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CLIMATE

Connecting Climate Change and the Law

May 28, 2024

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In this week's edition, we look in detail at ESMA's final guidelines on ESG and sustainability-related fund names. Staying with the regulatory guidance theme, we look at the Science Based Targets initiative's announcement of a major revision to the Corporate Net-Zero Standard, and the UK Government's plan to analyze the benefits of adopting the International Financial Reporting Standards corporate reporting standards to inform its own such standard. We end with the Biden Administration's latest initiative to protect forestlands consistent with its plans under the Inflation Reduction Act.

EU Financial Markets Regulator Publishes Criteria for ESG and Sustainable Fund Names

On May 14, 2024, the European Securities and Markets Authority (ESMA) published final guidelines for funds using ESG or sustainable terms in their names (the Guidelines). If competent authorities in each Member State elect to adopt them, in-scope funds will need to be in compliance with the Guidelines within nine months. The Guidelines apply to all alternative investment funds (AIFs) that are managed by EU alternative investment fund managers (AIFMs), and funds that fall within the scope of the **Undertaking for the Collective Investment in Transferable Securities (UCITS) Directive**. The Guidelines include criteria based on the ESG or sustainability-related terms used by AIFMs and UCITS funds, and can be summarized as follows:

Descriptions of key terms

The Guidelines set out descriptions of relevant key terms.

- Transition-related:
  - This includes terms derived from the base word "transition" e.g. "transitioning," "transitional," etc. and terms deriving from "improve," "progress," "evolution," "transformation," "net-zero," etc.
- Social-related:
  - This includes terms which give the investor any impression of the promotion of social characteristics, e.g. "social," "equality," etc.
- Governance-related:
  - This encompasses words which give the investor any impression of a focus on governance, e.g. "governance," "controversies," etc.
- Environmental-related:
  - This includes words which give the investor any impression of the promotion of environmental characteristics e.g. "green," "environmental," "climate," etc. Such terms may include abbreviations such as "ESG" and "SRI."
- Impact related:

- This encompasses terms derived from the base word “impact,” e.g. “impacting,” “impactful,” etc.

- Sustainability-related:
  - This includes terms only derived from the base word “sustainable,” e.g. “sustainably,” “sustainability,” etc.

Asset allocation

At least 80% of the assets of funds using transition-, social-, governance-, environmental- and impact-related terms must be used to meet the environmental and/or social characteristics or sustainable investment objectives in accordance with the binding elements of its investment strategy.

The same asset-allocation threshold also applies to funds using sustainability-related terms but in addition, these funds must also make a commitment to invest “meaningfully” in “sustainable investments,” as such term is defined in Article 2(17) of the Sustainable Finance Disclosure Regulation (SFDR). ESMA explains that investing “meaningfully” is a requirement that replaced what was an additional threshold of at least 50% of sustainable investments for funds using sustainability-related terms. The latter requirement was removed following feedback from stakeholders, some of whom cited the lack of clarity of the sustainable investment definition provided in the SFDR. **We have previously discussed** the mass downgrades in fund classification that resulted from that uncertainty. However, no further guidance as to the definition of “meaningfully” has been provided. The lack of a clear definition of what it means to commit to “invest meaningfully in sustainable investments” generates a degree of uncertainty and as such, asset managers will need to carefully consider what they take the term to mean.

Exclusionary criteria

For funds using transition-, social- and governance-related terms, investments should not be made in companies that are excluded from Climate Transition Benchmarks (CTB). CTB exclusions refer to companies involved in any activities related to controversial weapons, the cultivation and production of tobacco, or any activities that benchmark administrators hold in violation of the United Nations Global Compact (UNGC) principles or the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

The same CTB exclusions apply to funds using environmental-, impact- or sustainability-related terms, but such funds must also adhere to additional criteria under the Paris Aligned Benchmark (PAB) by excluding companies that derive:

- 1% or more of their revenue from exploration, mining, extraction, distribution or refining of hard coal and lignite;
- 10% or more of their revenue from the exploration, extraction, distribution or refining of oil fuels;
- 50% or more of their revenue from the exploration, extraction, manufacturing or distribution of gaseous fuels; and

- 50% or more of their revenue from electricity generation with a greenhouse gas intensity of more than 100 g CO2 e/kWh.

Further recommendations

The Guidelines include further specific criteria:

- Funds designating an index as a reference benchmark should only use transition-, social- and governance-related terms, environmental- or impact-related terms or sustainability-related term in their name if they fulfil the relevant requirements set out above.
- Funds using "transition-" or "impact"-related terms in their names should also ensure that investments used to meet the relevant threshold are on a clear and measurable path to social or environmental transition or are made with the objective to generate a positive and measurable social or environmental impact alongside a financial return.

Timelines

The Guidelines are due to be translated into all EU languages, and will be published on ESMA's website. Application will commence three months after that publication. Competent authorities will have two months after the Guidelines are published on ESMA's website to notify the regulator whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines. Funds existing before the application date will have six months after that date to comply.

Conclusion

Although it remains to be seen how each Member State implements the Guidelines, fund managers will need to familiarize themselves with them and ensure that any in-scope terms are being used in compliance with the rules. Such a review must be conducted – and any necessary changes implemented – within the next nine months. Non-compliance could potentially lead to greenwashing allegations and therefore carries risk of enforcement and litigation, as well as other consequences such as adverse publicity and reputational damage.

As noted by the U.S. Securities and Exchange Commission when introducing their "names rule" (**which we discussed in detail in a previous edition**), a fund's name "is the first piece of information that investors receive" and signals to investors the types of investments the fund will pursue. It is hoped that the Guidelines published by ESMA will provide clarity, enhance transparency and protect investors from unsubstantiated or exaggerated claims in fund names, increasing confidence and ultimately driving further investment.

SBTi Confirms Major Revision to Corporate Net-Zero Standard

On May 9, 2024, the Science Based Targets initiative (SBTi) **published the Terms of Reference** that will inform a major revision to the **Corporate Net-Zero Standard (CNZS)**, a global science-based standard for companies to set net-zero targets consistent with limiting global temperature rises to 1.5oC.

Key aspects of the existing CNZS include:

- Near-term targets to roughly halve emission before 2030

- Long-term targets to cut all possible emissions before 2050
- Neutralizing residual emissions with permanent carbon removal and storage
- Beyond Value Chain Mitigation (BVCM)

In reviewing the CNZS, SBTi has set out four goals: (1) to align with the latest scientific thinking and best practice, such as from the Intergovernmental Panel on Climate Change (IPCC) and the UN Secretary General's High Level Expert Group on the net-zero emissions commitments of non-state entities (HLEG), (2) to address challenges related to scope 3 target setting and implementation, (3) to integrate continuous improvement and target delivery, and (4) to improve structure and enhance interoperability with other SBTi standards as well as other relevant external frameworks and standards.

The revision is mandated to take place every two-to-five years in line with its regular review cycle. Throughout the review stakeholders are encouraged to provide their feedback via the **Project Feedback Form**.

Various stages of the process are due to be completed throughout 2024, with the aim to publish a final revised standard during Q4 2024.

SBTi's goal to update the CNZS so that it aligns with the latest scientific thinking and best practice underlines the importance of ensuring global cohesion across the myriad frameworks, models and standards that govern emissions-related metrics and targets. However, it remains to be seen how widely organizations continue to publicly align themselves with prescribed net-zero standards in light of recent exits from alliances such as **Climate Action 100+** and the **Net-Zero Asset Managers (NZAM)** initiative as we have discussed previously.

UK Government Forms Committee to Consider Endorsement of IFRS Standards

On May 16, 2024, the UK Government announced the formation of the UK Sustainability Disclosure Technical Advisory Committee (TAC) to analyze whether the endorsement of the International Sustainability Standards Board's (ISSB) corporate reporting standards would be of benefit to the country. In conducting such review, TAC will be supported by the Financial Reporting Council and 14 individual members from, among other organizations, financial institutions Barclays, HSBC and NatWest, PwC and academics from Edinburgh and Birmingham universities. TAC is expected to provide its recommendations to the Business Secretary later in 2024.

TAC will analyze IFRS S1 and IFRS S2, the two inaugural ISSB Standards which cover governance, strategy, risk management and metrics and targets. The UK's Department of Business and Trade (DBT) had originally announced the creation of new sustainability rules aligned with IFRS S1 and S2 in August 2023. The DBT announced its intention to create TAC at this time, **as we discussed previously**, but the May 16 announcement included the appointment of a Chair of the committee, which will kickstart the work planned for it. This review forms part of the UK Government's plans under the **green-finance strategy**, and includes plans for a further committee which will oversee the implementation of the recommendations TAC provides.

Although the review is likely to be met with positive support, the UK has been slow to move forward on developing a reporting framework. It is possible that this delay is in part due to uncertainty as to which companies should be in-scope. Whether or not this is the case, it is important that new and emerging reporting frameworks are closely aligned with existing global frameworks, like ISSB Standards, in order to promote consistency for companies that are subject to reporting obligations across various jurisdictions.

U.S. Agri Department Commits to Conserve Significant Forestlands

On May 13, 2024, the U.S. Department of Agriculture announced that, in partnership with 17 States, it will conserve nearly 168,000 acres of "economically and ecologically significant" forestlands. The forestlands in question support rural economies in those States, and through the Forest Legacy Program, 26 projects will work towards conserving them. The total USD154 million in funding for the projects is made up of USD84 million from the Land and Water Conservation Fund and USD70 million from the Inflation Reduction Act. This makes the it the largest climate investment in U.S. history.

The Biden Administration's Inflation Reduction Act (the Act) was passed into law in August 2022 and contains provisions for clean energy, climate mitigation and resilience, agriculture, and conservation-related investment programs, including provisions for who is eligible to apply for funding, and for which activities. Since being signed, the Act has enabled the U.S. Government to commit **USD6 billion to fund 33 projects** aimed at decarbonizing energy-intensive industries, reducing greenhouse gas emissions, supporting good-paying union jobs, revitalizing industrial communities, and strengthening the country's manufacturing competitiveness. The Biden Administration also has committed $3 billion to fund zero-emission port equipment and infrastructure, and contribute towards **climate and air quality planning at US ports**, as well as committing further funds to clean-energy manufacturing investments, and boosting the economy by creating jobs.

Conserving forestlands and preventing deforestation is an objective for authorities in a number of jurisdictions, **as we discussed in detail in our May 21 issue**.