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European Parliament Committee Finalizes ESG-Related Financial Sector Risk Reforms

February 10, 2023

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On January 24, 2023, Members of the European Parliament **voted** to adopt reforms to banking rules and implement the international Basel III agreement (Basel III). One of the objectives of Basel III is to enhance focus on ESG risks within the prudential framework.

Basel III is a comprehensive set of reform measures in banking prudential regulations, aimed at strengthening the regulation, supervision and risk management of the banking sector, and was introduced by the Basel Committee, a consortium of central banks from 28 countries, formed largely in response to the 2008 global financial crisis. The Basel III framework is designed to mitigate risk by requiring banks to maintain certain capital ratios to cope with market events. When initially proposed, Basel III was largely focused on credit risk, market risk and operational risk. The ESG elements have been introduced following growing awareness of systemic risks presented by climate change and the EU's objective for carbon neutrality by 2050.

Basel III is comprised of three parts, also referred to as pillars. Pillar I addresses minimum requirements for capital and liquidity adequacy; pillar II outlines supervisory monitoring and review standards; and pillar III promotes market discipline through prescribed public disclosures. Climate-related disclosures are included under pillar III. Such disclosures would require approximately 150 European banks to publish on a semi-annual basis qualitative and quantitative information on transition and physical risks, exposure to at-risk sectors and green lending.

The Committee did not approve a so-called "one-for-one" rule, pursuant to which banks would have to add a euro to their regulatory capital for each euro financing fossil fuel exploration or production in anticipation of future losses on those investments. The Committee did approve proposals that, among other things, would require: (i) regulators to take into account climate transition plans and targets when deciding on regulatory requirements for financial institutions, (ii) banks to adopt "transitional plans to address ESG risks in the short, medium and long term, with a special focus on the EU objective of achieving climate neutrality by 2050," and (iii) banks "to include ESG-related valuation consideration in the obsolescence of collateral." The Committee also mandated the European Banking Authority "to assess whether a dedicated prudential treatment of [ESG] exposures would be warranted. Based on that report the

Commission might adopt a legislative proposal in this regard." The Committee will now commence negotiations with member states over a final text of the rule.

Taking the Temperature: The proposed reforms passed by the Committee largely are in line with the direction of travel among global financial industry regulators to require banks to account for and disclose on climate and other ESG-related risks and opportunities. We have reported on similar developments in the U.S., Europe, Australia and elsewhere. The one-for-one rule rejected by the Committee has been controversial. We previously commented that it is not apparent that such a bright-line rule would be an effective method for achieving financial stability. The rule assumes financial risk associated with a particular category of assets in isolation, without considering the particular institution's overall risk exposure based on all applicable material factors, including industry exposure, strategy, and customer base. The rule also runs counter in spirit to the thrust of global prudential regulatory guidance, which is to not seek to compel financial institutions to abandon all emissions financing, but to devote appropriate efforts to assessing climate-related risks and opportunities and disclosing such assessments – a view endorsed by certain financial regulators. In our view, such a nuanced approach makes more sense in that it is tailored to the individual institution and consistent with global regulatory guidance on risk assessment.

ESMA Announces Review Covering the Marketing of Financial Products across EU including Greenwashing

February 10, 2023

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On January 16, 2023, the European Securities and Markets Authority (ESMA) **announced** the launch of a common supervisory action (CSA) in partnership with EU Member State national competent authorities (NCAs). The CSA will cover the application of MiFID II (Markets in Financial Instruments Directive) disclosure rules to marketing communications for financial products across the EU. The stated objective of the CSA is to better align supervisory culture across EU Member States. ESMA has tasked NCAs with reviewing marketing communications (including advertisements) for investment products and checking that these are fair, clear and non-misleading. The CSA will focus on marketing targeting younger consumers including through apps, social media and collaborations with affiliates such as influencers. The CSA will be conducted throughout 2023.

ESMA also plans to use the CSA to collect information on possible greenwashing practices in marketing and advertisements for financial products. ESMA's identification of greenwashing as a specific area of review is notable and demonstrates continued focus on climate-based marketing practices by European regulatory authorities. Between November 15, 2022 and January 16, 2023, three European supervisory authorities – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and ESMA – held a **call for evidence** on potential greenwashing practices in the whole EU financial sector, including banking, insurance and financial markets. We reported on the **consultation** and the **response** from the Securities and Markets Stakeholder Group (SMSG), which warned that EU rules on greenwashing must also cover "green bleaching."

Taking the Temperature: ESMA's focus on potential greenwashing practices in marketing materials for financial products across the EU is consistent with a global trend and echoes similar initiatives by other financial regulatory authorities. UK's Financial Conduct Authority (FCA) recently conducted a similar consultation on the regulation of sustainability claims by investment firms and plans to publish final rules by June 2023. In June 2022, the Australian Securities & Investments Commission (ASIC) published an information guidance sheet on how to avoid greenwashing when promoting sustainability-related products.

Enforcement activity relating to misleading environmental claims in financial product marketing materials is also on the rise. As we reported in October, the UK's Advertising Standards Authority ruled that two UK retail banking advertisements, which made claims about the financial institution's green credentials, were "misleading" and "omitted material information." In December, the ASIC issued three infringement notices to the Australian unit of a U.S.-headquartered asset manager for greenwashing infringements. We expect further enforcement action during 2023 as financial regulators continue to focus on this area.

IAASB Proposes Strategy and Work Plan for 2024-2027

February 10, 2023

By Sara Bussiere
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On January 11, 2023, the **International Auditing and Assurance Standards Board (IAASB)**, a "global independent standard-setting body that serves the public interest by setting high-quality international standards" for the global auditing and assurance profession, **proposed** a strategy and work plan for 2024 to 2027 (the Plan). The purpose of the Plan was to "accelerate the actions" identified in its 2020-2023 strategy and "[d]evelop the global accepted and leading audit, assurance, and related services standards enabling the performance of high-quality engagements that enhance trust in markets and evolve in a timely manner to meet rapidly changing public interest demands."

The Plan identifies four strategic objectives:

1. Support the consistent performance of quality audit engagements by enhancing our auditing standards in areas where there is the greatest public interest need;
2. Establish globally accepted standard(s) for assurance on sustainability reporting;
3. Strengthen coordination with the International Ethics Standards Board for Accountants and other leading standard setters and regulators to leverage better collective actions in the public interest; and
4. Create more agile, innovative ways of working in line with the Monitoring Group's reform vision.

Importantly, the Plan recognizes the increased demand for consistent global standards for non-financial information, driven, in part, by companies transitioning from "voluntary reporting commitments to requirements mandated across various jurisdictions" and "urgent call[s] to develop international standards on sustainability assurance." But the plan also recognizes that the intensifying calls for sustainability reporting is prompting other jurisdictional and international organizations to create their own assurance standards, which undermines, in IAASB's view, the "value of a global standard-setting solution that provides a baseline" that "promote[s] consistency, comparability, and transparency." To that end, the IAASB is coordinating with "other relevant standard-setting bodies" including the International Sustainability Standards Board (ISSB). The IAASB has requested comments from stakeholders by April 11, 2023.

Taking the Temperature: The IAASB is joining the long list of global industry standard-setters to emphasize the value of consistent standards, particularly in the face of the growing demands for sustainability and other non-financial information reporting. The Plan importantly makes a priority coordination among standard-setting bodies, such as the ISSB, to aim for consistency among different industries and jurisdictions. As noted in the Plan, it will be important for the IAASB to promptly issue its reporting standards

so that companies can utilize such standards as they increasingly transition from voluntary to mandatory reporting, and in order to avoid competing with other standard-setting bodies, which, as we have seen in the asset management and other industries, can cause confusion and virtually guarantees inconsistent reporting, which undermines the very purpose of the reporting standards in the first place. And we agree with IAASB's implicit position that the enactment of mandatory reporting requirements does not eliminate (and perhaps only enhances) the need for industry guidance provided by organizations such as IAASB. Mandatory regulation tends to be high-level and not prescriptive, leaving regulated entities to determine how to satisfy the requirements. Consistent guidance from recognized standard-setters such as IAASB helps to fill that gap. We also noted IAASB's reference to the "external reporting ecosystem," which it says "comprises preparers (i.e., entities and their management), those charged with governance, users of externally reported information, auditors, assurance and other practitioners, international and jurisdictional standard setters, and regulators and oversight bodies." We also have discussed that very few, if any, climate-related matters exist in isolation, and that companies should be taking a holistic approach to climate-related issues that encompasses governance (risk and opportunity assessment), data collection and assessment and disclosure.

SEC Receives Complaint of Alleged Greenwashing by International Energy Company

February 10, 2023

By Drew Newman
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On February 1, 2023, Global Witness – an international non-governmental organization – **filed** what it called a "groundbreaking greenwashing complaint" with the Securities and Exchange Commission (SEC)'s Climate and ESG Task Force asking the that it investigate Shell plc for possible violations of the federal securities laws.

Global Witness claims that Shell may be misleading investors by overstating its financial investments in energy sources under Shell's "Renewables and Energy Solutions" (RES) reporting segment. RES **includes** Shell's production and marketing of hydrogen, nature and environmental solutions and integrated power activities.

According to Global Witness's complaint, Shell has "mislabeled" the RES segment because it includes investments in fossil fuel-related activities that are not renewable or energy solutions. For example, Global Witness alleges that a "significant portion" of Shell's spending on RES is directed toward marketing and trading "natural gas" and gas-generated power. Citing international and domestic authorities, Global Witness claims that gas is not renewable or an energy solution.

Global Witness identifies two possible securities violations with Shell's RES segment. First, Global Witness alleges that lumping renewable and gas-related activities in the RES segment may not comply with International Financial Reporting Standards, which have specific criteria for what qualifies as a "reporting segment" and what can be aggregated under that reporting segment.

Second, Global Witness claims that the RES segment disclosure may either omit material facts that would give Shell's investors a clear understanding of the company's transition to renewable energy sources, or the representation that there is a segment that may qualify as a materially misleading statement because the segment includes a significant portion of spending on non-renewable and non-energy solutions. Global Witness suggests that, while Shell reported 12% capital expenditures on RES in 2021, the company spent only 1.5% total capital expenditure on developing renewable sources of energy such as wind and solar. These misstatements, according to Global Witness, "would have the effect of exaggerating the extent to which Shell is reducing its dependence upon fossil fuels and investing instead in renewable energy sources." Global Witness also claims that the RES segment may "obscure" for investors the "large and growing role that gas plays in Shell's portfolio."

According to **press reports**, Shell categorically denies misleading investors, stating that it is "confident" its "financial disclosures are fully compliant with all SEC and other reporting

requirements."

Taking the Temperature: Global Witness's complaint is just the most recent example of the heightened scrutiny companies are facing regarding claims of greenwashing – both from stakeholders and regulators around the world. As we previously reported, European regulators are seeking feedback from the EU financial sector on potential greenwashing practices. The Australian Securities and Investments Commission (ASIC) has also already imposed two greenwashing-related fines. More generally, we have commented on the increase in the number and varieties of climate-related litigation, including those commenced by NGOs like Global Witness. A different NGO recently commenced litigation in France against Danone under France's Corporate Duty of Vigilance Law on the basis that the company does not have an adequate plan to reduce its plastic footprint. We expect the trend of robust litigation and enforcement climate-related activity to continue. With respect to the Global Witness's complaint, the SEC started the ESG Task Force within the Division of Enforcement "to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment." The agency, however, is not required to open an investigation based on a complaint, which is not evidence of wrongdoing. As for Shell and other energy producers, we observe that they confront the challenge of both continuing to supply approximately 80% of the world's energy, including energy necessary to manufacture equipment required for renewable energy production, while at the same time navigating their own organization's climate transition, including the tasks of governance, data collection/assessment and disclosure. They should be held to the same standards as companies in other industries attempting to navigate a complex and dynamic environment where consensus around issues like data integrity and disclosure continues to emerge.