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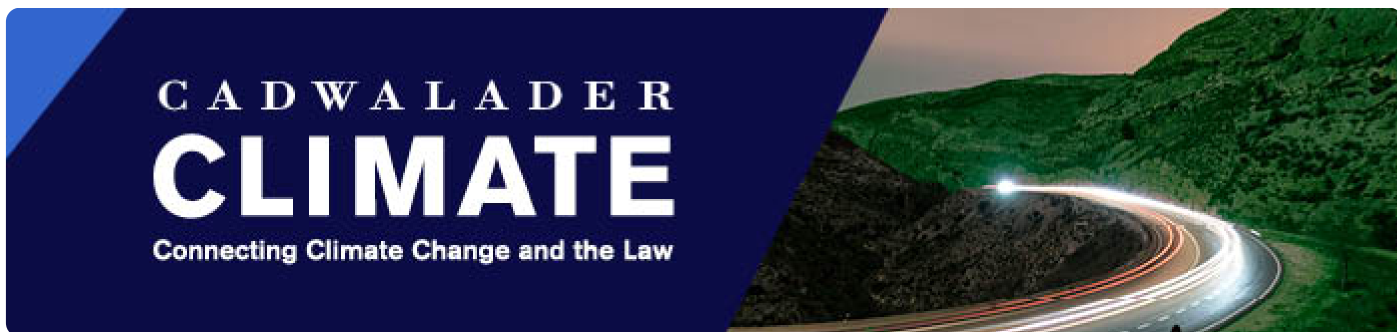

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Sustainable Markets Initiative Task Force Launches Transition Categorization Framework

February 7, 2023

By Duncan Grieve
Special Counsel | White Collar Defense and Investigations

On January 17, the Sustainable Markets Initiative (SMI) **announced** that its **Asset Manager and Asset Owner Task Force (AMAO Task Force)** has released a **Transition Categorization Framework**. The AMAO Task Force is comprised of 34 asset managers and owners that are members of the SMI. According to the accompanying press release, the aim of the Framework is "to categorise assets that fulfil the objectives for a pathway to a net zero transition, at both a company and a project level, and ensure that investors are not simply disinvesting from the more difficult sectors especially in emerging economies." The Framework's definition of transition finance focuses on financing the decarbonization of five key sectors – power, buildings, mobility, industry, and agriculture. Studies suggest that these sectors combined are responsible for 95% of global emissions.

The Framework establishes five categories of transition assets to enable "investment into sectors and regions vital to the net zero transition," four of which align with the Paris Agreement on climate change. The AMAO Task Force is also working with climate specialist organizations to support the appropriate metrics, thresholds and timelines required by a company or project to qualify for a particular category. These categories are:

- Transitioning: The asset is at or near net zero emissions or has a deliverable Paris-aligned pathway.
- Committed to Transition: The asset is committed to net zero and has a plan for evolving its business model to achieve a Paris-aligned pathway.
- Transition Enabler: The asset is required for the transition in other sectors and is prepared to invest to achieve net zero itself. These assets typically are inputs into infrastructure or products critical for a net zero economy.
- Interim or Phase Out: The asset is necessary for a period but with no role beyond 2050 or the accelerated phase-out of the asset is necessary for net zero.
- Aiming to Transition: The asset is committed to reducing emissions but with no clear pathway to net zero. Assets in this category do not qualify for Paris-aligned transition.

If the asset does not qualify for one of these five categories, "it is likely to be stranded in the future."

The SMI was established by King Charles, then the Prince of Wales, at the World Economic Forum 2020 Annual Meeting in Davos. The SMI's mission is to "build a coordinated global effort to enable the private sector to accelerate the transition to a sustainable future." The AMAO

Task Force was established to find “scalable ways for institutional investors to facilitate the reallocation of capital toward sustainable solutions, using the two most powerful levers at their disposal: 1) capital already invested in companies; and 2) fresh capital investments directed at climate mitigation and adaptation projects.” Its members include Bank of America, Blackrock, CalPERS, Goldman Sachs, HSBC, Morgan Stanley, State Street, and others.

Taking the Temperature: The key objective of the SMI AMAO Task Force Framework is to provide guidance to investors on how to categorize economic activity and assist with the development of net zero investment strategies. The Framework recognizes, however, that a key to gaining investor acceptance is ensuring the credibility of the transition categorization. As a result, “an asset in one of the four categories qualifying for transition allocation” must demonstrate a “commitment to decarbonisation, expressed through a public undertaking to achieve net zero or otherwise unambiguously stated,” and a “credible transition plan, which, like a financial plan, shows the investor how the company aims to achieve its targets and at what cost.” In short, according to SMI, the “credibility of transition plans for high-emitting sectors is the keystone in the transition finance agenda.” In this way, the Framework represents another effort, similar in ways to the proposed UK Green Taxonomy and EU Taxonomy, among others, that seek to address the challenges associated with identifying sustainable companies, assets, and activities, recognizing that certain businesses are necessary to facilitate climate transition even if not themselves Paris-aligned. The Framework gives as one such example “a mining company producing lithium or copper as an input into solar-PV or battery technology and broad electrification.” Such a company could be categorized as a “Transition Enabler” under the SMI Framework if it satisfies certain other sustainability criteria. As we have discussed, the challenge with all these classification schemes, however, is to engender consensus among them, and therefore promote predictability regarding what does and does not constitute a sustainable asset. The utility of taxonomies like the Framework will be constrained until differences among the various classification schemes are resolved, and debate is quieted about whether a particular asset should be deemed sustainable even within a single classification approach.

ECB Publishes Climate-Related Statistical Indicators To Promote Assessment and Measurement

February 7, 2023

By Sara Bussiere
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On January 24, the European Central Bank (ECB) **announced** the publication of “new experimental and analytical **indicators**” that are intended to help analyze climate-related risks in the finance sector and monitor green transition. This development follows the ECB’s detailed **climate action plan** announced in July 2021.

The indicators cover three areas:

- **Experimental indicators on sustainable finance**. These indicators cover debt instruments issued or held in the EU that are labelled as “green,” “social,” “sustainability” or “sustainability-linked.” The ECB observed that in addition to “boosting transparency, these indicators also help track progress on the transition to a net-zero economy. That said, the lack of internationally accepted and harmonised standards on what defines a green or sustainable bond makes the data less reliable overall.”
- **Analytical indicators on carbon emissions financed by financial institutions**. These indicators provide information on the carbon intensity of the securities and loan portfolios of financial institutions, and on the financial sector’s exposure to counterparties with carbon-intensive business models.
- **Analytical indicators on climate-related physical risks**. These indicators cover the impact of natural hazards, such as floods, wildfires or storms, on the performance of loans, bonds and equities portfolios.

In its accompanying press release, the ECB acknowledges that the new indicators are currently a work in progress. Experimental data does not yet correspond to the quality requirements of official ECB statistics and the analytical data has “a lower quality and certain – sometimes significant – limitations.” Although the ECB observes that the data should be used with caution, it has published the indicators to generate dialogue with “the statistical and research community and with other key stakeholders on how to better capture data on climate-related risks and the green transition.” The ECB intends to work further with national central banks to refine the indicators and to improve both methodologies and data sources.

Executive Board member Isabel Schnabel stated that “we need a better understanding of how climate change will affect the financial sector, and vice versa. For this, the development of high-quality data is key . . . The indicators are a first step to help narrow the climate data gap, which is crucial to make further progress towards a climate-neutral economy.”

Taking the Temperature: Financial regulators around the world increasingly have been driving the financial industry to acknowledge, assess, address and report on sustainability-related risks. In the last few months, for instance, the European Banking Authority published its roadmap on sustainable finance, which outlines the "objectives and timeline for delivering mandates and tasks in the area of sustainable finance and environmental, social and governance (ESG) risks;" the Australian Prudential Regulation Authority conducted a climate vulnerability assessment pursuant to which Australia's largest banks outlined how they would amend both their risk appetites and lending practices in response to increasing climate-related losses; Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England, has publicly stated that "the most effective firms had undertaken a methodical consideration of how climate risks could impact capital," and have "demonstrated effective practice by capturing climate in their macroeconomic scenarios or using specific climate scenarios to evidence their assessment of risk;" and the Deputy Governor of the Banque de France, the French central bank, Sylvie Goulard, stated in a speech that central banks need to take more aggressive action regarding nature-related risk given that "monetary assessments of ecosystem services have many limitations," in part because of their complexity and also because "shocks" in one sector can have significant impacts on other sectors. U.S. financial regulators also have been more active, although still lagging their European counterparts.

Nonetheless, the recent ECB publication demonstrates that challenges remain even for proactive financial institutions seeking to assess and report on climate-related opportunities and risks. Data limitations and the current lack of internationally accepted and harmonized standards on what constitutes a green or sustainable investment remain hurdles. While we anticipate these obstacles to diminish over time, in the current environment, financial institutions should deal with data and taxonomic problems through traditional solid governance procedures and expertise and accurate and thorough disclosure.

ESMA Stakeholder Group Warns Against “Green-Bleaching”

February 7, 2023

By Jason Halper
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In a **response** to a call for evidence on greenwashing by the European Securities and Markets Authority (ESMA), the Securities and Markets Stakeholder Group (SMSG) emphasized the importance for EU authorities to ensure that any new rules published on greenwashing also guard against “green-bleaching.” Green-bleaching is a term coined to describe financial market participants choosing not to claim ESG features of their products in order to avoid extra regulation and potential legal risks. The stakeholder group, which provides opinions on the technical aspects of regulation, suggests that adequate guidance on legally permissible representations may help in reducing this problem.

SMSG opened its response with the suggestion that the term “greenwashing” is itself limited and that “ESG-washing” would be more appropriate as it would capture the social and governance aspects of ESG. The response goes on to posit that the lack of a regulatory and European-wide definition of “impact investing” risks a mismatch of investor, regulator and financial firm expectations. SMSG recommends that providers of “impact” products “clearly explain their strategy and efforts to reinforce the ESG dynamic that is sought, to distinguish them from strategies that are ‘only’ based on meeting some ESG criteria.” Overall, according to SMSG, ESMA should introduce definitions for key terms such as “green,” “ESG,” “sustainable,” and “impact investing” in order to help reduce greenwashing and green-bleaching.

In its second recommendation, the SMSG encourages ESMA to identify potential gaps in the current regulatory framework prior to introducing new legislative requirements and advises the European Supervisory Authorities to first provide a list of practices that would violate existing regulations and amount to greenwashing. SMSG also observes that regulators need to adopt a flexible approach, and that unintentional mistakes or changes in data reported due to additional availability of data or the enhancement of calculation methodologies should be treated differently than grossly negligent or intentional misrepresentations.

SMSG’s response also recommends further clarification of what qualifies for Article 8 and Article 9 fund classification under the Sustainable Finance Disclosure Regulation (SFDR). An Article 8 fund under the SDFR is defined as a “Fund which promotes, among other characteristics, environmental or social characteristics . . . provided that the companies in which the investments are made follow good governance practices,” and an Article 9 fund as one which “has sustainable investment as its objective or a reduction in carbon emissions as its objective.” As we have **discussed**, following ESMA’s issuance of draft guidelines as part of a consultation on funds’ names using ESG or sustainability-related terms, a number of large asset managers announced downgrades to ESG funds from Article 9–the highest sustainability classification under the Sustainable Finance Disclosure Regulation—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.

Taking the Temperature: Greenwashing and green-bleaching have received significant regulatory and media attention, relatively more so than other climate-related phenomena. To name just a few examples, the UK's Competition Markets Authority just announced an investigation into the "accuracy of 'green' claims made about household essentials;" the Australian Securities and Investment Commission recently issued several greenwashing fines against regulated entities; and the Swiss Federal Council published a position paper on the prevention of greenwashing in the financial sector.

But we agree with SMSG that alleged greenwashing does not necessarily reflect intent to mislead, but rather could be the product of multiple other causes, including lack of agreement on what constitutes a sustainable product or business (taxonomical issues), poor quality or inconsistent data and/or assessment tools or lack of clear regulatory guidance. The SMSG response also is interesting for its recognition that very few, if any, climate-related matters exist in isolation. Instead, it refers to the ESG "ecosystem" supporting sustainable finance, which includes primary and secondary financial markets and derivatives. According to SMSG, "the ESG finance ecosystem should support the evolving nature of the ESG transition. In this respect, ESMA should provide clear guidance with respect to different ESG strategies. As not all ESG actors and projects are already 'dark green,' for instance, the ESG finance ecosystem should also encourage companies to adopt a greener (transition) agenda."

Finally, we have discussed the challenges associated with the ESG ratings landscape, including how consumers of such information can make sense of divergent scores that, at times, purport to encompass all of an issuer's ESG characteristics. That issue was not lost on SMSG, which (in our view correctly) pointed out that "methodological choices are presently not always sufficiently disclosed," and "investors may not be in a position where they can make truly informed decisions, making it necessary for them to compare several ESG ratings and conduct their own research in parallel, often using raw ESG data." As SMSG observed, the market would benefit from improved "availability, integrity, and transparency of ESG ratings."

Publication of PRI 2023 Reporting Framework

February 7, 2023

By Kya Henley
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The Principles for Responsible Investment (PRI), a UN-supported network of investors, has **announced** the publication of its 2023 Reporting Framework along with an update on accountability. This development, according to the PRI, represents a "key step forward in the development of the PRI's Reporting and Assessment functionality as the industry-leading reporting framework globally." Signatories now have until mid-May to prepare their responses before the reporting cycle opens. The updated reporting framework has been designed to align with leading global standards based on feedback submitted by signatories. These standards include the recommendations from the Task Force on Climate-related Financial Disclosures and the International Sustainability Standards Board. Other changes include reducing the detail of data to be reported and decreasing the overall number of indicators to ease the burden on signatories. Over 3,800 organizations are signatories to the PRI's six **Principles**, representing $121 trillion under management.

The Reporting Framework consists of six generally applicable modules and six industry-specific modules, each of which must be adapted by the particular signatory as appropriate to its business, industry and particular circumstances:

- Senior Leadership Statement: Signatories agree to incorporate ESG issues into their investment analysis and decision-making processes by, as appropriate:(1) addressing ESG issues in investment policy statements; (2) developing ESG tools; (3) assessing the capabilities of internal and external managers; (4) requesting that service providers incorporate ESG factors into their research and analysis, and (5) training investment professions on ESG investing.
- Organizational Overview: Signatories will incorporate ESG issues into ownership policies by (1) developing and publicizing an ESG-mind ownership policy; (2) exercising voting rights or monitoring voting compliance; (3) developing policies, regulations, and standard setting; (4) filing shareholder resolutions consistent with long-term ESG considerations; (5) engaging with companies on ESG issues; (6) participating in collaborative engagement issues; and (7) asking investment managers to undertake and report on ESG-related engagement.
- Policy, Governance and Strategy: Signatories will seek disclosures on ESG issues by the entities in which they invest by (1) asking for standardized ESG reports; (2) asking for ESG issues to be incorporated into annual financial reports; (3) asking for information on how companies have adopted or adhered to ESG norms, standards, codes of conduct, and initiatives; and (4) supporting ESG shareholder initiatives and resolutions.
- Manager Selection, Monitoring and Reporting: Signatories will promote acceptance and implementation of ESG principles by (1) including Principle-related requirements in requests

for proposals; (2) aligning investment mandates, monitoring procedures, and performance indicators and incentive structures with the Principles; (3) relaying ESG expectations to investment service providers; (4) reviewing relationships with service provides that do not meet ESG expectations; (5) supporting the developments of tools to benchmark ESG integration; and (6) supporting regulatory and policy developments that promote the Principles.

- Sustainability Outcomes: Signatories will enhance their effectiveness by (1) supporting networks and information platforms to share resources and pool resources, and using investor reporting as a learning source; (2) addressing relevant emerging issues collectively; and (3) developing and supporting collaborative issues.
- Confidence Building Measures: Signatories will report on their activities and progress by (1) disclosing how ESG issues are integrated within investment practices; (2) disclosing active ownership activities; (3) disclosing service provider ESG requirements; (4) communicating with beneficiaries about ESG issues and the Principles; (5) reporting on progress relating to the Principles using a the comply-or-explain method; (6) seeking to determine the impact of the Principles; and (7) using reporting to raise awareness among a broader group of stakeholders.

The six asset-class modules cover industry-specific issues in the areas of listed equity, fixed income, real estate, infrastructure, private equity and hedge funds.

The PRI's accompanying press release states that even though the minimum requirements will remain in place for the 2023 reporting cycle, they will remain under review throughout the year. The PRI explains that the minimum requirements were "introduced in 2018 to strengthen accountability amongst investor signatories by providing a baseline performance requirement, determined through reporting. To keep pace with a rapidly changing landscape, PRI committed to reviewing the minimum requirements to ensure they remain fit-for-purpose, and began a formal review process in 2020. Following the 2021 reporting cycle, the review of the minimum requirements was put on hold while PRI focused on improving the quality of the 2021 reporting dataset, delivering the 2021 reporting outputs and developing the improved 2023 Reporting Framework. "

Taking the Temperature: The changes to the PRI Reporting Framework in 2023 reflect the extensive consultation process conducted with PRI signatories and emerging consensus on the necessity for greater global coordination on climate-related disclosure standards. Greater alignment among influential voluntary initiatives is positive but emerging consensus on standards must be reflected in greater coordination in regulatory standards to have wider economic effect. We have previously covered the United Nations' High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities Report. Recommendation 10 of the Report describes the importance of moving from voluntary initiatives to regulated requirements.