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Connecting Climate Change and the Law

June 11, 2024

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In this week's edition, we discuss the U.S. government's proposed guidelines for the ever-controversial voluntary carbon markets. In the EU, ESMA published a report of its findings on greenwashing in the marketing materials of MiFID II instruments, and we look at a report which analyses the extent to which green bonds align with the EU Taxonomy.

U.S. Government Publishes Guidelines for Voluntary Carbon Markets

On May 28, 2024, the Biden-Harris Administration **launched a new set of standards** to advance the responsible development of voluntary carbon markets (VCMs) in an effort to increase confidence in a market that is often criticized for a lack of transparency and effectiveness. VCMs provide a marketplace for companies and individuals to purchase carbon offsets, which are used to cancel out the impact of climate-affecting activities. Such activities can include, for example, air travel where the carbon emitted by those journeys can be offset by funding projects that remove carbon emissions from the atmosphere.

The Policy and new Principles for Responsible Participation in Voluntary Carbon Markets (the Principles) include the following key guidelines:

1. Carbon credits and the activities that generate them should meet credible atmospheric integrity standards and represent real decarbonization.
2. Credit-generating activities should avoid environmental and social harm and should, where applicable, support co-benefits and transparent and inclusive benefits-sharing.
3. Corporate buyers that use credits should prioritize measurable emissions reductions within their own value chains.
4. Credit users should publicly disclose the nature of purchased and retired credits.
5. Public claims by credit users should accurately reflect the climate impact of retired credits and should only rely on credits that meet high integrity standards.
6. Market participants should contribute to efforts that improve market integrity.
7. Policymakers and market participants should facilitate efficient market participation and seek to lower transaction costs.

We discuss carbon offsets frequently in different contexts, but more commonly in relation to greenwashing allegations. For example, **a recent judgment against a German airline** which upheld a complaint regarding advertisements claiming that certain of its flights were "carbon neutral," thanks to carbon offsets. The court found that the projects the airline funded via carbon offsets were not in fact suitable for actual offsetting because the project duration was not commensurate with the length of time the carbon emitted by the flight remains in the atmosphere.

This case touches upon the reasons why carbon offsetting is controversial. It is argued that many of the projects funded by carbon offsets are not actually effective in reducing carbon emissions, or that certain of those projects would have happened without the carbon credit funding. Instead, it is suggested that companies ought to focus on cutting their direct emissions. However, when introducing the new Principles, the Biden administration noted that offsets can be an important way to help companies reduce their emissions as long as appropriate

guardrails are put in place. The Principles do also encourage businesses to focus primarily on cutting emissions within their own supply chains, before purchasing carbon offsets.

It should be noted that the Principles are not binding or enforceable. Instead, companies are encouraged to abide by them in the hope that this will lead to rising standards for high-integrity and high quality carbon offsets. Together with other initiatives, such as the Integrity Council for the Voluntary Carbon Market, which attempts to set out principles for what constitutes an effective carbon offset, such an aim may well be achievable. Still, the Principles are lacking in some respects, including because they do define "high quality" projects. Without stricter guidance, cheap and ineffective credits are likely to continue to be purchased.

ESMA Publishes Report on Compliance with MiFID II Marketing Rules Highlighting Concerns Regarding Sustainability Claims

On May 27, 2024, the European Supervisory and Markets Authority (ESMA) **published a report** on its Common Supervisory Action (CSA) and an accompanying Mystery Shopping Exercise (MSE) on marketing disclosure rules under MiFID II. ESMA found that while investment firms generally complied with the rules for marketing materials, there were some concerns with sustainability claims. ESMA identified areas for improvements as well as its intention to conduct further similar CSAs in this area. ESMA employed the use of a CSA and MSE in this context specifically to gather evidence of greenwashing. ESMA concluded that:

- sustainability-related processes and procedures should include control functions and senior management in order to ensure that sustainability claims are fair, clear and not misleading. In reviewing information fed back from National Competent Authorities (NCAs) ESMA noted that (i) firms do not have specific processes and procedures for sustainability-related claims in marketing material; and (ii) firms implemented additional controls only in some circumstances, including for example the development of internal guidance regarding products with particular greenwashing risk and the involvement of sustainability officers or units when relevant.
- ESMA noted its concerns around the presentation of information on sustainability issues in marketing materials, particularly highlighting examples of non-compliant sustainability claims reported by NCAs, including: (i) advertising that a financial instrument supports the environment, without supporting the green nature of such instrument with any evidence, and (ii) the sustainability characteristics of financial instruments are not presented in a balanced way compared to the other characteristics of the instruments. Consequently, investors would be given the (misleading) impression that these financial instruments are ESG-oriented. The NCAs also noted significant differences in the level of detail provided from firm to firm. Examples of poor practice include advertisements containing generic references, unsubstantiated information and disclosures and information not being presented in a balanced manner. In this context, ESMA emphasized the need for firms to ensure that financial products and services subject to MiFID II are fair, clear and not misleading.

Going forward, ESMA noted that in addition to carrying out further similar CSAs and MSEs to identify greenwashing, it would continue communicating with NCAs on these topics and exchanging information on planned follow-up action. ESMA will also provide technical advice to the European Commission to support the development of relevant legislation.

ESMA's focus on greenwashing ties into a key focus of the European Green Deal. In April 2024, the European Commission announced action it had taken under Articles 5 (prohibition of unfair commercial practices), 6 (misleading actions) and 7 (misleading omissions) of the Unfair Commercial Practices Directive (UCPD) which affords consumer protection against greenwashing. **As we discussed in our May 14, 2024 issue**, in addition to the UCPD, EU consumers benefit from several other protections against misleading environmental claims under: (i) the Directive on empowering consumers for the green transition, which explicitly bans claims, based on the offsetting of greenhouse gas emissions, that a product has a neutral, reduced or positive impact on the environment in terms of greenhouse gas emissions; and (ii) the Proposal for a Directive on substantiation and communication of explicit environmental claims (Green Claims Directive), proposed by the Commission in March 2023, provides that Member States shall ensure that traders carry out an assessment to substantiate explicit environmental claims. In particular, under the Green Claims Directive, traders are required to be transparent about which part of the claim concerns their own operations, and which aspects are based on buying offsets.

Fitch Report Shows One-Fifth of Green Bonds Aligned with EU Taxonomy

In its **'ESG Ratings Insights: EU Taxonomy Alignment' report**, Sustainable Fitch reported that a fifth of green bonds rated by the firm have alignment to the EU taxonomy. The majority of these are from European issuers. Of this proportion, the most aligned activities by use of proceeds are in renewable energy and clean transportation where there is a clear contribution to decarbonization and the activity replaces a fossil-fuel based alternative. Sustainable Fitch also noted that around 36% of rated green bonds meet the taxonomy's substantial contribution criteria , but not the 'do no significant harm' and minimum safeguards criteria. This proportion was thus partially aligned with the EU taxonomy but could not be considered fully EU taxonomy-aligned.

Although the majority of EU Taxonomy-aligned bonds were issued by EU-based entities, Sustainable Fitch outlined that there may be a higher proportion aligned with the framework that are issued by non-EU entities but do not provide specific disclosures related to its detailed criteria. Globally, as regulators increase supervision of sustainable finance, the divergence may increase if local requirements differ from the EU Taxonomy, highlighting the drawbacks of a lack of global alignment between different regulatory frameworks.

Of the green bonds that are partially aligned, i.e., those that meet substantial contribution criteria (SCC) but are not EU Taxonomy-aligned, are issued by banks, followed by bonds from utilities, power generation and real estate.

EU Taxonomy is the first and most comprehensive taxonomy related to environmentally sustainable activities. It sets out science-based criteria for meeting net zero emissions on a sectoral basis by 2050 and was published in the Official Journal of the European Union on June 22, 2020. It is also the basis for the EU Green Bond Standard which aims to be one of the world's most comprehensive green bond labels.

UKSIF Members Express Concern Over Litigation Risks from New FCA Sustainability Measures

In a report published in May 2024, members of the UK Sustainable Investment and Finance Association (UKSIF) forum expressed their concerns about the risk of litigation arising from the Financial Conduct Authority's anti-greenwashing rule. The anti-greenwashing rule came into force on May 31, 2024 and requires in-scope firms to ensure that sustainability claims they make are consistent, fair, clear and not misleading. What this means in practice is that sustainability claims should be:

1. Correct and capable of being substantiated;
2. Clear and presented in a way that can be understood;
3. Complete – they should not omit or hide important information and should consider the full life cycle of the product or service; and
4. Fair and meaningful where comparisons are made to other products or services.

We discuss these requirements in detail **here**. UKSIF members are concerned in particular with requirement three above – that their claims should be complete and not omit or hide important information and should consider the full life cycle of the product or service. The report notes that this could present a problem "where a fund's sustainability profile and performance changes over time or where there are data gaps." In addition, the broad scope of the rule means that all types of communications are covered, and firms have not been provided with much time to comply with the FCA announcing that it would come into effect only the month prior.

The rule is part of a wider package of measures to be introduced by the FCA through the Sustainability Disclosure Requirements and investment labels regime which **we discussed previously**. In order to use one of the investment labels, a firm must have invested at least 70% of its assets in line with the relevant label's criteria. UKSIF notes in its report that there is concern in particular around the "improver" label – which covers products that are not sustainable but aim to improve sustainability over time – as there is uncertainty as to how funds with this label should evolve once their targets have been achieved. There is also a lack of clarity as to how a fund should assess and determine the 70% threshold and how it would apply to certain asset classes such as private markets.

UKSIF makes ten recommendations on how asset managers can navigate the implementation of the SDR and investment labels regime:

1. Carefully consider what label, if any, to apply.
2. Focus on demonstrating compliance with the 70% threshold.
3. Establish a firm-wide product classification framework.
4. Step up engagement with distributors at the earliest opportunity.
5. Perform a broad, firm-wide greenwashing review.
6. Develop a taxonomy of terms to identify potential greenwashing.
7. Focus on what is most relevant and material to your business and clients in your reporting.
8. Streamline data collection and leverage existing processes.
9. Align reporting cycles with TCFD reporting where possible.
10. Adopt a strategic, long-term approach to disclosure.

The requirements are onerous and although there has been a short period of time to allow firms to ensure they are in compliance before the rule came into force, it should not be entirely new

to FCA-regulated firms. This is because various sections of the FCA Handbook already require firms to ensure that the information they communicate is fair, clear and not misleading (see, for example, the Principles for Businesses (PRIN)). Some firms will also be familiar with greenwashing guidance published by other UK authorities such as the Competition and Markets Authority's (CMA) guidance on environmental claims, and the Advertising Standards Authority's (ASA) guidance. The FCA collaborated closely with both authorities to ensure cohesion between the different frameworks. Still, the concerns are understandable given that all three authorities have clearly signaled their intention to focus on tackling greenwashing. For example, the CMA announced that it had commenced a wide-ranging investigation into the accuracy of green claims made in the fast moving consumer goods and fashion sectors as we discussed previously **here** and **here**. Similarly, **ASA publicly sanctioned advertisements** containing misleading sustainability-related claims from: three major airlines (December 2023); a global car manufacturer (November 2023); and three oil and gas companies (October 2022).