Australian Government Seeks Input on Implementation of Carbon Credit Scheme

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In August 2023, the Australian Department of Climate Change, Energy, the Environment and Water (DCCEEW) solicited feedback on proposed amendments to the Australian Carbon Credit Unit (ACCU) Scheme. This is the third step in the process of modernizing the ACCU, which was initiated in 2022, when an independent panel reviewed the Scheme with the goal of increasing its efficacy and transparency. The panel delivered **16 recommendations** in December that year. The Australian Government accepted the recommendations in principle in January 2023, and began translating them into concrete and actionable updates. The ACCU Review Implementation Plan was released in June 2023.

ACCUs are a tradable financial product and have largely been purchased by the Australian Government. The market is also open to private parties, typically those motivated by compliance obligations or voluntary commitments, though ACCUs tend to be generated by land-based projects with "practice changes," i.e., livestock removal, native plantings, or forest regeneration. Two industrial project methods also exist: landfill gas, which involves landfill methane being converted into biogas or electricity, and carbon capture and storage.

The DCCEEW sought feedback on a number of areas including:

- new ACCU Scheme principles;
- information publication requirements;
- the Commonwealth Government's role as a purchaser of ACCUs;
- the functions of the Carbon Abatement Integrity Committee; and
- the requirements for native title consent to projects

Taking the Temperature: As we discussed in our previous coverage of the ACCU Scheme, a key concern with Australia's carbon credit market has been a lack of transparency regarding the basis for the carbon credits. Globally, there has been considerable scrutiny of carbon credit schemes, including by the United Nations and at COP27 in November 2022. Lack of transparency and effectiveness continue to be major concerns. We have frequently discussed the perceived drawbacks and criticisms of the use of carbon credit schemes here, here and here. In September, Reuters reported that,

for the first time in seven years, voluntary carbon markets had shrunk, as large corporations retreated from previous commitments. For example, Shell stepped back from its spending and volume targets for carbon offsets after previously declaring an intent to invest $100 million a year in offsets and use credits equivalent to 120 million tons of CO2 per year by 2030.

Another concern with the lack of integrity in carbon credit markets is the greenwashing risk we discussed previously, particularly in high-emissions industries such as transportation and aviation. In the U.S., a group of Democratic senators last year called for better oversight of the market for carbon offsets. In an October 2022 letter to the Commodity Futures Trading Commission, senators pointed to the potential for companies to engage in greenwashing and the risk that carbon credits may in fact reduce incentives for corporations to actively work towards carbon reduction: "The purchase of offsets allows many of these multinational companies to make bold claims about emission reductions and pledges to reach 'net zero,' when in fact they are taking little action to address the climate impacts of their industry. Several studies have highlighted that carbon offset projects are frequently illegitimate, and those that do contribute to meaningful emissions reductions are often representative of broader 'pay to pollute' schemes that place profit over protecting frontline communities." In response, the Whistleblower Office of the Division of Enforcement of the CFTC issued an alert on June 20 advising the public on how to identify and report potential violations connected to fraud or manipulation in the carbon markets.

UK Institute of Directors: UK's FRC Should Maximize Adaptability of Governance Code

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In September 2023, the UK's Institute of Directors (IoD) announced its broad support for changes to the UK Corporate Governance Code proposed by the Financial Reporting Council (FRC). The FRC's proposed revisions seek to improve internal controls, internal and external assurance, and ESG reporting. In addition, the proposals discuss the role of audit committees and executive pay. The revised Code would be applicable to accounting years beginning on January 1, 2025.

The IoD opinion can be found in two documents: its **response** to the FRC consultation and its recent policy paper, **"Are Boards Losing Control?"** In the IoD's view, the proposed reforms are useful, but do not go as far as the sweeping reforms made in 2018, which resulted in the implementation of the existing Corporate Governance Code.

Complying with the UK Corporate Governance Code is required for approximately 900 companies—those with a premium listing on the London Stock Exchange. The Code is principles-based; more prescriptive recommendations are contained in additional provisions. Companies are expected to apply the Code's principles in their reporting, though this varies considerably by company, as the Code employs a "comply or explain" model in which companies can delineate their reasoning in not complying with any provisions.

While generally supportive of proposed changes to the Code, the IoD lists a few key caveats. The IoD believes that boards are better suited than regulators to promote the best interest of their companies, so it took issue with some of the more explicit directions for boards. The IoD also concluded that the Code was not a deterrent for companies in deciding whether to list in the UK, but stressed that the FRC should highlight the adaptability of the Code, in order to avoid seeming overly prescriptive. In particular, the IoD flagged the "comply or explain" provisions, stressing that this is the Code's key selling point.

An area that the IoD highlighted in particular was a recommendation that audit committees be primarily responsible for ESG disclosures, control, processes and assurance, noting that not all audit committees enjoy similar capabilities or expertise on the part of committee members, and many may already have a full portfolio within their mandates. For some firms, the audit

committee may not even be the appropriate body, but rather, for certain companies an ESG-specific committee would be better suited, or the entirety of the board.

The IoD also addressed the increasing reporting and disclosure requirements placed on companies. The IoD stressed that the Code should minimize this burden whenever possible: reporting ought to provide a value-add for stakeholders.

Finally, the IoD expressed its support for the FRC's effort to strengthen the Code's provisions with respect to executive pay. The object of the FRC's revision in this area is to facilitate a transparency and foster an environment where executives are not rewarded for poor decision-making (whether misconduct or significant financial underperformance). The IoD supported increased information on clawback provisions, including express clawback provisions in employment contracts.

Taking the Temperature: As we have reported, there is strong support for mandatory, standardized ESG reporting in the UK, including the desire to align with EU efforts with the goal of achieving something approaching uniformity in reporting frameworks. Concerns remain, however, about the costs and burdens associated with reporting requirements, and the consequent impact on the UK's competitiveness in attracting capital and company listings.

Texas Federal Judge: DOL ESG Investing Rule Does Not Violate ERISA

November 7, 2023

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On September 21, 2023, a Texas federal court **dismissed an action** commenced by more than two dozen Republican state attorneys general challenging a 2022 Department of Labor (DOL) Rule that addressed consideration of ESG factors by retirement plan fiduciaries in their decision-making. **As we previously reported**, Plaintiffs had alleged that the Rule violated the Administrative Procedure Act because it is arbitrary and capricious and "runs afoul" of ERISA.

The DOL Rule provided that fiduciaries' investment decisions "must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis." But the Rule also clarified that risk and return factors "may include" ESG factors depending on individual facts and circumstances. On summary judgment, the Court found that the Rule did not violate ERISA's mandate that a fiduciary must discharge his or her duties concerning a plan "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of" providing "benefits" to them. While recognizing that the term "benefits" refers to "financial benefits," the Court found that the DOL Rule did not require fiduciaries to prioritize other goals. According to the Court: "Indeed, since at least 2015, DOL has posited that ESG factors 'may have a direct relationship to the economic value of the plan's investment.' 80 Fed. Reg. at 65 136. And likewise, the 2020 [prior iteration of the] Rule stated that failing to consider ESG-related risk-return factors could constitute a violation of the duty of prudence in some circumstances: 'For example, a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations.' 85 Fed. Reg. at 72848.

In addition, the Court found, the Rule "explains that fiduciaries remain free 'to determine that an ESG-focused investment is not in fact'" consistent with a fiduciary's duty of prudence, 87 Fed. Reg. at 7383 1, and "stresses that a 'fiduciary's determination with respect to an investment ... must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis.' Hence, 'risk and return factors may include [ESG] factors on the particular investment,' but '[w]hether any particular consideration is a risk-return factor depends on the individual facts and circumstances.'" In short, the Rule "makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating an incentive for a fiduciary to put a thumb on the scale in favor of ESG factors."

Taking the Temperature: On September 21, 2023, plaintiffs filed a notice of appeal of the decision to the Fifth Circuit, and a similar suit is also pending against the DOL, filed by

two retirement plan participants, in a Wisconsin federal court on February 21 (*Braun v. Walsh*), such that challenges to the DOL Rule will persist.

As we've previously reported, in March Democratic Senators Jon Tester (D-MT) and Joe Manchin (D-WV) joined Senate Republicans to pass H.J. Res. 30, aimed at repealing the rule. The legislative move was largely symbolic, as President Biden was expected to and ultimately did veto the measure. The anti-ESG faction within Congress continues to press their position, both legislatively, with the introduction of new bills aimed directly and indirectly at the DOL rule.

UK Consults on Proposals to Boost Diversity and Inclusion in Regulated Firms

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On September 25, 2023, the UK's Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) released a **joint consultation paper CP23/20** on a new regulatory framework on diversity and inclusion. The FCA and PRA's starting points on the consultation are that: (1) non-financial misconduct (NFM) is misconduct for regulatory purposes; and (2) greater diversity and inclusion can lead to better customer outcomes.

CP 23/20 sets out a number of proposals intended to develop diversity and inclusion strategies backed up by data and targets and subject to regulatory reporting requirements. These are framed within proportional and flexible principles that will mean that obligations will largely attach to larger firms depending on their number of employees, status under the Senior Managers and Certification Regime (SMCR) and whether they are regulated by both the FCA and PRA. The large-firm threshold is being set at 250 employees based on an average number over a rolling three-year period as at a specified annual reference date, and calculated on a solo entity basis capturing activities carried out from an establishment in the UK.

Proposals

Better integration of non-financial misconduct (into staff fitness and propriety assessments, conduct of business rules and suitability criteria for firms

The proposals would apply to all regulated firms with a 'Part 4A permission,' i.e., authorized firms, with the exception of credit rating agencies, payment services and e-money firms, and will include NFM within conduct rules, fit and proper assessments for employees and senior personnel, and suitability guidance on threshold conditions. The requirements are all framed within the guiding principle that NFM is misconduct and not a principle in and of itself, and will make it clear that misconduct within the workplace, and similarly serious behavior in a person's private life, can also be relevant. Proposed expansions to the scope of conduct rules will make it clear that serious instances of NFM may amount to breaches of those rules. Also proposed is consideration of material NFM and its impact on a firm's ability to satisfy the threshold conditions for doing business when applying for authorization.

Data reporting

All firms will need to report their average number of employees annually, with the exception of Limited Scope SMCR firms (as financial services are typically ancillary to their main business). Firms with 251 or more employees have additional reporting obligations, again excluding all Limited Scope SMCR firms.

D&I strategies and targets

These will be required of all dual-regulated firms (FCA and PRA) and all firms with 251 or more employees excluding all Limited Scope SMCR firms. Larger firms will be expected to develop and embed a flexible, evidence-based D&I strategy with a plan for measuring and meeting objectives and goals, anticipating obstacles and ensuring the adequate dissemination of awareness among staff. Maintenance and oversight of the D&I strategy will be a board responsibility, and firms will need to be satisfied that the strategy is and remains fit for purpose and taken it into account when setting targets. Those targets are expected to address underrepresentation at board and senior leadership level and across the employee population as a whole, but the FCA is not proposing to mandate the demographic characteristics targets should cover.

Data disclosure and risk and governance

These measures will be required of all firms with 251 or more employees excluding all Limited Scope SMCR firms. Firms will be required to annually collect and report on data across a range of demographic characteristics, inclusion metrics and targets through a regulatory return, with a reporting window of three months from the reference date. The FCA is also proposing to produce its own regular aggregated report and to identify areas that need further supervisory input.

On risk and governance, the FCA is proposing new guidance for large firms on treating D&I as a non-financial risk.

Next Steps

Responses to the consultation are due by December 18, 2023, and rules will come into force 12 months from the publication of a Policy Statement in 2024.

Taking the Temperature: The financial regulator of a key global financial market focusing on social factors like diversity and inclusion highlights its growing importance as a regulatory area, though to date overshadowed by the regulatory attention paid the "E" in "ESG."

This was particularly the case following a decision of the Upper Tribunal in which it overturned the FCA's decision to withdraw an individual's regulatory approval following his conviction for sexual offenses, on the basis that he was not a fit and proper person. On appeal, the Upper Tribunal determined that the FCA had failed to establish the requisite degree of relevance of his conduct, as it concerned his fitness and propriety; this was because the regulator failed to establish a link between the two. From the FCA's perspective the court's decision highlighted a gap in guidance.

As the FCA's chief executive commented, the regulator has "taken a lead among regulators in taking a clear stance that non-financial misconduct, such as sexual harassment, is misconduct for regulatory purposes." The new rules could significantly reduce any gray areas in some respects, such as those faced by the FCA in recent years. However, how the rules will balance criminal law principles, such as a person's right to be regarded innocent until proven guilty, may present an entirely new challenge.

SEC Modernizes the "Names Rule" for Funds

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What's in a name? According to the Securities and Exchange Commission, quite a bit. On September 20, 2023, the SEC **adopted amendments** to the Investment Company Act of 1940, most notably to the "Names Rule" governing the names of funds to ensure that they do not mislead investors regarding the fund's risks and investment characteristics. **The SEC commented** that the updates are designed to "address[] materially deceptive and misleading use of environmental, social, or governance (ESG) terminology in fund names."

As the SEC noted, the fund's name "is the first piece of information that investors receive" and **signals to investors** the types of investments the fund will pursue. The Names Rule was first implemented in 2001 and required any fund whose name suggested an investment in a particular type of industry or geographic location to invest 80% of its assets accordingly. This 80% rule could be implemented in two ways: (1) a fund could implement a "fundamental policy" for its investment strategy that could not be changed without shareholder approval; or (2) a notice policy that allowed a fund to amend its investment strategy subject to a 60-day notice period to shareholders.

The amended rule will implement five major new changes:

First, the 80% investment policy requirement will now apply to any fund name that contains terminology suggesting the fund invests according to certain themes and characteristics. The "primary types of names" that the revised rule is intended to cover are ones like "growth" or "value" or terms that reflect the fund's intention to align itself with ESG factors. The rule will also require a fund to value its derivative investments according to the derivatives' notional amount instead of its market value when calculating compliance with the 80% rule.

Second, funds will be required to inform investors through prospectus disclosures the definitions of the terms used in the fund's name as well as the criteria for determining which investments the fund will pursue in connection with its thematic investment strategy. Additionally, any fund names that imply a particular investment focus or tax-exempt status must be consistent with the plain-English use of those terms or relevant industry terminology.

Third, funds will still be required to comply with the 80% rule at the time the fund invests assets and "under normal circumstances." The amendments now additionally require the fund to

review its investment portfolio on a quarterly basis and provides for a 90-day period to restore compliance if a fund is out of compliance with its 80% investment policy.

Fourth, a registered closed-end fund whose shares are not listed on a national securities exchange by and large will be prohibited from altering its 80% investment policy absent shareholder approval. The SEC commented that this requirement is intended to prevent funds from altering their investment strategy where holders of the fund are limited in their options to sell their investments. Under the amendments, a fund can avoid a shareholder vote if it offers a repurchase or tender opportunity.

Fifth, the amendments update the notice requirement for certain funds to address the use of electronic delivery methods and communications to provide additional specificity regarding the substantive content of the notice and delivery mechanisms.

The amended rule became effective as of December 10, 2023. Fund with net assets in excess of $1 billion will be required to comply within 24 months, while those with less than $1 billion will have 30 months.

Taking the Temperature: The Names Rule is consistent with the SEC's overall focus on ESG issues. For example, as we have noted previously, the SEC formed 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." Likewise, the SEC's Division of Examinations' examination priorities for 2023 included a focus on ESG-related advisory services and fund offerings. 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." The Names Rules furthers this examination priority. Even earlier, in April 2021, the Division of Examinations issued a Risk Alert focused on ESG investment by asset managers, stating that "in response to investor demand, investment advisers and funds have expanded their various approaches to ESG investing and increased the number of product offerings across multiple asset classes. This rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks. For instance, the variability and imprecision of industry ESG definitions and terms can create confusion among investors if investment advisers and funds have not clearly and consistently articulated how they define ESG and how they use ESG-related terms, especially when offering products or services to retail investors. Actual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals." In July 2021, the SEC's Asset Management Advisory Committee's ESG subcommittee issued a series of recommendations "to improve the data and disclosure used for ESG investing, in order to create better transparency for investors, and better verifiability of investment products' ESG strategies and practices."

More generally, financial regulators in many jurisdictions have attempted to address ESG-related issues in the asset management industry, in part due to greenwashing

concerns. We reported late last year, for instance, on the decision by a number of large asset managers to downgrade European ESG funds totaling tens of billions of dollars from Article 9 – the highest sustainability classification under the EU's Sustainable Finance Disclosure Regulation (SFDR) – to the broader, and less restrictive, Article 8. These announcements followed draft guidelines published by the European Securities and Markets Authority as part of a consultation on funds' names using ESG or sustainability-related terms. As defined in the SFDR, Article 8 funds are those that promote Environmental or Social characteristics but do not have them as the overarching objective. Article 9 funds are those that have specific sustainable goals as their objective.