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Disclosure: FCA Proposes Regulation of Investment Firm Sustainability Claims

October 28, 2022

Disclosure

By Jason Halper
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The UK's Financial Conduct Authority (FCA) has announced a proposal for regulating sustainability claims by investment firms. In its accompanying **consultation paper**, the FCA proposed three sustainable fund labels as part of its wider anti-greenwashing policy. The labels are: (i) "sustainable focus" funds, which have at least 70% of the fund invested in assets that "meet a credible standard of environmental and/or social sustainability, or that align with a specified environmental and/or social sustainability theme;" (ii) "sustainable improver" funds, which "invest in assets that, while not objectively environmentally or socially sustainable at present, have the potential to deliver measurable improvements in their environmental and/or social sustainability over time, including in response to the stewardship influence of the firm;" and (iii) "sustainable impact" funds, which "aim to achieve a positive, measurable contribution to real world sustainability outcomes," and "commit to deliver and report on [the investor's] contribution to a positive environmental and/or social sustainability outcome through financial as well as other types of investor" influence.

The FCA also proposed implementing restrictions on how certain terms, including "ESG," "green," or "sustainable," can be used in product names and marketing material together with a more general anti-greenwashing rule that will apply to all regulated firms. This announcement follows the government's **roadmap to sustainable investing** published in October 2021. The FCA's consultation is open until January 25, 2023, and it intends to publish the final rules by June 2023. Implementation will continue through 2025.

Sacha Sadan, the FCA's Director of Environment Social and Governance, stated that the proposal "places the UK at the forefront of sustainable investment internationally. We are raising the bar by setting robust regulatory standards to protect consumers in line with our wider FCA strategy."

Taking the Temperature: The FCA's proposal is notable in part because it diverges from analogous provisions in the EU's Sustainable Finance Disclosure Regulation (SFDR). This divergence obviously presents challenges for investment firms subject to dual UK and EU regulation. The SFDR requires investment funds to adopt one of three product classifications, Article 6 (non-ESG products, which still must disclose certain information on their consideration of sustainability risks), Article 8 (funds that promote —but do not have as an objective—sustainability) and Article 9 (funds with sustainability goals as their objectives). Sadan herself identified this issue, stating "we will not expect every Article 8 fund to just get in," ***i.e.*****, secure a sustainability label. She also**

distinguished the FCA's overall approach, stating that in "Europe, there is a perception that Article 9 funds are better than the others, which can be confusing. Investors quite rightly want to own a diversified portfolio which includes these different elements, such as impact and improvers." In the U.S., the Securities and Exchange Commission (SEC) has proposed yet another set of rules for investment funds, including requiring specific disclosures on ESG strategies and, for ESG funds that consider environmental factors, disclosures of greenhouse gas emissions. The SEC also proposed three categories of ESG funds: (i) Integration Funds, which take into account ESG factors but place no greater weight on them than non-ESG factors; (ii) ESG-focused funds, which make ESG factors a significant part of the investment thesis; and (iii) Impact Funds, which pursue a specific ESG outcome. Asset managers need to tread carefully through the thicket of overlapping but inconsistent regulation to the extent they are subject to multiple jurisdictions' authority and thoroughly document the basis for their sustainability disclosures.

Regulation: EBA Report on ESG Risk and Supervision of Investment Firms

October 28, 2022

Regulation

By Simon Walsh
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On October 24, the European Banking Authority (EBA) announced the publication of its **report** on incorporating ESG risks into the supervision of investment firms. The report is intended to establish foundations for the integration of ESG risk considerations into the supervisory process of investment firms and covers elements including: (a) business model analysis; (b) assessment of internal governance and risk management; and (c) assessment of risks. According to the EBA, proportionality is a "key element" of the supervisory approach and competent authorities should consider elements such as an investment firm's "business model, size, internal organization and the nature, sale and complexity of its services and activities, but also the materiality of its exposure to ESG risks."

The executive summary to the report states: "The EBA acknowledges the challenges presented by the assessment of ESG risks in light of current data and methodological constraints. It is recommended that the supervisory processes follow a gradual approach, prioritizing the recognition of ESG risks in investment firms' strategies and governance arrangements, and later incorporating ESG risks in the assessments of risks to capital and liquidity. Supervisory assessment practices are expected to develop over time, alongside the expected improvements in the availability of ESG data as well as the development of methodologies to assess the impact of ESG factors on financial risks."

Taking the Temperature: This report underlines the importance of regulators adopting an internationally-consistent approach when creating rules for ESG-related matters. It should be reassuring for financial institutions, especially ones operating internationally, to see bodies such as the EBA attempting to establish clear guidance with the intention of creating a coherent and proportionate regulatory landscape. Financial institution regulators in the U.S., EU and other jurisdictions likewise are continuing to develop and refine supervisory procedures for regulated institutions. A key consideration, from a regulated entity perspective, is consistency among jurisdictions to enable financial firms to assess ESG-related issues globally and according to a largely unified set of criteria.

Regulation: Industry Comments on SEC's Fund Name Proposal

October 28, 2022

Regulation

By Sara Bussiere
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The SEC's proposal to amend the "Names Rule," first announced in May 2022, has elicited significant comment from industry. With these changes, the SEC's goal is to improve standards of marketing by ensuring that funds are able to show that 80% of their holdings match the fund's name. Over 100 companies and investors have submitted public comments ahead of the deadline next week, and the SEC reports holding 11 meetings with industry groups.

Commentary is mixed. For instance, a spokesperson for Better Markets, a financial reform group, stated that they "wholeheartedly support" the proposed changes and that "investors need to know that their funds are being invested in the way that they expect. The name is a very powerful influence." On the other hand, Capital Group called the proposal a "proposed expansion of scope [that] is an overly broad and unhelpfully blunt solution." Fidelity expressed concerns that funds would only be given 30 days to remedy their non-compliance with the 80% rule. It argues that 180 days would be more appropriate and that, by "prescribing a rigid set of conditions, the [SEC] may be unintentionally hampering a fund's ability to meet new and unforeseen challenges." The Investment Company Institute stated that the proposals would increase costs for funds due to the increased monitoring required to maintain compliance. The SEC estimates that costs to industry could reach $5 billion.

Taking the Temperature: Reactions to the proposed rule reflect the reality that compliance with ESG-focused regulation often will be complex, time-consuming and costly. Well-intentioned investment firms also are understandably concerned about the risks of inadvertent non-compliance. While all these concerns should abate over time as consensus forms around ESG-related measurement metrics and taxonomies (*i.e.*, what constitutes a sustainable investment), for the moment the challenges to investment firms remain formidable given the overall lack of firm guidance on these issues.

Green Finance: Global Investment Bank Establishes Emissions Reduction Targets for Carbon-Intensive Sectors

October 28, 2022

Green Finance

By Timbre Shriver
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A major financial institution has established a series of emissions reduction targets for four carbon-intensive sectors. On October 21, the bank **announced** that the "targets represent a core element of [its] sustainability strategy and reflect the bank's commitments as a founding member of the Net Zero Banking Alliance." The published net zero aligned objectives for 2030 and 2050 address the oil & gas (upstream), power generation, automotive (light duty vehicles), and steel sectors. For the oil & gas sector, Deutsche Bank hopes to achieve a 23% reduction in its Scope 3 upstream financed emissions by 2030 and a 90% reduction by 2050. For the other three sectors, the bank is targeting significant, but varying, percentage reductions in Scope 1 and 2 financed emissions. Deutsche Bank stated its intention to publish an update on its financed emissions and pathway alignment in March 2023.

Jörg Eigendorf, Chief Sustainability Officer at Deutsche Bank, stated "this is an important step to reduce the carbon footprint of our loan book progressively. . . . We are focusing on supporting our clients on their net zero journey."

Taking the Temperature: The steps taken by Deutsche Bank are a good example of how financial institutions are attempting to address climate-related challenges, including potential regulation. Earlier this week, another global financial institution, Royal Bank of Canada (RBC), issued its Net-Zero Report, which disclosed new targets for financed emissions reductions in the oil and gas, power generation, and automotive industries by 2030. As RBC acknowledged—and, as is true for all emissions financing commitments—the "achievement of these targets will depend on the collective efforts and actions across a wide range of stakeholders, which are outside of our control," including government policies, technological developments, and climate and data science evolution.