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SEC Exams to Include ESG Focus in 2023

February 21, 2023

By Jason Halper
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On February 7, the Division of Examinations of the U.S. Securities and Exchange Commission (SEC) **announced** the publication of its **2023 examination priorities**, which include a focus on ESG-related advisory services and fund offerings.

In its press release, the SEC stated that “the Division will continue its focus on ESG-related advisory services and fund offerings, including whether funds are operating in the manner set forth in their disclosures. In addition, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in the investors’ best interests.”

Under the heading of notable new and significant focus areas and a subheading “Environmental, Social, and Governance (ESG) Investing,” the Division states: “[registered investment advisors] and registered funds are competing for the rising investor demand for ESG-related investments and strategies that incorporate certain ESG criteria, and, thus are increasingly offering and evaluating investments that employ such strategies and investments. Therefore, the Division will continue its focus on ESG-related advisory services and fund offerings, including whether the funds are operating in the manner set forth in their disclosures. In addition, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors’ best interest.” The Division added that the “priorities reflect the Division’s assessment of certain risks, issues, and policy matters arising from market and regulatory developments, information gathered from examinations, and other sources, including tips, complaints, and referrals, and coordination with other Divisions and Offices at the SEC as well as other regulators. While the Division will allocate significant resources to the examination issues described herein, it will also conduct examinations focused on and devote resources to new or emerging risks, products and services, market events, and investor concerns.”

SEC Chair Gary Gensler commented that “[i]n a time of growing markets, evolving technologies, and new forms of risk, our Division of Examinations continues to protect investors,” with Division of Examinations’ Director Richard R. Best stating that the "priorities reflect the changing landscape and associated risks in the securities market and are the product of a risk-based approach to examination selection that balances our resources across a diverse registrant base. We will emphasize compliance with new SEC rules applicable to investment advisers and investment companies as well as continue our focus on emerging issues and rules aimed at protecting retail investors.”

Taking the Temperature: There is nothing particularly surprising in the Division’s announcement given the SEC’s overall attention to ESG-related issues within its

investor protection purview. To name a few, the SEC announced its proposed climate-related disclosure rule in March 2022. The SEC's final rule is expected to be issued in April 2023. Before that, the SEC established a task force focused on climate and ESG issues in March 2021. But the Commission is divided on the appropriate way to address ESG considerations in financial services. Notwithstanding its proposed climate rule and ESG task force, SEC Commissioners Uyeda and Peirce have expressed the view held by some lawmakers who take the position that disclosure rules specifically targeting climate and other ESG subjects are unnecessary and will impose an excessive regulatory burden on corporations. The disagreement within the SEC mirrors the debate occurring in the U.S. more broadly. For instance, Democratic members of Congress have established a sustainable investment caucus whereas certain Republican members of Congress have launched various inquiries or initiatives targeting financial organizations deemed excessively concerned with ESG issues. As we have commented, however, those in the latter camp arguably are missing the point: whether or not the SEC climate rule survives as proposed, or in modified form, or even if it is invalidated via court challenges (an outcome we think unlikely), companies need to consider and report on material risks, developments and opportunities, whether arising from climate issues, social impact movements, or other forces. Likewise, asset managers need to consider those same issues when making investment decisions as well as reporting on the sustainability characteristics of their investment portfolios – issues that have put them at the forefront of calling for greater issuer disclosure on ESG-related matters.

FCA Publishes Discussion Paper on Sustainability-Related Governance

February 21, 2023

By Duncan Grieve
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On February 10, the UK's Financial Conduct Authority (FCA) **published** a discussion paper titled "Finance for positive sustainable change: governance, incentives and competence in regulated firms." The paper considers whether regulated firms – which include banks, insurers and asset managers – should be expected to incorporate sustainability into their strategy along with the existing regulatory expectations of senior management as they carry out their firm's climate transition plans. In referring to "sustainability," the FCA makes clear it takes a broad view of that concept that goes beyond climate, stating that "attention is turning also to other – often inter-related – sustainability topics, such as human rights, diversity and inclusion, nature and biodiversity. There is increased scrutiny from investors and a demand for wider sustainability-related measures to be considered." In this vein, the FCA also referred to ISSB comments that "'sustainability is a condition for a company to access over time the resources and relationships needed (such as financial, human, and natural), ensuring their proper preservation, development and regeneration, to achieve its goals.'"

The FCA is seeking views on a broad range of topics, many of which are focused on the intersection of governance and ESG issues. For instance, one topic on which views are being sought is connecting pay to sustainability goals, including adjusting remuneration when sustainability-linked targets are not achieved. The FCA states that "[t]he credibility of ESG targets rests upon their stretch and rigour," and that "high bonus payouts against ESG goals cannot continue alongside limited progress on real-world ESG outcomes." The FCA also "wants to understand how far firms are setting sustainability-related objectives and building these into their business models and strategies." Additionally, the FCA will seek views on how companies are approaching conflicts of interests, stating that "policies are often generic and do not specifically consider issues as they relate to stewardship."

The FCA states that it is "committed to supporting the role of the financial sector in enabling an economy-wide transition to net zero, and to a sustainable future more broadly." Furthermore, the FCA claims to be "encouraging an industry-wide dialogue on firms' sustainability-related governance, incentives, and competence." The discussion paper includes "commissioned articles from experts with relevant and interesting perspectives on firms' sustainability-related governance, incentives, competence and stewardship arrangements."

Interested parties have until May 10 to submit responses to the discussion paper by answering the questions set out in Annex 1.

The FCA is also taking steps to counter the risk of greenwashing by informing asset managers, in a **"Dear Chief Executive" letter**, of its intention to test ESG and sustainable investing

claims made in communications with investors. The letter makes clear that the FCA will seek to ensure that asset managers' governance structures are appropriate to "oversee and review management information about product development, ESG and sustainability integration in investment processes, third-party and proprietary ESG information providers, and other ESG and sustainability claims made by the firm."

This announcement follows various other ESG-related steps taken by the FCA, including the **establishment** of an ESG Advisory Committee to assist the board of the FCA with executing its ESG-related responsibilities. Additionally, the FCA has **convened** an independent group to develop a voluntary code of conduct covering ESG data and ratings providers. The **FCA's consultation** on the regulation of sustainability claims by investment firms, first announced in October 2022, concluded on January 25.

Taking the Temperature: The FCA's obvious emphasis on governance issues in its discussion paper underscores that it is not possible to separate climate or other ESG issues from the board and management's discharge of their obligations. For example, the FCA states that "of particular relevance," "the governance pillar of the Task Force on Climate-Related Financial Disclosure's (TCFD) recommendations emphasises the importance of board and management focus on climate-related issues. The TCFD notes that, in gauging the effectiveness of an organization's climate response, investors and other stakeholders need to understand "the role an organization's board plays in overseeing climate-related issues as well as management's role in assessing and managing those issues. Such information supports evaluations of whether climate-related issues receive appropriate board and management attention." The other pillars of the TCFD's recommendations go on to consider:

- **how climate-related issues may affect an organization's "businesses, strategy, and financial planning over the short, medium, and long term" (Strategy)**
- **how "climate-related risks are identified, assessed, and managed and whether those processes are integrated into existing risk management processes" (Risk Management)**
- **the metrics used to measure and manage climate-related risks and opportunities by an organization and key climate-related targets (Metrics and Targets)**

The discussion paper also cites the International Sustainability Standards Board's governance-related disclosure requirements, which cover virtually all aspects of director and officer conduct in assessing and managing climate-related risks, opportunities and other material issues. Likewise, the SEC's proposed climate rule focuses extensively on climate-related governance and related disclosure. The bottom line is that financial regulators, globally recognized standard-setting organizations and others all have commented on the need to proactively address climate issues from governance and disclosure standpoints. While the various regulations and frameworks are not uniform, they are consistent in recognizing this underlying principle.

UK's Advertising Regulator Publishes Rules on Making Carbon Neutral and Net-Zero Claims

February 21, 2023

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On February 10, the UK's advertising regulator, the Advertising Standards Authority (ASA), **announced** the publication of updated guidance for advertisers making environmental sustainability-related claims to consumers, including use of the terms "carbon neutral" and "net zero." The ASA explained that the amended guidance reflects the "key principles of the Competition and Markets Authority's guidance on environmental claims on goods and services" and that "in light of the low understanding and lack of consensus around the meaning of carbon neutral and net zero claims, [the Committees of Advertising Practice] and [the Broadcast Committee of Advertising Practice] advise advertisers to take into account the following guidance, which draws on key principles of the [Competition and Markets Authority] guidance, and, if followed, means that claims are less likely to mislead."

The updated guidance is as follows:

- Avoid using unqualified carbon neutral, net zero or similar claims. Information explaining the basis for these claims helps consumers' understanding, and such information should therefore not be omitted.
- Marketers should ensure that they include accurate information about whether (and the degree to which) they are actively reducing carbon emissions or are basing claims on offsetting, to ensure that consumers do not wrongly assume that products or their manufacture generate no or few emissions.
- Claims based on future goals relating to reaching net zero or achieving carbon neutrality should be based on a verifiable strategy to deliver them.
- Where claims are based on offsetting, they should comply with the usual standards of evidence for objective claims set out in this guidance, and marketers should provide information about the offsetting scheme they are using.
- Where it is necessary to include qualifying information about a claim, that information should be sufficiently close to the main aspects of the claim for consumers to be able to see it easily and take account of it before they make any decision. The less prominent any qualifying information is, and the further away it is from any main claim being made, the more likely the claim will mislead consumers.

These amendments follow a review carried out by the ASA's Climate Change and the Environment project, which identified the use of carbon neutral and net zero claims as a "priority area . . . given their increasing prevalence and the potential for consumers to be misled

by them." Participants of the review asked for greater transparency regarding offsetting and that there was little consensus as to the meaning of "carbon neutral" and "net zero."

Last year, the ASA **ruled** that two UK retail banks had made "misleading" claims that "omitted material information" in their billboard advertisements. While ASA did not impose a financial penalty, the banks are not permitted to use the advertisements again and must ensure that future marketing communications making environmental claims were "adequately qualified and did not omit material information about its contribution to carbon dioxide and greenhouse gas emissions." The ASA also has made greenwashing-related rulings involving companies operating in other sectors including an **airline** and an **oil and gas company**. In both of these cases, the companies were not permitted to use the advertisement again.

Taking the Temperature: The ASA states that it intends to "carry out monitoring" to assess the impact of the new guidance for up to six months following publication. Depending on the outcome of this review, there may be further developments to the rules governing advertisers. Additionally, the ASA states that they are aware of "entirely unqualified" claims being made, and that they will be taking "proactive action immediately to address such claims." Firms operating outside the guidance should expect regulatory intervention. As a non-governmental self-regulatory organization (SRO), the ASA's enforcement powers are somewhat limited. These include publishing the non-compliant companies' details on its website until they comply, placing advertisements to highlight the non-compliance, working with social media and search engines to remove content and asking other ASA members to "revoke, withdraw or temporarily withhold recognition and trading privileges." For persistent rule breakers, the ASA has the power to refer the companies to other consumer protection agencies such as Trading Standards. Notwithstanding the limits of its enforcement authority, the ASA's action highlights that regulators around the world, including SROs, remain focused on greenwashing, and as we have commented, we expect litigation and enforcement activity arising from allegations of false sustainability claims to continue to increase in the near and medium terms.

Continuing Challenges for Companies Attempting to Meet Net-Zero Goals

February 21, 2023

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The **2023 Corporate Climate Responsibility Monitor (CCRM)**, produced in partnership by Carbon Market Watch and the New Climate Institute, contend that of the 24 multinational corporations assessed in the review – "the largest three global companies with bold climate pledges from eight consumer-facing industrial sectors" – 15 of them have proposed climate change strategies that "do not add up to what their pledges might suggest." While each of the 24 assessed companies is affiliated with the UN-sponsored Race to Zero campaign, publicly committing to decarbonization efforts aligned with limiting global warming to 1.5 degrees Celsius, the CCRM commented that, in the authors' view, it is now "more difficult than ever" to differentiate between companies that demonstrate "real climate leadership" and those engaged in "unsubstantiated greenwashing."

CCRM highlighted that there is an ongoing "2030 blind spot" where companies are now falling "well short" of climate goals without any third-party oversight or enforcement. While the CCRM stated that GHG and carbon emissions must drop between 43% and 48% by 2030 to achieve Paris-aligned temperature increase limits, the assessed companies are on pace for a median reduction of just 15% of full value chain emissions. "Overall, the net-zero pledges of the 24 companies translate to a commitment to reduce just 36% of the companies' combined GHG emission footprint, by the respective net-zero target years." The Report also comments on the use of carbon offsets, noting that the "24 sampled companies plan to offset 23–45% of their combined 2019 emission footprint to claim achievement of their long-term net-zero pledges," which is beyond the 10% maximum articulated by the Science Based Targets Initiative for the use of carbon offsetting.

The CCRM proposed that while companies on their own initiatives need to continue to "play a central role" in decarbonization efforts, regulators also need to be involved in order to accelerate and monitor net-zero transition efforts. According to the CCRM, shareholder activism and consumer pressure are not likely to, on their own, provide the catalyst necessary to promote the requisite corporate action.

Taking the Temperature: The CRRM is hardly the first organization to highlight the challenges faced by companies in implementing credible plans to achieve publicly articulated net-zero goals. A recent report by CDP commented on similar concerns.

Likewise, the SustainAbility Institute at global consultancy group Environmental Resources Management (ERM) also highlighted various studies suggesting a gap between issuers' statements on climate change and their actual transition policies, with one study suggesting that 65% "of net zero targets among global publicly traded companies do not meet minimum procedural standards of robustness (e.g., include a plan to achieve the target, publish progress on target achievement, etc.)." For issuers, the focus on a supposed divergence between publicly articulated climate goals and the implementation of transition plans sufficient to meet those goals will remain an area of concern from both a regulatory and litigation perspective. To mitigate those risks, companies should focus on climate-related governance (monitoring and assessing material risks and opportunities), data collection/assessment (including alignment with SBTi or other data standard setters) and disclosure (including necessary caveats or qualifications on articulated climate goals).