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Regulation: FCA to Develop Code for ESG Data and Ratings Providers

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Regulation

By Duncan Grieve
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On November 22, the UK's Financial Conduct Authority (FCA) **announced** the creation of a group to develop a voluntary Code of Conduct covering ESG data and ratings providers with the aim of bringing about greater market transparency. The ESG Data and Ratings Code of Conduct Working Group will be comprised of investors, ESG data and ratings providers and rated entities. It will be co-chaired by M&G, Moody's, the London Stock Exchange Group and Slaughter and May, with the International Capital Market Association and the International Regulatory Strategy Group acting as joint Secretariat. The group will meet for the first time later this year and will focus on outcomes in the areas highlighted in the International Organization of Securities Commissions' (IOSCO) **recommendations** published earlier this month, including transparency, good governance, management of conflicts of interest, and systems and controls. In the announcement, the FCA reiterated its intention, if the "Treasury extends its regulatory perimeter," to develop a "proportionate and effective regulatory regime."

Taking the Temperature: The lack of consistency among ratings providers in terms of their source data, methodologies and weightings of the various aspects of ESG is an issue that we previously have highlighted in Cadwalader Climate and in our in-depth ESG ratings article. Such market divergence has led to, among other things, the same company having materially different ratings from different ratings providers. More generally, it means that asset managers and other consumers of ratings continue to have difficulty understanding how to make use of a particular provider's ratings, if they refer to ratings at all. A key to helping resolve this confusion is greater transparency into methodologies on the part of ratings providers. In that sense, the FCA's initiative, including its focus on transparency, offers the chance for greater clarity in this area. The FCA's approach also recognizes the global nature of climate-related issues, with the FCA stating that its "Code will seek to be internationally consistent, by taking into account not only IOSCO's recommendations but also developments in jurisdictions such as Japan and the EU. This will help encourage the development of consistent global standards."

Disclosure: Various Asset Managers Downgrade ESG Fund Classifications

November 29, 2022

Disclosure

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A number of large asset managers have announced their intention to downgrade ESG funds totaling tens of billions of dollars from Article 9–the highest sustainability classification under the Sustainable Finance Disclosure Regulation (SFDR)—to the broader, and less restrictive, Article 8. The asset managers include Amundi, BlackRock, DWS, HSBC AM, Axa, Invesco, NN Investment Partners, Pimco, Neuberger Berman, Robeco and Deka. These announcements follow draft guidelines **published** on November 18 by the European Securities and Markets Authority (ESMA) as part of a consultation on funds' names using ESG or sustainability-related terms. The ESMA consultation closes on February 20, 2023. The main elements of ESMA's consultation paper are (i) a quantitative threshold (80%) for the use of ESG related words; and (ii) an additional threshold (50%) for the use of "sustainable" or any sustainability-related term only, as part of the 80% threshold.

As defined in the SFDR, Article 8 funds are those that promote Environmental or Social characteristics but do not have them as the overarching objective. Article 9 funds are those that have specific sustainable goals as their objective.

In announcing the downgrades, several asset managers identified the lack of guidance regarding how to apply existing regulatory announcements in distinguishing Article 8 from Article 9 funds as the reason for the change. Clémence Humeau, head of sustainability coordination and governance at Axa, stated that "we would have liked a clearer definition of what is a sustainable fund … because now there are as many definitions as there are asset managers." Elodie Laugel, head of responsible investing at Amundi, which indicated that its decision affects $46 billion in assets, stated that "the regulation is not bringing enough clarity in terms of definition … which creates strong discrepancies in the market while leaving plenty of grey areas," and that it was their "responsibility … to protect clients [so] with such uncertainty and evolving regulation, [Amundi has] decided to take a very cautious approach."

Taking the Temperature: While on the one hand these announcements represent a reaction to specific potential regulatory guidance, they also reflect a broader significant concern over accusations of greenwashing. Just last week, the U.S. Securities and Exchange Commission announced a $4 million settlement with the asset management arm of a leading financial institution over alleged failures, between 2017-2018, to have written policies and procedures regarding the ESG research used to select and monitor investments and, thereafter, to have inconsistent application of the policies until February 2020. Two funds and a separately managed investment strategy were at issue.

The SEC fine is over twice the amount imposed on another financial institution earlier this year for allegedly misrepresenting that all investments in certain mutual funds had undergone an ESG quality review. And in a different context, greenwashing concerns may have been at least the partial cause for several large banks to consider withdrawing from the Glasgow Financial Alliance for Net Zero (GFANZ) amid questions regarding their ability to satisfy increasingly stringent decarbonization commitments and the potential to be subject to litigation or enforcement actions as a result. That led to GFANZ amending its membership rules by dropping its connection to the UN-supported Race to Zero campaign. The combination of all of this creates a dynamic where regulatory efforts to promote accurate disclosure around the sustainability profile of investments arguably has the potentially negative consequence of promoting "greenhushing" and hindering industry climate initiatives. We expect this tension to resolve over time as regulatory guidance clarifies and market consensus builds. In the meantime, however, financial firms need to continue to be cautious about use of sustainability labels for investment products and to have a documented basis and methodology for supporting any such descriptions.

Regulation: Department of Labor Rule On ESG Investing

November 29, 2022

Regulation

By Timbre Shriver
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On Tuesday, November 22, the U.S. Department of Labor (DOL) **announced** a final rule overturning previous restrictions on the ability of retirement plan fiduciaries to consider ESG-related factors in their investment decisions. The **final rule**, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, builds on **Executive Order 14030** signed by President Biden on May 20, 2021. The Rule clarifies that, consistent with the fiduciary duties of prudence and loyalty under the Employee Retirement Income Security Act (ERISA), retirement plan fiduciaries may consider ESG factors when selecting investment and exercising shareholder rights, such as voting proxies.

According to the **fact sheet** accompanying the announcement, the Rule provides that "a fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG considerations on the particular investment or investment course of action."

Secretary of Labor Marty Walsh stated that "today's rule clarifies that retirement plan fiduciaries can take into account the potential financial benefits of investing in companies committed to positive environmental, social and governance actions as they help plan participants make the most of their retirement benefits."

A majority of the rule will take force 60 days after it is published in the Federal Register. However, there is a delayed application of one year after publication for some proxy voting provisions to provide "fiduciaries and investment managers additional time to prepare."

Taking the Temperature: The DOL Rule reflects a view, frequently articulated by large institutional asset managers, that climate change and other ESG factors can be material to the companies in which they invest and therefore are properly considered as part of the investment process. However, the Rule also has been cited as another salvo in the ongoing politicization of climate change and ESG generally, particularly in the asset management area. As we have discussed, state treasurers have withdrawn assets from firms over their consideration of ESG factors in investment decisions and barred institutions from underwriting syndicates due to supposed anti-energy views. Asset managers are left to walk an increasingly narrow line through these competing views on the appropriate role of climate considerations in the investment process.

Litigation and Enforcement: SFO Interview Points to Crackdown on Green Investment Fraud

November 29, 2022

Litigation and Enforcement

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In a recent **interview**, and accompanying **social media post**, the Chief Investigator of the UK's Serious Fraud Office (SFO), Michael Gallagher, stated that the agency is focused on tackling 'green fraud'. He cited examples of recent SFO investigations that resulted in prison sentences for individuals seeking to exploit the current consumer appetite for green investments. Gallagher explained his view that fraud "moves with the times" and that the SFO has seen "climate fraud cases grow exponentially" to involve millions of pounds and span multiple jurisdictions across the world. The SFO expects to see individuals and organizations attempting to take advantage of the growth in the sustainable-investment market by "manipulating consumer and investor behavior through social conditioning" by offering false investment opportunities that are purportedly beneficial to the environment but, in reality, only benefit the fraudsters.

The cases highlighted included the 2018 investigation into a solar panel scheme that resulted in six individuals receiving prison sentences where 1,500 retail investors invested in "a supposedly safe and eco-friendly scheme." Gallagher also referenced a recent forestry investments investigation which resulted in 11-year prison sentences for two individuals who "deceived thousands into investing … into their Brazilian tree plantation scheme." The scheme was sold to investors as "high-reward, low-risk" and as a secure and sustainable investment. In reality, however, little investment took place and the two individuals instead "spent millions of investors' money on luxury purchases to fund their lavish lifestyles."

Taking the Temperature: As in the EU and the U.S., the UK increasingly has focused on greenwashing as an enforcement priority. The current director of the SFO, Lisa Osofsky, is set to depart her role in summer 2023 at the end of her 5-year term. The appointment of a new director will likely bring about a change in direction at the agency but the focus on fraud relating to purportedly green and ESG investments looks set to remain a key target for investigation and prosecution.