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Diverging Paths: The EU-US ESG Regulatory Debate and the Implications for EU Competitiveness

The pace of change with regard to attitudes, laws and regulations on climate change matters in the ten years since the adoption of the Paris Agreement in 2015 has been head spinning. In the early years of the past decade, there appeared to be a growing international consensus on the need to finance the transition to net zero. In its ambitious Sustainable Finance Action Plan, published in 2018, the European Union ("**EU**") sought to position itself as a global leader in the area of sustainable finance, introducing a complex framework of new disclosure rules intended to provide investors with the information they needed to make investments aligned with their sustainability goals. In the US, at a federal level, the SEC proposed rules aiming to standardise how companies report their climate-related risks and impacts, while a large number of states introduced sustainability reporting regulations. The Inflation Reduction Act ("**IRA**") introduced significant tax incentives to facilitate the transition towards sustainable energy.

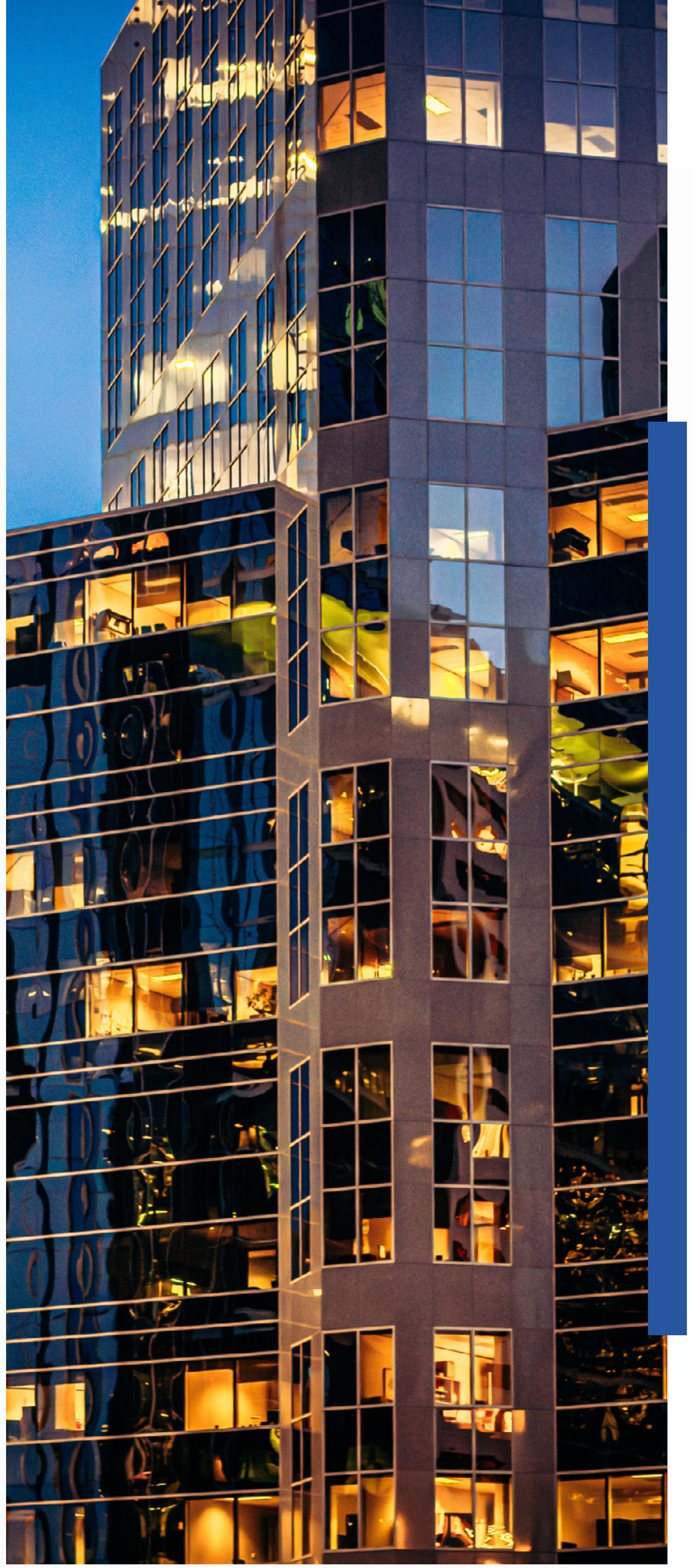
In more recent years, we have seen the US's withdrawal from the Paris Agreement and denouncement of the United Nation's Sustainable Development Goals ("**SDGs**"), legal challenges to the SEC's proposed corporate disclosure rules, ultimately leading to their defence being abandoned earlier this year, and a significant rollback on the clean energy tax credits and other climate-related provisions in the IRA. A number of US states have implemented policies to restrict ESG considerations in state investments, requiring investment decisions to be based solely on financial considerations, and "blacklisting" asset managers deemed to be boycotting fossil fuels. A number of asset managers have withdrawn from climate initiatives such as the Net Zero Asset Managers Initiative, which had launched as recently as 2020 but suspended its activities in January of this year.

The EU's Ongoing Commitment

The "ESG backlash" and change in the administration in the US coincided with the reconstitution of the European Commission in 2024, a year in which both the Letta[1] and Draghi[2] reports on the future of the EU's single market and on EU competitiveness were published. The EU's renewed focus on competitiveness and growth posed questions as to whether the EU would pursue its European Green Deal with continued zeal, particularly in light of the prospect of increasing deregulation across the Atlantic. President von der Leyen's mission letter[3] to Commissioner Albuquerque reaffirmed the Commission's climate objectives, including its goal to become the world's first climate-neutral continent by 2050, and its commitment to the UN SDGs and the Green Deal. The letter made it clear that the EU intends to remain a global leader in sustainable finance, referring to scaling up sustainable finance, in particular transition finance and climate resilience.

The Simplification Agenda

Notably, the mission letter also referred to the Commission's focus on reducing administrative burdens and simplifying legislation, including reducing reporting obligations by at least 25%. The new Commission acted with purpose in this regard, publishing the Omnibus I proposal in February of this year, which includes proposals to significantly reduce the scope of the reporting requirements under the Corporate Sustainability Reporting Directive ("**CSRD**") and proposed amendments to reporting obligations under the Taxonomy Regulation. While the proposals have been described by the Commission as 'simplification' rather than 'deregulation' efforts, the effect of the proposals, if adopted, would be to significantly scale-back CSRD reporting obligations, with 80% of companies taken out of scope and a two-year delay to reporting for those that would continue to be subject to the CSRD.[4]



1 Enrico Letta "Much More than a Market" April 2024
2 Mario Draghi "The future of EU competitiveness" September 2024
3 Mission Letter Ursula von der Leyen President of the European Commission to Maria Luis Albuquerque Commissioner for Financial Services and the Savings and Investments Union 17 September 2024
4 See our briefing notes "CSRD – The European Commission Proposes Significant Deregulation" and "CSRD and the Omnibus Proposal – Implications for Asset Managers".

From a burden reduction perspective, the CSRD changes will no doubt be welcomed by many EU companies. However, reduced sustainability reporting poses challenges to fund managers already dealing with significant data challenges in meeting their obligations under the Sustainable Finance Disclosure Regulation ("**SFDR**") and the Taxonomy Regulation. To fill the data gap, fund managers will have to continue to rely on ESG data and ratings sold by third-party providers, potentially increasing costs for investors. The fact that ESG data providers remain unregulated at EU level, and that ESG data is not standardised and often incomparable, adds to the compliance challenges for asset managers. The lack of available, reliable data will likely lead to the increased use of estimates in meeting disclosure obligations, which, in the absence of clear guidance on the use of such estimates, may increase the risk of greenwashing and undermine the trust and confidence of investors in the financial system.

Recognising that the "*regulatory burden has become a brake on Europe's competitiveness*",[5] the Commission's simplification agenda includes proposals to address the issue of fragmentation and the unnecessary duplication of regulatory burdens, particularly the barriers and costs relating to operating group structures across EU member states and to the distribution of investment funds across the EU, with legislative proposals expected later this year.[6]

The review of the SFDR, one of the cornerstones of the EU's sustainable finance framework, does not fit neatly into this new simplification and burden reduction agenda. Work on the review of the SFDR commenced in 2023, prior to the publication of the Draghi report and the reconstitution of the Commission, and the introduction of a new product classification regime to replace the current disclosure regime is difficult to reconcile with a simplification objective. While criticisms of the current SFDR censuring the complexity of the disclosures for retail investors and questioning the usefulness of the disclosures for professional investors are warranted, asset managers have already incurred significant compliance costs and made substantial changes in order to comply with the disclosure regime and are now faced with a further potentially significant overhaul of the framework.

One of the most notable challenges in implementing the SFDR related to the misalignment in timing of the introduction of obligations. For example, the EU imposed detailed disclosure obligations on market participants at a time when there were no corresponding reporting obligations on investee companies, creating significant data gaps and resulting in less comparable, comprehensible disclosures for investors, undermining the purpose of the EU disclosure regime. The proposed reduced scope of the CSRD is likely to compound these challenges.

There continues to be misalignment between the SFDR, the Taxonomy Regulation and the provisions relating to investor's sustainability preferences in the Markets in Financial Instruments Directive ("**MiFID**"). A more coherent, consistent framework should be the objective of an holistic approach to the Omnibus I Proposal, the SFDR review and a future review of MiFID.

What do investors have to say?

In addition to diverging policy and regulatory approaches with regard to ESG reporting and disclosures, there may also be divergence in investor preferences between the EU and US. In both jurisdictions, the geopolitical environment has drawn attention away from sustainability issues and towards economic growth, competitiveness and defence. While assets in global ESG funds ended 2024 8% higher than in 2023 to reach an annual record high of $3.2 trillion, inflows had been declining in the three years prior to 2025, and redemptions were at a record high of $11.8 billion in the first quarter of 2025 globally. While not representative of an established pattern, in the second quarter of 2025, European investors drove a recovery in sustainable funds, investing $8.6 billion of net new money into ESG funds over those three months, after redeeming $7.3 billion in the previous quarter. Meanwhile, the US saw the eleventh consecutive quarter of withdrawals.[7]

There has also been a marked difference between the EU and the US in relation to the level of support for shareholder resolutions with an ESG objective, with asset managers in the UK and Europe supporting 81% of shareholder ESG proposals on average in 2024, compared with 25% support in the US.[8] New restrictions on permissible shareholder resolutions introduced by the SEC earlier this year preceded a sharp fall in the number of environmental and social proposals submitted to shareholder vote. Arguably, this could impact US companies' insight into the market's view of financially material ESG themes.[9]

There have been instances of EU pension funds withdrawing from or reviewing mandates with asset managers that have revised their ESG credentials or withdrawn from climate initiatives such as NZAM and Climate Action 100+. Although it may be too early to determine whether this is the "*early phase of a broader movement*", European pension funds and other long-term asset owners remain committed to sustainable investing.[10]

5 European Commission "A Competitiveness Compass for the EU" 29 January 2025
6 Matheson "Developments Impacting the Supervision of Investment Funds" April 2025
7 Morningstar "Global Sustainable Fund Flows: Q2 in Review"
8 ShareAction "Voting Matters 2024" February 2025
9 Morningstar "Amid New Curbs on ESG Shareholder Resolutions, Companies May Lose Useful Signals from Investors" 19 August 2025
10 Financial Times "European and UK pension funds drive transatlantic split in sustainable investing" 21 May 2025

Closing Comment

As the political debate continues regarding issues such as climate change, DEI and whether defence investment is compatible with ESG principles, from a market participant's perspective, the future direction for ESG and sustainable finance is arguably less about values and principles and more about reputational management, satisfying investor demand for opportunities meeting their preferences, and the need for greater regulatory alignment.

In order to fulfil their duties to their investors and for risk management purposes, asset managers must take into account sustainability risks that may impact fund performance. While the EU devised its sustainable finance framework with a view to channelling capital towards sustainable investments to assist the EU in meeting its 2050 net zero target, from a purely market-driven point of view, investors ought to be given the opportunity to benefit from climate adaptation as an investment strategy, giving investors access to investment returns from companies and projects that promote and progress the transition.

It is often argued that the US innovates while the EU regulates, but it must be remembered that regulation in itself is not inherently bad, as attested by the asset managers who lobbied for and supported the introduction of the US Investment Companies Act 1940 and who saw the benefits regulation brought to the collective reputation of the industry and the enhanced trust it engendered. Accepting that regulation can bring benefits to an industry, there is, however, a need for alignment between the various legislative and regulatory initiatives contributing to the EU's sustainable finance agenda, to ensure that the complexities and costs of compliance do not undermine EU competitiveness.

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