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UK Updates Its Green Finance Strategy and Launches ESG Ratings Regulation Consultation

April 4, 2023

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On March 30, 2023, the UK government **announced** the publication of its **2023 green finance strategy**, updating its earlier 2019 strategy, which is intended to mitigate climate-related risk and damage while increasing the amount of capital available to finance "net zero and environmental objectives." Additionally, the government published a **nature markets framework**, which has been developed to scale up private investment in nature recovery and sustainable farming. The executive summary of the framework states that the "development of high-integrity nature markets is a key part of [the UK government's] strategy to enable firms to mobilise" private investment flows to nature.

As part of its updated strategy, the UK government has **launched a consultation** on the scope of a future regulatory regime for ESG ratings providers. Interested parties have until June 30 to submit their responses to the Financial Conduct Authority. The consultation states that "Treasury considers there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers. These outcomes could be brought about through regulation." In terms of its planned regulatory approach, the Consultation states that the "FCA has indicated that, subject to consultation, they anticipate their regulatory approach would take the main elements of IOSCO's recommendations as a starting point for rules," but would not "seek to harmonise the varying methodologies and objectives of ESG ratings as a regulatory outcome." The recommendations of IOSCO, the International Organization of Securities Commissioners, focus on transparency of methodologies and data sources, good governance, conflict of interest management, and the existence (or lack) of "robust systems and controls."

The government is currently proposing an extensive list of exceptions to coverage under the proposed regulation, which have been set out in the consultation document. For example, unprocessed, or "minimally processed," data that does not have an assessment element is not in scope. Also proposed to be excluded are credit ratings even if they consider ESG factors (which already are subject to regulation under the Credit Ratings Agencies Regulation), investment research even if it references ESG considerations, and proxy advisory services recommendations, which, "even if related to ESG matters, are provided for a specific purpose (informing shareholders) and therefore should not be subject to the same regulation as ESG ratings." In terms of geographic coverage, "Treasury proposes to capture, at a minimum, the

direct provision of ESG ratings to users in the UK, by both UK firms and overseas firms. This includes direct provision to both institutional and retail users in the UK. This would not capture the provision of ESG ratings by any UK or overseas firm to any user outside the UK." Recognizing the potential for conflicting ESG ratings regimes among different jurisdictions, the Consultation states that "if other jurisdictions introduce similar regulation to that which would be present in the UK, and where there are suitable cooperation mechanisms, HM Treasury will consider whether to expand its deference framework to provide for the recognition of equivalent overseas regimes."

In announcing the updated strategy, the UK's financial regulators issued a **joint statement** that they "are now actively supervising and holding organisations within [their] regulatory perimeter (both real economy and financial services) to account on climate-related matters." The statement highlights greenwashing as an example of a "real risk to the transition, to market integrity and to investors." Nikhil Rathi, Chief Executive Officer of the Financial Conduct Authority said: "We welcome this updated Green Finance Strategy, which represents an important milestone, building on collective efforts to date and setting out a clear plan for the future. We are working hard to ensure that the UK market is well positioned to support the transition to net zero. We're playing our part in delivering a world-leading framework for transition plan disclosures through our collaboration with the UK Transition Plan Taskforce."

Taking the Temperature: The UK government's announcement of an update to its green finance strategy follows several recent developments from UK regulators, including the classification of nuclear power as environmentally sustainable, the Bank of England's updated assessment of climate-related risks and the regulatory capital framework for financial institutions, and the UK Pensions Regulator's announcement of the launch of a new initiative aimed at tightening regulation around ESG data published by trustees, as part of a wider campaign to assess whether trustees are properly discharging their ESG and climate change reporting duties. The focus of the updated green finance strategy on attracting capital is consistent with a recent statement by the Green Technical Advisory Group, an independent advisor to the UK government, in a recent paper arguing that the UK must "significantly raise its own game" on net-zero to avoid losing out to international competitors, as "the race to attract global capital to support green industry and market development is well and truly on again."

The proposal to regulate ESG ratings is notable. As we have previously discussed, there is significant uncertainty in the ESG ratings market resulting from a variety of issues. First, ESG ratings providers use different ranking methodologies that can lead to divergent rankings for the same company. ESG ratings providers use a variety of sources of data, methodologies, and formulae to arrive at their ultimate ESG scores. They present their data using different scales—some using letter rankings with others providing numerical scores—causing difficulty when trying to perform one-to-one comparisons between ESG ratings providers. Some ratings providers rely solely on publicly available information as their source data, whereas others rely on questionnaires and feedback from companies directly, which may include material information not otherwise available to the public, in addition to information that is publicly available. Second, lumping all of "E" and "S" together—or, at times, all of the different issues within each of these categories—can obscure the reason for a particular company's ESG rating. The at times low correlation among ranking scores, the lack of

granular information as to the basis of the rating, and, more generally, concerns around the transparency of ratings processes have led some to question the value, or how to best make use, of ESG ratings. Third, most ratings do not assess companies' sustainability profiles, but instead are based on the impact of climate change on a company's anticipated financial performance: If an ESG ratings provider concludes that climate change neither poses a risk nor offers opportunities to the company's bottom line, it may issue a higher ESG rating that is not necessarily reflective of that company's sustainability efforts.

In light of these issues, it is not surprising that the concept of ESG ratings regulation is not limited to the UK. Regulators or legislators in India, the U.S., the EU and elsewhere likewise are considering the issue.

Investors Accuse Large Asset Manager of Not Adequately Addressing Climate Risk

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More than 1,400 individual investors have **signed a letter** asserting that a large U.S.-based asset manager is violating its fiduciary duty to mitigate climate-related investment risks.

The Letter asserts that Vanguard is:

- violating its duty of care by falling behind "prudent investors acting in a like capacity." The investors cite as an example their contention that "Vanguard's peers, BlackRock and State Street," are more active in casting proxies consistent with their climate expectations and, unlike Vanguard, have joined industry coalitions like Climate Action, whereas Vanguard recently withdrew from the Net Zero Asset Managers initiative.
- violating its duty of loyalty by withdrawing from NZAM. According to the investors, Vanguard took this action in its own interest in response to political pressure about such industry climate collaborations to the detriment of Vanguard's clients.

The Letter closes by demanding that Vanguard release "a comprehensive plan outlining concrete steps the company will take to address climate risk," which should include adopting "investment stewardship guidelines that prioritize decarbonization in line with a 1.5°C pathway," articulating the "proxy voting consequences for companies that fail to meet" Vanguard's stewardship guidelines, and applying "rigorous climate risk criteria and analysis across its entire portfolio."

Taking the Temperature: We have written extensively on the challenges confronting asset managers as a result of issues stemming from climate change. For years industry participants have led the call for greater transparency on the part of issuers in terms of addressing climate-related risks and opportunities, both to permit asset managers to make informed investment decisions and to report on the sustainability characteristics of their investment portfolios. That, in turn, at least in part has led to a "backlash" on the part of mostly Republican-led U.S. state governments to pass laws aimed at financial institutions that do business with these states, principally by requiring the state treasurer to maintain a list of financial institutions that "boycott" energy companies and mandating that state finance officials divest assets invested with, or exclude from municipal underwriting syndicates, firms that remain on the list. At the same time,

financial industry climate collaborations have come under fire as potentially violative of antitrust laws, and we previously reported on Vanguard's decision to withdraw from the NZAM, albeit not on expressed concerns around antitrust liability. In the UK, in contrast, the Competition Markets Authority has issued a proposed rule that would provide guidance on the application of UK competition law to agreements between or among competitors relating to "environmental sustainability agreements," with the goal being to establish an analytical framework that would constitute a "more permissive approach" to competitor agreements aimed at combating or mitigating climate change. Bank shareholders, investors, and climate advocacy groups also are in the mix, with, for example, shareholder proposals having been submitted by New York City Comptroller and pension funds to four global banks seeking certain climate-related disclosure, NGOs writing to the CEOs and board chairs of five major European banks "urging them to stop directly financing new oil and gas fields by the end of this year," and three climate advocacy groups filing a lawsuit alleging that a global financial institution violated the French Duty of Vigilance Act.

Report on Greenwashing in the Food Sector Highlights Consumer-Focused Regulatory Activity on Climate Claims

April 4, 2023

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A **report** released by Dutch environmental advocacy group Changing Markets Foundation has highlighted alleged "greenwashing" in the UK and German food sectors, including via claims such as 'carbon neutral,' 'climate positive,' and 'net zero,' as well as specific claims about low methane. The report also stated that green advertising was impacting consumer choices, with 42% of UK consumers more likely to buy products with 'carbon neutral' labels and 29% "willing to pay slightly or much more" for products so labelled. "In Germany the picture is much the same, with 35% of consumers more likely to buy a meat or dairy product labelled 'carbon neutral' and 36% more likely to buy meat or dairy labelled 'climate positive', with 32% and 36% willing to pay more for these labels, respectively." Changing Markets in its Report also identified over 50 examples of what it claims are misleading "green" claims on food products themselves and within marketing materials for food products, with meat and dairy companies featuring prominently.

The report represents an example of continued focus on consumer greenwashing, with the European Commission, for example, recently publishing its proposed draft "**Green Claims Directive**," which we **recently discussed**. The Green Claims Directive will oblige companies to be more transparent about the potential environmental impacts of their products. The Directive resulted from analyses carried out by the EC, which found that more than 50% of environmental claims for publicly available goods and services were "vague, misleading or [based on] unfounded information." Likewise, the UK's advertising regulator, the Advertising Standards Authority (ASA), **recently 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."

Taking The Temperature: In addition to increasing regulatory guidance regarding green advertising, regulatory enforcement activity and private litigation also has been on the rise. For instance, last year the ASA ruled that two UK retail banking advertisements, which made claims about the financial institution's green credentials, were "misleading" and "omitted material information." The billboard advertisements, which stated how the bank was planting trees and transitioning to net zero, were posted on bus stops in Bristol and London in October 2021 just prior to the COP26 climate change summit. The ASA determined that the two advertisements should not be used again and that the bank

should 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."

In January, a global food products company was sued for violating France's Corporate Duty of Vigilance Law on the ground that the company does not have an adequate plan to reduce its plastic footprint. And, in Australia, the Australian Securities & Investments Commission (ASIC) issued three infringement notices to the Australian unit of a large U.S.-headquartered asset manager for greenwashing infringements. The breach involved three funds that were set up to exclude certain tobacco investments but excluded only manufacturers of cigarettes and related products, not companies involved in the sale of such products. The ASIC was concerned that the disclosure statements for these funds "may have been liable to mislead the public by overstating an exclusion, otherwise known as an investment screen."

Montana Residents Challenge State Energy Policy as Unconstitutional

April 4, 2023

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A trial has been scheduled for June 12 in a case involving climate-related constitutional challenges to actions by the State of Montana, its governor, and various state agencies. In ***Held v. Montana***, sixteen Montana residents—ranging from ages 2 to 18—claim they “have been and will continue to be harmed by the dangerous impacts of fossil fuels and the climate crisis,” and that the defendants have violated the Montana constitution by fostering and supporting fossil fuel-based energy policies in the state that led to these conditions. According to the complaint, defendants “have created and implemented a long-standing fossil-fuel based state energy system,” which is codified as part of Montana law, “that contributes to dangerous climate disruption in violation of [plaintiffs’] constitutional rights.” The state energy policy **includes** provisions that purportedly promote fossil fuel energy, such as “increas[ing] local oil and gas exploration.” The plaintiffs also challenge an aspect of the state energy policy providing that any environmental review conducted in connection with action taken in furtherance of the policy “may not include a review of actual or potential impacts beyond Montana's borders. It may not include actual or potential impacts that are regional, national, or global in nature.” According to the complaint, “[t]his has been interpreted to mean that defendants cannot consider the impacts of climate change in their environmental reviews.”

Several constitutional provisions **allegedly were violated** as a result of these actions, including the “inalienable . . . right to a clean and healthful environment,” the obligation of the “[t]he state and each person [to] maintain and improve a clean and healthful environment in Montana for present and future generations,” and Montana’s due process and equal protection provisions. Plaintiffs seek declarations that the energy policy and environmental impact provision are unconstitutional and various forms of injunctive relief, including requiring defendants to develop environmental remedial plans.

While the court has already ruled that it has no authority to force the defendants to create a remedial plan, the court set a trial date after finding that the plaintiffs have standing to seek declarations that the challenged state policies and the actions taken in furtherance of those policies violate the Montana constitution.

Taking the Temperature: The outcome of the *Held* trial may shape the fate of other constitution-based climate-related challenges, including in Hawaii, Utah, and Virginia.

Overall, as we have reported, climate-focused litigation is on the rise. In Europe, for instance, there have been multiple recent examples of activist investors and NGO's using the courts as a method of exerting pressure on companies. We reported on an attempt by six NGO's in French courts to suspend an oil pipeline project in Uganda and Tanzania. Three climate advocacy groups brought a claim in France alleging that a financial institution breached the Duty of Vigilance Act in connection with emissions financing. In the High Court of England and Wales, a non-profit, ClientEarth, has brought a claim against an oil company for not "properly managing climate risk." And, earlier this year in the U.S., an NGO filed what it called a "groundbreaking greenwashing complaint" with the Securities and Exchange Commission's Climate and ESG Task Force, asking that it investigate an energy producer for possible violations of the federal securities laws.