposal**). The Names Rule Proposal would expand the Names Rule to require that a fund adopt a policy to invest at least 80% of its respective assets in the relevant category (**80% Investment Policy**) if its name suggests a focus "in investments that have, or whose issuers have, particular characteristics". The Names Rule Proposal includes growth and value as well as terms indicating that the fund investment decisions incorporate one or more ESG factor(s). For the purposes of the proposed amendments, the term "ESG" would encompass terms such as "socially responsible investing", "sustainable", "green", "ethical", "impact" or "good governance" to the extent that they describe environmental, social and/or governance factors that may be considered when making an investment decision. However, under the current rule, such names are generally considered by many fund sponsors to be investment strategies not subject to the 80% Investment Policy requirement.

The Names Rule Proposal indicates that fund sponsors would retain flexibility in specifying how funds will define their required 80% Investment Policies, define the terms used in such Policies, and determine (in many instances) which investments are appropriate to include in the 80% Investment Policy basket. However, as noted above, any investment focus-related terms used in a fund's name would be required to be defined "consistent with those terms' plain English meaning or established industry use".

The SEC also proposes to codify that compliance with a fund's 80% Investment Policy is not a safe harbour to the prohibitions on adopting a fund name that is materially deceptive or misleading under Section 35(d). Under the proposed amendments, the following may be deemed to be materially deceptive or misleading practices: "substantial" investments made outside (i) the 80% Investment Policy that are "antithetical" to the fund's investment focus, or (ii) an index fund's 80% Investment Policy to invest in assets connoted by a specific index in circumstances where the reference index's composition is contradictory to the index's name. For example, a "fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves could be materially deceptive or misleading for the purposes of Section 35(d). The proposed amendments also specifically address "integration funds", stating that the use by an integration fund of "ESG" or an ESG-related term in its name, thereby suggesting that the fund incorporates ESG factors in the fund's investment process, would be considered materially deceptive and misleading.

Additionally, the proposed amendments would remove the current principles-based approach of requiring that funds comply with their 80% Investment Policy "under normal circumstances" and specifically define situations in which a fund (either a fund with a name suggesting an investment focus or a tax-exempt fund) may temporarily deviate from its 80% Investment Policy. Such deviations could occur as a result of: certain market fluctuations or other circumstances not caused by fund purchase/sale activity; unusually large inflows or redemptions; adverse market, economic, political or other conditions requiring a fund "to take a position in cash and cash equivalents or government securities to avoid a loss"; or repositioning/liquidating fund assets in connection with reorganisations, fund launches, or when appropriate notice of an 80% Investment Policy change has been provided to shareholders.

Generally, a fund would be required to re-attain compliance with its 80% Investment Policy "as soon as reasonably practicable" but, in any event, within 30 consecutive days. For comparison, the current Names Rule provides a fund with greater flexibility in its interpretation, only requiring compliance with an 80% Investment Policy "under normal circumstances".

### State-level anti-boycott legislation

States such as Florida have introduced broad anti-ESG legislation, while other states have introduced statutes more specific to firearms and fossil fuels/energy.<sup>39</sup> As of September 2022, two states, Wyoming and Texas, had passed laws prohibiting government entities from investing in funds and/or contracting with companies that discriminate against firearm entities or firearm trade associations.<sup>40</sup> At least 10 other states have pending legislation related to firearms boycotts.<sup>41</sup> Five states – Kentucky, North Dakota, Oklahoma, Texas and West Virginia – have introduced laws prohibiting government entities from investing in funds and/or contracting with companies that boycott fossil fuels.<sup>42</sup> At least six states have pending legislation related to fossil fuel boycotts.<sup>43</sup> Other state statutes prohibit government entities from investing in funds and/or contracting with companies that boycott mining, production agriculture and commercial timber.

States have also introduced legislation to align the investment of public money with social and climate-related goals. Illinois' Sustainable Investing Act directs government entities managing public funds to consider materially relevant ESG factors.<sup>44</sup> Connecticut has a policy prohibiting state pension funds from investing in civilian firearms manufacturers and requiring banks and financial institutions that wish to work with the State Treasurer to disclose their policies on firearms.<sup>45</sup> Massachusetts and New Jersey have similar laws that are currently pending.<sup>46</sup> Maine prohibits state pension funds from investing in the 200 largest publicly traded fossil fuel companies.<sup>47</sup> California, Massachusetts, New York, Vermont and New Jersey have pending laws that would prohibit the investment of public funds in fossil fuel companies.<sup>48</sup> Nevada, Pennsylvania and Rhode Island have announced policies to divest public funds from businesses that sell or manufacture "assault-style weapons".<sup>49</sup> Rhode Island has proposed a statute that would prohibit the investment of public funds in companies that operate private for-profit prisons.<sup>50</sup>

### Endnotes

1. Action Plan: Financing Sustainable Growth is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN>.
2. In summary, the 10 action points are: (1) establishing an EU classification system for sustainable activities; (2) creating standards and labels for green financial products; (3) fostering investment in sustainable projects; (4) incorporating sustainability when providing financial advice; (5) developing sustainability benchmarks; (6) better integrating sustainability in ratings and market research; (7) clarifying institutional investors' and asset managers' duties; (8) incorporating sustainability in prudential requirements; (9) strengthening sustainability disclosure and accounting rulemaking; and (10) fostering sustainable corporate governance and reducing short-termism in capital markets.
3. The Strategy for Financing the Transition to a Sustainable Economy is available here: [https://eur-lex.europa.eu/ressource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/ressource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF).
4. "What is the Green Deal?" is available here: [https://ec.europa.eu/commission/presscorner/detail/en/fs\\_19\\_6714](https://ec.europa.eu/commission/presscorner/detail/en/fs_19_6714) and a factsheet describing the architecture of the Green Deal is available here: [https://ec.europa.eu/commission/presscorner/detail/en/fs\\_21\\_3671](https://ec.europa.eu/commission/presscorner/detail/en/fs_21_3671).
5. The European Climate Law is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1119&from=EN>.

6. ESMA's sustainable finance roadmap for 2022-24 is available here: [https://www.esma.europa.eu/sites/default/files/library/esma30-379-1051\\_sustainable\\_finance\\_roadmap.pdf](https://www.esma.europa.eu/sites/default/files/library/esma30-379-1051_sustainable_finance_roadmap.pdf).
7. Regulation (EU) 2020/852, available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN>.
8. Regulation (EU) 2019/2088. The consolidated version, as amended by the Taxonomy Regulation, is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R2088-20200712&from=EN>.
9. "[S]ustainable investment" means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, 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."
10. The April 2021 EU Sustainable Finance package is available here: [https://finance.ec.europa.eu/publications/sustainable-finance-package\\_en](https://finance.ec.europa.eu/publications/sustainable-finance-package_en).
11. Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of "do no significant harm", specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports, is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022R1288&from=EN>.
12. Directive 2014/95 EU.
13. Regulation (EU) 2019/2089, available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2089&from=EN>.
14. ESMA's response to the Commission's consultation on the BMR review included its views on climate benchmarks, and the response is available here: [https://www.esma.europa.eu/sites/default/files/library/esma81-393-502\\_esma\\_response\\_to\\_the\\_ec\\_consultation\\_on\\_the\\_bmr\\_review\\_2022.pdf](https://www.esma.europa.eu/sites/default/files/library/esma81-393-502_esma_response_to_the_ec_consultation_on_the_bmr_review_2022.pdf).
15. Commission Delegated Regulation (EU) 2021/2139 is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R2139&from=EN>.
16. Commission Delegated Regulation (EU) 2022/1214 is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022R1214&from=EN>.
17. Commission Delegated Regulation (EU) 2021/2178 is available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R2178&from=EN>.
18. Directive 2011/61/EU.

19. Directive 2009/65/EC.
20. Directive 2014/65/EU.
21. Letter from the Chancellor to the FCA “Recommendations for the Financial Conduct Authority”, dated 23 March 2021, is available here: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/972445/CX\\_Letter\\_-\\_FCA\\_Remit\\_230321.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/972445/CX_Letter_-_FCA_Remit_230321.pdf).
22. *Ibid.*
23. The TCFD has over 1,000 supporters, which are headquartered in 55 countries, span the public and private sectors and include organisations such as corporations, national governments (Belgium, Canada, Chile, France, Japan, Sweden and the UK), government ministries, central banks, regulators, stock exchanges and credit rating agencies.
24. The Green Finance Strategy is available here: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/820284/190716\\_BEIS\\_Green\\_Finance\\_Strategy\\_Accessible\\_Final.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf).
25. The Interim Report is available here: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/933782/FINAL\\_TCFD\\_REPORT.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933782/FINAL_TCFD_REPORT.pdf).
26. The Roadmap is available here: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/933783/FINAL\\_TCFD\\_ROAD\\_MAP.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROAD_MAP.pdf).
27. The FCA’s ESG strategy is available here: <https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities>.
28. The ESG Reporting Guide is available here: <https://en-rules.hkex.com.hk/rulebook/environmental-social-and-governance-reporting-guide-0>.
29. The SFC circular dated 11 April 2019 is available here: <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=19EC18>.
30. The amended SFC circular dated 29 June 2021 is available here: <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=21EC27>.
31. The consultation conclusions are available here: <https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP5>.
32. The Green Plan is available here: <https://www.greenplan.gov.sg>.
33. The SGX guidelines are available here: <https://www.sgx.com/regulation/sustainability-reporting>.
34. The MAS Guidelines are available here: <https://www.mas.gov.sg/regulation/guidelines/guidelines-on-environmental-risk-management-for-asset-managers>.
35. The MAS information papers published on 31 May 2022 are available here: <https://www.mas.gov.sg/publications/monographs-or-information-paper/2022/information-papers-on-environmental-risk-management>.
36. *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Rel. Nos. IA-6034 & IC-34594 (25 May 2022).
37. In addition, the amendments would require the tagging of certain ESG disclosures using the Inline Extensible Business Reporting Language (**Inline XBRL**) structured data language. This would apply to funds that file registration statements on Forms N-1A, N-2 or S-6, annual shareholder reports on Form N-CSR and annual reports on Form 10-K.
38. The proposed amendments in this section would apply to open-ended funds (including exchange-traded funds) and closed-ended funds (including business development companies) – but not unit investment trusts (**UITs**) – that incorporate ESG factors into their investment process. The Proposal would also amend Form N-8B-2 to require a UIT to, if one or more ESG factors are used to select portfolio securities, briefly describe how the factors are incorporated (including which factors are used). UITs would not be subject to the proposed annual report requirements because a UIT is not required to provide a management’s “discussion of fund performance” section in its annual reports.
39. The Resolution Passed on 23 August 2022 by the Florida State Board of Administration is available here: <https://www.flgov.com/wp-content/uploads/2022/08/ESG-Resolution-Final.pdf>.
40. Wyoming adopted HB 0236 on 7 April 2021 and Texas adopted SB No. 13 regarding fossil fuels effective on 1 September 2021. Additionally, Texas adopted SB 19 regarding firearms effective on 1 September 2021.
41. Arizona HB 2437 transmitted to Senate on 24 February 2022, Indiana HB 1409 (companion to SB 397) effective on 1 July 2022 Kentucky HB 123 (*see supra* endnote 14), Louisiana HB 978 pending Senate final passage as of 5 June 2022, Missouri SB 492 and SB 1048 passed General Laws Committee 30 March 2021 and 12 April 2022, Ohio HB 297 in Committee as of 12 May 2021, Oklahoma HB 3144 passed by the House 1 March 2022, South Carolina HB 3506 referred to Committee on the Judiciary on 12 January 2021, South Dakota SB 182 introduced on 2 February 2022, and West Virginia SB 555 introduced on 2 February 2022.
42. Kentucky SB 205 signed on 8 April 2022 prohibiting government entities from entering into a contract for goods or services that boycott energy companies, Kentucky HB 123 regarding firearms returned to Appropriations and Revenue on 3 March 2022, Texas *see supra* endnote 12, and West Virginia SB 262 effective on 10 June 2022.
43. Idaho HB 737 introduced on 3 March 2022, Louisiana HB 141 and HB 25 both referred to Committee on Retirement 14 March 2022.
44. Illinois Sustainable Investing Act 30 ILCS 238 effective on 1 January 2020.
45. Information on Connecticut Responsible Gun Policy introduced on 3 December 2019, available here: <https://portal.ct.gov/OTT/About-the-Treasury/Responsible-Gun-Policy>.
46. Massachusetts H.55 introduced on 22 January 2019 and New Jersey S 1407 introduced on 10 February 2022.
47. Maine enacted Sec. 1.5 MRSA §1957 on 16 January 2014.
48. California SB 1173 referred to the Cross Committee on 2 June 2022, Massachusetts H 4170 introduced on 30 September 2021, New York SB S4783A introduced on 12 February, Vermont S 251 referred to Committee on 15 March 2022, and New Jersey S 1407/A 1752 introduced on 11 January 2022.
49. Information on Nevada’s proposed law is available here: <https://thehill.com/news/state-watch/3510766-nevada-says-it-will-end-investment-in-companies-that-make-assault-style-weapons>, Pennsylvania SB 748 introduced on 7 July 2021.
50. *Id.*

## Acknowledgment

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**Julien Bourgeois** joined Dechert in 1999. Mr. Bourgeois is a co-chair of Dechert LLP's ESG Task Force. Mr. Bourgeois focuses on the asset management industry, advising US-registered investment companies and their directors, as well as their investment advisers and other service providers, on regulatory, compliance, governance and enforcement matters. He has experience with all aspects of investment company representations, including: board matters; exemptive applications; initial and ongoing registrations; complex fund reorganisation transactions; affiliation considerations; and structuring funds of funds, manager of managers funds and registered funds using alternative investment strategies and fee arrangements.

**Dechert LLP**  
1900 K Street, NW  
Washington, D.C., 20006-1110  
USA

Tel: +1 202 261 3451  
Email: [julien.bourgeois@dechert.com](mailto:julien.bourgeois@dechert.com)  
URL: [www.dechert.com](http://www.dechert.com)



**Mikhaelle Schiappacasse's** practice focuses on the structuring, establishment, management, marketing, and restructuring of fund platforms and investment funds, including hedge, debt, real estate, private equity and funds of funds, across a broad range of asset classes and fund domiciles. Ms. Schiappacasse also advises on the establishment of asset management businesses, including the drafting and negotiation of shareholders' agreements and limited liability partnership agreements. She also acts for investment funds and their managers on general corporate, regulatory and compliance matters. She is a co-chair of Dechert LLP's ESG Task Force.

**Dechert LLP**  
160 Queen Victoria Street  
London, EC4V 4QQ  
United Kingdom

Tel: +44 20 7184 7845  
Email: [mikhaelle.schiappacasse@dechert.com](mailto:mikhaelle.schiappacasse@dechert.com)  
URL: [www.dechert.com](http://www.dechert.com)



**Tyler Payne** is an associate in the financial services group. Mr. Payne focuses his practice on financial services matters. He advises US-registered investment companies, including mutual funds, business development companies and exchange-traded funds, as well as private funds and investment advisers on various regulatory, compliance and business matters. Mr. Payne also assists clients with developing and launching new funds and requests for exemptive relief from the SEC.

**Dechert LLP**  
One International Place, 100 Oliver Street  
Boston, MA, 02110-2605  
USA

Tel: +1 617 728 7197  
Email: [tyler.payne@dechert.com](mailto:tyler.payne@dechert.com)  
URL: [www.dechert.com](http://www.dechert.com)



**Stanley Tiu** focuses his practice on asset managers and financial services regulation. He advises and represents mutual and hedge fund managers on a range of matters, including the establishment, registration and maintenance of collective investment schemes as well as ancillary issues around their organisation, such as on negotiations with service providers, global distribution arrangements and fund manager regulation. A large component of Mr. Tiu's practice involves advising UCITS and other European funds (such as Luxembourg RAIFs) in Hong Kong – he advised on Hong Kong's first two UCITS to be authorised via the Luxembourg–Hong Kong Mutual Recognition of Funds regime, and on the first equity long/short UCITS to be authorised in Hong Kong.

**Dechert LLP**  
31/F Jardine House  
One Connaught Place, Central  
Hong Kong

Tel: +852 3518 4755  
Email: [stanley.tiu@dechert.com](mailto:stanley.tiu@dechert.com)  
URL: [www.dechert.com](http://www.dechert.com)

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Real Estate  
Renewable Energy  
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