Thomson Reuters Institute

# ESG – Navigating past the noise

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# Introduction

The past year has not been kind to companies seeking to combat climate change, increase diversity in their workforce, or bring greater rigor to the oversight of issues that fall under the environmental, social & governance (ESG) umbrella. ESG has become a polarizing, politicized term, and it has been seized upon by politicians who see such policies as a threat to the voters and companies they represent. The backlash has been most visible in the United States, where anti-woke rhetoric and policies from far-right Republican states have all but made the ESG moniker a thing of the past.

While the political rhetoric has been less heated in Europe, there has been some backsliding on the policy front. United Kingdom Prime Minister Rishi Sunak watered down many of his government's previous commitments to Net Zero in a speech in September; and his delays to energy efficiency requirements for residential properties and his failure to introduce a ban on fossil fuel vehicles echoed the populist rhetoric of some anti-woke U.S. politicians.

Separately, the European Commission (E.C.) has delayed the introduction of sector-specific reporting under its Corporate Sustainable Reporting Directive (CSRD) after its President Ursula von der Leyen said in March that she intended to slash European Union reporting requirements by 25%.

Both the U.K. and E.U. face parliamentary elections next year, but for now, the political backsliding has annoyed many in the financial sector. U.K. Finance — the trade body that represents banks and lenders — issued a statement in October that clear direction was needed from the government if the finance industry was to be challenged into Net Zero transition.

The irony of the politicization of ESG issues is that it comes against the backdrop of catastrophic weather events across the world. The first half of 2023 witnessed massive wildfires, flooding, and temperatures rising to levels never seen before across many regions. According to the Copernicus Climate Change Service, the June to August 2023 period was the planet's warmest since records began in 1940.

All of this comes ahead of COP28 in December, the annual United Nations climate change conference. Former U.S. vice president Al Gore, a leading environmentalist, warned that "the deck is stacked against a successful outcome."

Gore said the "doubling down" on fossil fuels by energy companies amounted to the sector taking off "the disguise" around its powerful, negative influence on climate action. He attacked the "buddy-buddy" relationship between political leaders and the fossil fuel industry, which he said was threatening the prospects for climate action.

## Progress continues despite politics

One could be forgiven for asking whether there is any good news. Yet, there is. When one looks beyond the inflammatory headlines and reported death of ESG, progress is being made by investors, companies, and governments.

For investors, the appetite for sustainable projects appears unabated. One of the biggest catalysts has been the U.S. Biden administration's Inflation Reduction Act (IRA), fueling billions of dollars in new clean energy and manufacturing investments.

Government regulations are also moving ahead. Financial authorities in Hong Kong and Singapore have put forward numerous new proposals, including increased carbon disclosure, green taxonomies, and transition planning, to name a few. In the European Union, despite some changes that will impact the CSRD, there is no delay to when E.U. and non-E.U. based companies must begin complying with its reporting requirements. These deadlines remain January 1, 2025, for most large E.U. corporations and January 1, 2028, for non-E.U.-based firms.

In the United States, while the Securities and Exchange Commission (SEC) drags its feet on a final climate disclosure rule for publicly traded firms, the state of California has charged ahead with its own disclosure requirements, affecting thousands of companies operating within the state.

With the need to meet growing regulatory obligations, the siloed nature of ESG functions in many companies is breaking down. There is a greater urgency to integrate climate and social reporting more closely with traditional functions such as operations, legal, and finance. This is a transformation that firms with a longer-term view see as essential — the need to embed sustainability processes across their organizations.

This report will outline the latest regulatory developments and hurdles that companies face as they seek to navigate through the noise of divisive politics. Many companies are rising to the challenge, recognizing their fiduciary duties to shareholders, employees, and other stakeholders. The term ESG may have become toxic in some quarters, but the underlying problems have not receded. Firms with a view towards long-term viability and competitiveness understand the issues at hand, whatever the label.

# U.S. Inflation Reduction Act — catalyst for investment

Institutional investors, asset managers, and big-bank sustainability officers have been unabashed in describing the numerous sustainable projects and investments in which they are involved or are spearheading. The common refrain heard across many conferences on the sidelines of this year's U.N. General Assembly was how the Biden administration's IRA, with $360 billion in climate incentives, is prompting a broad array of investment projects.

While many acknowledge that the U.N. goal of limiting the earth's temperature increase to 1.5°C was proving elusive, there was no shortage of accolades for the IRA, and how climate finance has benefited. "The IRA has outperformed most people's expectations," said Steve Howard, vice chair at Temasek, Singapore's sovereign wealth fund.

Passed in 2022, the IRA provides $369 billion in energy security and climate-change incentive programs over the next 10 years. Additional provisions for loan guarantees, as well as incentives in other legislation, bring total funding to around $950 billion. Experts said there was clear evidence that the U.S. government program was unleashing substantial private sector investment.

"The IRA has jump-started investments," said Serena McIlwain, secretary of the environment for the state of Maryland, noting that $10.3 million in funds from the IRA have resulted in $130 million in private capital investment which has been focused primarily on energy-efficient transportation in her state. "This shows how using public funds pushes private investment," she told a conference.

In the year since the IRA was signed into law, there have been more than $110 billion in new clean energy manufacturing investments, including more than $70 billion for the electric vehicle (EV) supply chain and more than $10 billion for solar manufacturing, according to the U.S. government and industry experts.

"The lesson we have learned from the IRA is that incentives work," said Karen Fang, global head of sustainable finance at Bank of America. Fang noted that IRA investment tax credits are transferrable, prompting even industry incumbents such as oil & gas companies to take notice and examine how they could use such credits to transition towards renewable energy.

In a separate study, the Rhodium Group, an independent researcher, estimated there was $213 billion in new investment in the manufacturing and deployment of clean energy, clean vehicles, building electrification, and carbon management technology in the United States over the past year, a 37% annual increase. "We estimate that $37 billion of the $137 billion in announced manufacturing investment over the past two years has already occurred," the Rhodium report stated. "On a quarterly basis, actual clean manufacturing investment reached $13.6 billion in Q2-2023, five times more than the quarterly average two years ago."

The numbers seen so far represent a floor on top of which much greater investment is expected, said Trevor Houser, a partner at Rhodium Group in Oakland, California.

Indeed, some investors also see a series of complementary trends emerging, which could help drive down the costs for newer, greener forms of technology. "The incentives in the law could drive a virtuous cycle across newer technologies and markets," said Pieter Houllebergs, managing director at Decarbonization Partners, a BlackRock & Temasek joint venture. "It will encourage more adoption, which drives down costs, which drives up adoption, which then further drives down costs — which is what we as investors look for."

"The multiplier effect of the incentives in the bill means that the market for attractive green investments effectively just got bigger."

## Sustainable investment continues to grow, outperform

If one puts aside the stimulative effects of the IRA, sustainable investments have continued to grow, and returns have outperformed traditional funds.

In the first half of 2023, for example, sustainable funds saw a median return of 6.9%, beating traditional funds' 3.8% and reversing their underperformance in 2022, according to a new Sustainable Reality report from the Morgan Stanley Institute for Sustainable Investing. Investor demand also remained strong as sustainable funds' assets under management (AUM) reached record levels.

"Our mid-year update shows the resilience of ESG funds with a return to outperformance after a challenging 2022," said Jessica Alsford, chief sustainability officer at Morgan Stanley.

Other surveys point to similar, upbeat performance for sustainable investment given the challenging macro-environment and when compared to other funds. "The global universe of sustainable funds attracted close to $18 billion of net new money in the second quarter of 2023.

This inflow was lower than the revised $31 billion in the first quarter," noted Morningstar in a report for the first half of 2023. "Yet, this is still better than the overall global fund universe, which returned to outflows of over $37 billion in the second quarter amid continued challenging macro conditions, including sticky high inflation, higher interest rates, and a looming recession."

And in a sign that Wall Street firms see continued value in sustainable investing, Goldman Sachs Asset Management announced in October that it has raised $4 billion for a new fund to invest in infrastructure assets, including energy transition, transport, and logistics. The fund, called West Street Infrastructure Partners IV, was backed by institutional investors, wealthy clients, and bank employees.

"The infrastructure asset class is positioned to benefit from some of the most exciting secular tailwinds associated with decarbonization, digitization, de-globalization, and demographics," said Scott Lebovitz, co-head of Infrastructure at Goldman Sachs Asset Management.

# ESG regulations gather pace — E.U., Asia and California out front

Political rhetoric may have turned against ESG policies in some countries, but financial regulators have continued to advance regulations that hold companies accountable for their sustainability claims, request increased climate disclosure, as well as assist firms with their transition plans towards more sustainable economies. The following is a summary of regulatory developments in the E.U., the U.K., the U.S., Singapore, and Hong Kong.

## E.U.'s CSRD on schedule

In October, the E.C. made some changes that will affect the CSRD, but there is no delay to when E.U. and non-E.U. based companies must begin complying with its reporting requirements. These deadlines remain January 1, 2025, for most large E.U. corporations and January 1, 2028, for non-E.U. based firms.

A tweak to thresholds in the E.U. Accounting Directive has introduced an anomaly in the definition of E.U. and non-E.U.-based corporations subject to CSRD. For instance, E.U.-based corporations will now only be considered large if they have a balance sheet exceeding €25 million and a net turnover exceeding €50 million. The net turnover threshold for non-E.U.-based corporations with a branch or subsidiary in the region remains unchanged at €40 million.

The E.C. has also pushed back the timeline for the next wave of European Sustainability Reporting Standards (ESRS), which is what corporations will use to meet their reporting requirements under CSRD. Sector-specific ESRS was originally scheduled to be adopted in June 2024, but the Commission's 2024 work plan, published in October, said there would be a two-year delay to adoption.

Corporations will still be expected to report in line with the first set of common ESRS, which was adopted in July. There are nine in total, spanning all three ESG categories.

### Regulatory reporting

The E.U. is working with the International Sustainability Standards Board (ISSB) to ensure their member countries' ESG standards are compatible and interoperable.

Emmanuel Faber, chair of ISSB, told E.U. lawmakers in September that while ISSB's standards differ from the ESRS in that the ISSB rules required banks to report their financed emissions while the ESRS require investors to consider materiality, there was plenty of commonality.

The endorsement of ISSB standards by the International Organization of Securities Commissions (IOSCO) will also help ensure the interoperability of the two sets of standards. And eXtensible Business Reporting Language (XBRL) — a freely available and global framework for exchanging business information — is viewed as an important enabler for interoperability that can reduce the reporting burden for firms reporting in both the E.U. and internationally.

Private sector interoperability initiatives are also underway. The Carbon Disclosure Project (CDP), which has operated a voluntary environmental disclosure program for 20 years, said it will align its disclosure request to ISSB. CDP will collect data from 20,000 corporations in 2023 and will invite the corporations to take part in the data collection by 740 financial institutions.

In September, CDP announced it was partnering with XBRL International, the body that oversees the digital reporting language, to integrate ISSB's sustainable standards into its 2024 survey.

## U.K. authorities increase focus on sustainability-linked bonds

The U.K.'s Financial Conduct Authority (FCA) is investigating sustainability-linked bonds. In June, Sacha Sadan, the group's director of ESG, wrote to market participants to highlight the regulator's concerns. They were twofold: first, that such bonds often were not tied to issuers' transition plan key performance indicators; and second, that the incentives for banks to promote sustainability-linked bonds often lacked transparency.

Since then, the International Capital Market Association (ICMA) has said regulators should unpack the problem into actionable concerns if they want to tackle so-called greenwashing, in which issues make false or exaggerated claims about the environmentally friendly or sustainable nature of their products. "For sustainable bonds, these areas of concern are: i) lack of ambition; ii) strategic inconsistency; iii) mismanagement of wider sustainability risks; and iv) actual deception," the ICMA stated in an October paper.

The takeaway for issuers and sponsoring banks should be to follow global and national best practices and to ensure that any sustainability-linked bond is firmly tied back to the issuer's transition plan. (As further guidance, the U.K. government's Transition Plan Taskforce published its disclosure framework in October.)

Another focus for regulators is the so-called green bond labels. Any firm wishing to market a bond under the E.U.'s green bond label will have to ensure that it is linked to a transition plan, after a political agreement was reached in October. Specifically, to qualify to use the E.U. green bond label, issuers will have to show how the proceeds of the bond link into its transition plan.

The FCA is expected to publish its final rules for the use of green labels for retail investment funds before the end of the year. The regulator pushed out its original timeline after the fund sector said the proposal would see 70% of funds marketed as sustainable lose the label.

## ESG ratings regulation

In September, the European Commission published its proposal for regulating ESG ratings, which does not seek to harmonize the methodologies underlying ESG ratings, only to increase underlying transparency. ESG rating providers will remain in control of their methodologies and continue to be independent in their choice to ensure a variety of approaches are available in the market, the E.C. stated.

The U.K. government is also considering the responses in its consultation on regulating ESG providers. In the meantime, the FCA has welcomed a voluntary code of conduct for ESG ratings providers, which should be in place by the end of 2023. The code was an important step in increasing transparency and trust in the growing market for ESG data and ratings products, Sadan said.

# California charges ahead on climate disclosure rules as companies await SEC regulation

Meanwhile, the Climate Corporate Data Accountability Act (SB 253), signed into law by California Governor Gavin Newsom, is the first-of-its-kind mandatory climate emissions disclosure rule in the United States. A second bill, SB 261, requires disclosure of climate-related financial risks, in accordance with recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD).

U.S. companies operating in California with more than $1 billion in annual revenue will likely have to report on their own climate emissions, as well as those of their suppliers, beginning in 2026. The new climate disclosure rules come as the SEC is still preparing the final version of its own climate disclosure rule. While there are certain similarities between the SEC proposal and California's laws, there are also important differences.

## California disclosure rules are closer to E.U. regulations

For example, the California regulations go further than the SEC's proposed climate rule, whereby the state's rules apply to both public and private companies that do business in the state and meet certain annual revenue thresholds. The SEC's proposed climate rule targets only public companies reporting to the SEC, including U.S. public companies and foreign private issuers.

"In this respect, the California rules more closely approximate the European Union's CSRD, which applies to non-E.U. entities that meet certain presence and size thresholds," the law firm Cooley stated in a note to clients.

## Scope 3 emissions seen as major challenge

California's disclosure regulations and CSRD both require companies to report on their Scope 3 emissions, which encompasses those of parties along the company's supply chains. While the SEC included Scope 3 in its initial proposal, it is unclear whether the final rule will include such emissions, which have become highly politicized in the U.S. Congress and among industry groups.

In California, while large companies such as Google and Apple are well-advanced in identifying Scope 3 emissions, smaller companies are likely to struggle, experts said. "For better or worse, it's a regulatory burden for a lot of companies," said Bill Tarantino, a partner at Morrison Foerster in San Francisco.

To comply with California's new laws, experts said companies that fall within the $1 billion annual revenue threshold should be actively establishing cross-functional teams to manage the climate reporting process.

"Companies should start by assigning internal responsibility for climate reporting, which often includes setting up a cross-functional committee of management team members from operations, legal, and finance," Cooley relayed to its clients. "Companies also should begin building an internal system for climate reporting and related data governance and disclosure controls."

## Singapore drives global transition to Net Zero with launch of "transition planning guidelines

The Monetary Authority of Singapore (MAS) has issued a set of consultation papers proposing guidelines on transition planning for banks, insurers, and asset managers, with the aim of enabling the transition to a Net Zero economy.

The Guidelines on Transition Planning have set out MAS's supervisory expectations for financial institutions to have a sound transition planning process. This will enable effective climate change mitigation and adaptation measures by their customers and investee companies, MAS said. "Indiscriminate divestment from carbon-intensive activities will not get us to a Net Zero world," said Ravi Menon, managing director at MAS. Instead, financial institutions must actively support their borrowers, insured parties, and investee companies to progressively decarbonize their activities through credible transition plans.

"We may have to accept [that] short-term increases in financed, facilitated, or insurance-associated emissions arising from these plans, provided these plans support climate-positive outcomes consistent with a Net-Zero pathway," Menon said. "Regulators must support financial institutions in such efforts, and this is why MAS is taking the lead in setting clear supervisory expectations on transition planning for our financial institutions."

### Focus on physical and transition risks

Engagement should be the major lever for financial institutions to steward their customers and investee companies to transition in an orderly manner, according to MAS. Financial institutions should engage their customers and investee companies on the physical and transition risks they face and work closely with them to implement effective measures to reduce their carbon footprint and build resilience to climate change.

Also, financial institutions should take a multi-year approach, beyond the typical financing or investment time horizons, to facilitate a more comprehensive assessment of climate-related risks, MAS stated, noting a holistic treatment of risk enables better risk discovery. "As financial institutions are exposed to climate-related risks through the effects of both transition and physical risks to their portfolios, they should take an integrated approach to climate mitigation and adaptation measures by working closely with their customers and investee companies." MAS stated.

Financial institutions should also consider environmental risks beyond climate-related risks in their transition planning. The loss of nature capital and biodiversity must be recognized and addressed as related but distinct environmental risks to be managed.

Further, transparency supports accountability and promotes credibility. Financial institutions are expected to disclose meaningful and relevant information to help stakeholders understand how they are responding in the short-, medium-, and long-term to material climate-related risks, and the governance and processes for addressing such risks.

## Using science-based sectoral pathways

Menon said MAS has also communicated to financial institutions the importance of referencing appropriate science-based sectoral pathways with meaningful intermediate targets for decarbonization. Indeed, financial institutions have been urged to take a closer look at their investment exposures in various sectors. For instance, if a financial institution is financing the energy sector, the institution is encouraged to examine "the international energy pathway to Net Zero," which requires a substantial reduction in fossil fuel-generated power by 2030 and the elimination of all unlimited coal power by 2040.

"So, in my transition plan, I can continue to finance fossil fuels, as long as there is a credible pathway to decommission or cease that financing over a period of time," Menon told a conference in September. "You've got to repeat this in cement, in aluminum, mining, utilities, building, aviation, maritime, [as] not all the sectors have Net Zero transition pathways."

It is crucial for a financial institution to understand the availability of decarbonization pathways when they are working with a steel plant, for example. "Are you achieving reductions in emissions through use of better technology, better processes, and so on?" Menon asked. "Bringing closure of emissions is a credible transition plan — yet, if there is no reduction in emissions, then it doesn't count as one."

## Finding synergy in public-private funding

A better synergy between public-private funding for financing infrastructure projects that are marginally bankable is expected to be one of the major breakthroughs for the Singaporean central bank's push for the Net Zero transition over the next couple of years. "The time is running out. We need to get this done," said Menon, adding that MAS has stepped up to complement efforts to promote transition and blended finance. "We need to reduce the risks in marginally bankable transition projects to attract private capital," Menon explained.

## Focusing on blended finance

Blended finance synergizes public and private capital to mobilize financing for marginally bankable projects. "To reduce overall risk and improve bankability, we need more catalytic and concessional funding from the public sector, multilateral development banks, and philanthropic sources," he said.

Menon also highlighted the importance of better use of public money to attract private capital, urging the public capital market to take on a bigger role, such as conducting more risk mitigation.

The Network for Greening the Financial System (NGFS), chaired by Menon, aims to launch a handbook on blended finance at the COP28 summit in December. "We will release a conceptual note next month on the handbook, which will serve as a preamble," said Menon during the Green Swan Conference 2023.

The handbook will be organized according to three key themes: i) it will identify key elements needed to build a blended climate finance ecosystem; ii) it will highlight best practices and principles to scale up blended finance for climate adaptation and mitigation; and iii) it will identify demonstrative projects that highlight good mechanisms for scaling blended finance.

## Consultation on ESG ratings

On a different subject, MAS closed a public consultation in August on an industry code of conduct for providers of ESG ratings and data products. The move is part of an innovative approach to improve ESG compliance, which is centered on an industry code of conduct that was co-created by MAS and industry participants. The industry code of conduct will be the first step in establishing standards for the quality, reliability, and transparency of ESG ratings and data products in Singapore.

MAS reported the industry code was in line with its "phased" regulatory approach and establishes minimum industry standards of transparency in methodologies and data sources, governance, and management of conflicts of interest. MAS also will monitor the implementation of the industry code, and take into consideration international developments, before taking further steps to formalize a regulatory framework for ESG rating providers.

As the integration of sustainability-related risks and opportunities into capital allocation decisions becomes increasingly mainstream, the use of ESG ratings and data products for investing and capital allocation has grown.

While the sector is nascent and rapidly changing, regulators are at various stages of developing regulatory approaches for these providers. IOSCO's final report on ESG Ratings and Data Products Providers highlighted numerous concerns, including the lack of transparency in the methodologies and data sources, governance and controls, as well as management of conflicts of interest.

## MAS's Project Savannah

Finally, MAS is developing a digital reporting framework for data on ESG credentials to help businesses gain access to financing and supply chain opportunities. The ESG reporting initiative will be pitched to small- and midsize enterprises internationally.

MAS reported that the initiative would establish a common framework of ESG metrics for micro-, small- and midsize enterprises, giving them the capability to generate basic sustainability credentials and begin their journey towards meeting the U.N.'s Sustainable Development Goals.

The project will be developed alongside the United Nations Development Program and the Global Legal Entity Identifier Foundation, and the parties have signed an agreement to begin the collaborative initiative to ensure that small- and midsize enterprises can continue to access capital markets by establishing their ESG credentials.

The initiative, dubbed Project Savannah, aims to build upon existing digital regulatory initiatives and will enable businesses to generate ESG data credentials that can be housed in smaller enterprises' legal entity identifier records. Project Savannah will focus on capacity-building, simplified reporting, and accessible data.

Micro-, small- and midsize enterprises "will thus be able to transmit verified entity information and key ESG data to their business partners, strengthening their ability to gain access to global financing and supply chain opportunities," MAS stated.

## Green taxonomies in Hong Kong

The Hong Kong Monetary Authority (HKMA) released the city's first green taxonomy consultation paper on May 30, concerning prototypes, benefits, sectors, and criteria. It aims to offer a standardized framework for classifying financial products based on environmental sustainability.

The consultation brings Hong Kong one step closer to reaching its sustainability goals in achieving carbon neutrality before 2050, in line with the government's strategy, as set out in Hong Kong's Climate Action Plan 2050.

This classification system allows investors to identify and invest in activities that are making a positive impact on the environment, while avoiding those that have a negative impact. "It helps to align investment decisions with climate goals and reduce the risk of investing in assets that are not aligned with a low-carbon future," the consultation paper stated.

The taxonomy can also help unlock new investment opportunities for green technology and sustainable projects and increase transparency and accountability in the financial sector.

## ESG reporting requirements consultation

Also in the city, the Stock Exchange of Hong Kong (SEHK) has published a consultation proposing climate-related reporting requirements for listed companies. The proposal is a major step towards aligning Hong Kong with the baseline for climate-related reporting standards being developed by the ISSB.

"The most significant developments of the proposed ESG reporting framework are the alignment with international standards, the requirement for more specific and quantitative disclosures, and mandating listed issuers to disclose climate-related information within their ESG reports," said Stephen Chan, a partner at Dechert in Hong Kong.

The proposed framework would be aligned with international standards, including those developed by the TCFD, the ISSB, and the Global Reporting Initiative. "This would ensure that Hong Kong's framework is consistent with global best practices and facilitates international comparability," Chan said.

The proposed framework would also require more specific and quantitative disclosures, such as emissions data, climate-related scenario analysis, and internal carbon pricing. "This would provide investors and stakeholders with more detailed and meaningful information on a company's ESG performance and risks," Chan added.

The SEHK expects market feedback by July 14, 2024.

# Greenwashing, litigation risks grow for firms

Regulators and law enforcement have increased their focus on greenwashing by companies, with the U.S. SEC penalizing firms as well as introducing new rules to combat the growing problem. Other regulators in Europe, the United Kingdom, and Asia are also stepping up their activities.

## U.S. SEC enforcement actions and new rules

In September, the SEC fined DWS Investment Management Americas Inc., a subsidiary of Deutsche Bank, $19 million over ESG violations. In its greenwashing action, the SEC found that DWS made materially misleading statements about its controls for incorporating ESG factors into research and investment recommendations for ESG-related products, including certain actively managed mutual funds and separately managed accounts. The agency said that DWS "marketed itself as a leader in ESG that adhered to specific policies for integrating ESG considerations into its investments."

The action underscored the seriousness with which the SEC is taking misleading claims over ESG investments, experts said. "I think [the action] says that the SEC is serious about what comments you make, and if you are making claims about the environment you have to be able to back it up," said Steven Rothstein, managing director at Ceres, a nonprofit focused on sustainability issues.

While the SEC's $19 million penalty against DWS is the highest so far for a greenwashing case, it is far from the first. Last year the SEC hit Goldman Sachs and BNY Mellon with $4 million and $1.5 million fines, respectively, for similar failures.

## SEC action on "Names Rule"

In a further sign of the SEC's effort to crack down on greenwashing, the agency amended an existing rule focused on deceptive or misleading marketing practices by U.S. investment funds. The changes to the two-decades-old SEC Names Rule now require that 80% of a fund's portfolio matches the asset advertised by its name. It takes aim at a boom in funds that have tried to exploit investor interest in ESG issues and investing by choosing fund names that inaccurately reflect their investments or strategies.

"The SEC's recently adopted enhancements to the Names Rule, which requires honesty in the use of mutual fund labels, was another step the SEC has taken to protect investors and ensure the integrity of the ESG marketplace," said Stephen Hall, legal director and securities specialist at Better Markets, a nonprofit focused on financial reform. "But unless rigorously enforced, the laws and rules on the books can do little good."

## Europe steps up enforcement of false sustainability claims

In a similar move in September, the European supervisory authorities (ESAs) issued a second annual joint report on financial firms, noting an overall improvement in adherence to the reporting requirements outlined in the Sustainable Finance Disclosure Regulation (SFDR).

The SFDR aims to improve transparency in the market for sustainable investment products, prevent greenwashing, and increase transparency with regards to sustainability claims made by financial market participants. The ESAs, however, instructed national regulators to consider taking enforcement action against financial firms that lagged their peers in SFDR compliance.

The European Securities and Markets Authority (ESMA) also urged national regulators to get tough with companies making unsubstantiated claims in listing documents and annual reports. In its annual review of such documentation, ESMA noted the enforcement and remedial actions taken against issuers for failure to properly represent their climate-related exposures or actions.

To date, there have yet to be any fines issued against firms for greenwashing in the E.U., in contrast to several penalties issued by the U.S. SEC. However, the cost of having to restate financial statements, as well as the reputational damage that implies, is something executives and boards should consider.

In July, the ESAs published their common understanding of greenwashing, and ESMA is considering restrictions on the use of green and sustainability wording in fund names after analysis showed that investors preferred funds with such titles.

In October, ESMA said the share of E.U. investment funds under its regulatory framework for managing and selling mutual funds with ESG words in their name has increased to 14% in 2023, compared to less than 3% a decade earlier. Separately, it identified a greenium (a pricing benefit based on the logic that investors are willing to pay extra or accept lower yields in exchange for a positive sustainable impact) in debt markets. ESMA reviewed 8,696 bonds from issuers domiciled in the European Economic Area, with a combined outstanding face value of €3.7 trillion. "Issuers of ESG bonds did benefit from statistically significant pricing in the past driven by their issuer-level ESG credentials," ESMA stated.

## Litigation risk crystallizes

On another front, there is growing evidence that climate risk is leading to increased litigation against companies. Indeed, it has been eight years since Mark Carney, then-Governor of the Bank of England, first warned that one of the main ways in which climate risk would crystallize for financial firms would be through litigation. Now, his prediction may be coming to pass.

Not only is France's BNP bank being sued in two separate climate- and nature-related cases, but the U.K.'s FCA is itself facing litigation over its approval of a prospectus for oil group Ithaca Energy.

In September, Frank Elderson, member of the Executive Board of the European Central Bank (ECB) and vice-chair of its supervisory board, said some 560 climate-litigation cases had been filed internationally since 2021. Elderson said the risks from litigation for banks were two-fold: i) direct litigation targeting their lending practices; and ii) indirect litigation targeting their customers. Companies are not just being targeted for what they are doing but also for what they are not doing.

For example, oil giant Shell was successfully sued by Client Earth, a non-governmental organization (NGO) for a lack of ambition in its Net Zero transition plan. Shell is appealing the decision, but the case should still be essential reading for corporate boards as an example of the risks that need to be considered.

"Has the Shell case been analyzed in-depth and have the possible repercussions for the bank been discussed in detail in board meetings?" Elderson said.

The types of cases being pursued against financial firms can be categorized under three broad headings, according to the NGFS: greenwashing, breach of corporate due diligence, and breach of directors' obligations. Further, financial regulators have published several guides to assist financial firms with tackling climate-related litigation risk. In 2020, the ECB set out how banks should go about mitigating green litigation risks, and more recently the NGFS published a guide for supervisors on identifying climate-related litigation risks at financial firms.

## Regulators tool-up for greenwashing challenge

Regulators are increasingly turning to technology to help them spot and stamp out greenwashing. The Global Financial Innovation Network, for example, recently hosted a showcase of technology firms that had designed tools that could be deployed by regulators to detect greenwashing.

Many of the solutions highlighted used large language models and artificial intelligence to search for anomalies in firms' ESG statements and product disclosure documents. Some used open-source data to check that the various claims by firms on environmental and human rights issues could be substantiated — essentially fact-checking them against local social media posts and news articles — and flagging inconsistencies for regulatory follow-up.

International regulators have also been experimenting with technological solutions to ensure greater integrity in green bonds and carbon credits. The Bank for International Settlements' innovation hub and the Hong Kong Monetary Authority's Genisis 2.0 have project-tested two prototypes that use blockchain or smart contracts. Both showed that the technology could be leveraged to increase integrity and reduce greenwashing.

In September, Rodrigo Buenaventura, chair of Spain's market regulator, the Comisión Nacional del Mercado de Valores, and IOSCO's Sustainable Finance Taskforce, said that digitalization and the use of blockchain technology could improve the integrity of carbon credits. "The data available on climate mitigation projects that underpin issuance of carbon credits is currently not easily comparable on a regional and global basis. This could mean issues like double counting the same projects, which harms the integrity of credits in issuance," explained Buenaventura. "Distributed ledger technology is being explored for use in voluntary carbon markets, either for tokenization of carbon credits or the simplification of monitoring or certification processes."

In Asia, central bankers argue that well-defined green taxonomies and enhanced environmental disclosure requirements will help discourage greenwashing in corporate bond markets. Such measures will help offset greenwashing risks and behavior, boost investor confidence, and stabilize the financial markets, according to the HKMA.

"These would be important policy implications for policymakers to consider when designing relevant regulations to curb this unscrupulous behavior and foster a healthier development of green bond markets," the HKMA stated, adding that greenwashing is common in bond markets, and around one-third of corporate issuers were found to have poorer environmental performance after their initial green bond issuance.

The financial ecosystem has, to an extent, penalized such behavior. Firms found to have used greenwashing to sell financial products were found to be less likely to issue green bonds again and to have to pay higher issuance costs even if they were subsequently able to re-issue green bonds, suggesting that investors were then less willing to invest in their bonds.

Financial authorities in both Hong Kong and Singapore have issued guidance to help define which funds can be marketed as ESG funds within their jurisdictions, including naming and disclosure requirements. Their guidance is intended to help offset the risk of greenwashing and promote financial stability, as well as help investors avoid becoming trapped in investments which amount to greenwashing. In Hong Kong and Taiwan, regulators provide an online listing of ESG funds so that investors can easily identify those classified as ESG in the jurisdiction.

MAS will require ESG-labelled funds to make disclosures on a continuous basis. Investors will receive annual updates on the extent to which the fund has achieved its ESG focus. The required information will include details about the ESG fund's investment strategy, the criteria and metrics used to select investments, and details of any risks and limitations associated with the fund's strategy.

# Voluntary carbon markets come under greater scrutiny

It is two years since the Conference of the Parties to the United Nations Framework Convention on Climate Change (COP26) supposedly cleared the way for the ramping up of voluntary carbon markets (VCMs). To date, however, progress has been slow, and scandal continues to plague the VCMs.

Behind the scenes, however, work to introduce integrity into the market has continued. In July, the Integrity Council for Voluntary Carbon Credits (ICVCM) launched its benchmark for assessing VCMs. The intention is that issuers of VCMs have their methodologies accessed by ICVCM and that all existing credits can be reassessed as compatible with its core carbon principles.

IOSCO also has stepped in to consider if its members can help bring credibility to carbon markets. In the last year, it has carried out two consultations into carbon markets, issuing recommendations for its members in July as to how they can support or help establish well-functioning compliance carbon markets, such as the European Emissions Trading System and California's Cap-and-Trade program.

A second IOSCO report, this time on what its members might do to improve VCMs is due to be released for COP28 in December. Most respondents to the consultation see a role for IOSCO similar to the one it has taken with climate data standards. In July, it endorsed the ISSB's first two standards.

Some respondents also called for IOSCO to endorse a single central registry of carbon credits to ensure there is no double-counting and that credits stay retired. Singapore-based Climate Warehouse, an initiative borne out of the World Bank's meta-registry, was highlighted as a possible central registry contender in several responses. The government of the United Arab Emirates (UAE), which will host COP28 in December, has said a key focus for the event will be "addressing serious concerns around quality and accountability" so that the potential of VCMs can be realized.

"The COP28 Presidency will bring together heads of states, ministers of finance and environment, local communities, and companies to unite and improve standard-setting frameworks to underpin high integrity transactions," the UAE government stated.

## California's carbon market disclosure law poses immediate compliance challenge for companies

Together with landmark regulations on carbon emissions disclosure, the state of California has approved a carbon market disclosure rule that will affect many companies as early as next year. The Voluntary Carbon Market Disclosures Act (AB 1305) was signed into law in October by Gov. Newsom along with two other major pieces of legislation — the Climate Corporate Data Accountability Act and the Climate-Related Financial Risk Bill. While the latter two have received the most attention, the carbon market rule may in the short run be more consequential for companies operating in the state.

"The Voluntary Carbon Market Disclosures Act, in particular, requires immediate attention, since it takes effect at the beginning of 2024," wrote Michael Littenberg, a partner at the law firm Ropes & Gray in New York, in a note to clients. "That Act has broad applicability. It has no turnover threshold or de minimis exceptions. It also is not limited to U.S.-organized entities. It therefore will apply to many companies that do not have to make California GHG emissions and climate risk disclosures."

The legislation focuses on the marketing and sale of voluntary carbon credits and is intended to combat greenwashing in connection with the purchase, sale, or marketing of carbon credits. The scope of the California law extends to numerous activities related to carbon markets.

The law captures plenty of activity, said Morrison Foerster's Tarantino. "It does require some detailed disclosures pretty quickly and it is a challenge because there are a lot of companies trying to re-evaluate their carbon strategies."

There has been much press attention and class action lawsuits over whether voluntary carbon credits support the representations for which companies are using them. Yet, penalties for violating the law can be significant. Disclosure violations are subject to a per-violation civil penalty of up to $2,500 per day if the information is unavailable or is inaccurate on the company's website. The maximum penalty is capped at $500,000 per violation.

## What should companies do to prepare?

Legal experts outlined several steps they say were needed for companies to comply with the new rule. The first would be to create an inventory of existing climate-related public claims.

"Businesses can create an inventory of their existing climate-related claims that includes details of documents/information substantiating those claims, any KPIs (key performance indicators) and targets associated with those claims, and any third-party verification of the claims," noted law firm Kirkland & Ellis.

Based on the inventory, businesses can consider whether any of their existing disclosures lack adequate substantiation or could potentially be misleading. They can then put in place a plan to address the identified deficiencies. "Businesses may wish to work with counsel to manage any legal or reputational risks involved in modifying or adding to existing disclosures and to ensure all disclosures comply with applicable regulatory requirements across jurisdictions," Kirkland & Ellis continued.

Companies might then consider third-party verification for their claims and develop disclosure controls and procedures for future climate-related claims.

In Asia, meanwhile, there are governmental efforts to introduce carbon tax credits to offset polluting activities, such as coal-fired power plants. For instance, Singapore has encouraged the use of high-integrity carbon credits as a complementary financing instrument to accelerate the early retirement of coal-fired power plants. To that end, MAS has teamed up with McKinsey & Co. to publish a working paper that explores the use of high-integrity carbon credits to reduce the economic gap for early retirement of coal power plants. Such high-integrity carbon credits would be generated when a coal-fired power plant is retired early and replaced with cleaner energy, therefore reducing carbon emissions. MAS referred to the credits as transition credits.

Accelerating the retirement of such coal-fired power plants is a critical priority for limiting the global average temperature increase to 1.5°C, a limit set by signatories of the 2015 Paris Agreement.

Coal power-generation remains the single largest source of carbon emissions. "If left to operate without active intervention, coal-fired power plants will exhaust two-thirds of the carbon budget that we have remaining to keep the rise in global temperature to within 1.5°C," according to the working paper. "The call for indiscriminate cessation of coal-fired power plants is not a practical solution."

The paper rolled out four major elements of this transition-credits-led decarbonization approach, which include quantifying the economic gap, leveraging transition credits, and mitigating major transaction risks.

# Insurers under pressure as weather events pose new risks

A series of catastrophic weather events, worsening climate prediction models, and mounting claims have made U.S. insurers extremely cautious about the regions in which they choose to operate and further restrictive in their underwriting. Their investment portfolio, however, is yet to become climate resilient.

In their role as institutional investors, insurers continue to possess large holdings in traditional sources of energy in their portfolios. State regulators, the primary authority over insurers in the United States, largely agree about the insurance industry's need to be cognizant of climate risk and maintain healthy levels of solvency to pay out large and unexpected claims.

However, regulators remain sharply divided on insurers' continued ability to invest in or hold assets related to traditional sources of energy that are expected to diminish in value over time. The California Department of Insurance's 2016 demand that insurers publicly disclose their assets in fossil fuels and voluntarily divest from them, was met with legal action from states with economies that thrive on traditional sources of energy. No other state regulation has mandated divestment since.

Insurers' primary strategy to deal with climate risk is the purchase of reinsurance, an analysis of data from sustainability nonprofit Ceres showed. Much opacity shrouds insurers' investments, but the last available data from 2019 analyzed by Ceres and other climate-focused consultancies — ERM and Persefoni — showed the top 16 U.S. insurers held approximately 50% of the more than $500 billion in fossil fuel-related assets owned by the sector.

The National Association of Insurance Commissioners (NAIC), a group of state regulators, adopted the TCFD standards for insurers to aid transparency and provide a supervisory tool for regulators to assess the impact of climate-related risks on the insurance sector. Regulators in only a few states — such as Connecticut, California, Washington, and New York — have reportedly engaged in private discussions with companies on their transition plans based on data disclosed in the TCFD form.

A June report from the Federal Insurance Office called the actions by states and regulators "commendable" but said it was fragmented and "limited in several critical ways." U.S. Treasury Secretary Janet Yellen encouraged more state insurance regulators and NAIC to deepen and broaden their efforts to fully integrate climate risk into their oversight.

About half of chief compliance officers in a KPMG survey of insurers said they were in the process of implementing sustainability or ESG compliance programs, although nearly as many said they are still in the planning and development stages. Key areas of focus for the companies included monitoring and testing, regulatory scanning, and policy management, the KPMG survey noted.

## More supervision ahead

U.S. insurers have so far been spared broader scrutiny on the impact of climate risk on their business but that could soon change as states and federal regulators look at climate risk from a broader financial perspective.

For example, the White House Council of Economic Advisors has said regulators need to develop stress tests for insurers, akin to the response to the 2008 financial crisis, and policymakers need new ways to assess the systemic risk of climate change for the macroeconomy.

Meanwhile, economists and industry experts have also amplified their warnings about climate risk posing a severe threat to insurers on the frontlines of successive disasters. Skyrocketing claims could result in a crisis that threatens to spill into the mortgage, housing, and broader financial market, they have warned. Indeed, actual insured losses from natural catastrophes have increased to an average of $100 billion annually over the past five years, compared to an average of less than $70 billion over the previous five-year period, a report from risk analysis firm Verisk said.

Experts fear insurers will retreat from more markets as losses deepen, exacerbating a crisis in uninsured and under-insured communities that may cascade into mortgage defaults, a decrease in the values of personal and commercial properties in disaster-prone areas, and potentially even a housing and banking crisis, if left unsupervised.

The Federal Insurance Office has recognized this risk and called for more work by state and federal regulators and policymakers to better understand climate-related risks, their implications for the industry and for the stability of the financial system, including housing markets and the banking sector.

"On the physical risk side, insurance companies may face unexpected claim payouts exceeding projections due to the increasing frequency and intensity of natural disasters," stated a new paper from the Federal Reserve Bank of New York. "Moreover, insurers' asset side can also be affected as physical climate events could cause losses to the value of financial assets. For example, sea level rise or hurricanes can cause damage to coastal properties, thereby decreasing the value of mortgage bonds," the paper continued. "The [2008] global financial crisis has demonstrated the negative externalities that arise from undercapitalized financial institutions, including insurance companies, emphasizing the importance of addressing potential climate change risks."

Despite its significance, however, policymakers' current understanding of climate change risk in the insurance sector, including both physical and transition risks, remains limited. The omission of the insurance sector in many regulatory climate stress tests is a notable concern, the paper noted.

### Europe turns to "catastrophe bonds"

The need to encourage the uptake of catastrophe bonds will be discussed at two conferences organized by the European Insurance and Occupational Pensions Authority (EIOPA) later this year.

Last April, EIOPA and the ECB said that only one-quarter of climate-related catastrophe losses is insured in the E.U. The supervisors said that such a gap posed a risk to economic and financial stability. "Insurance plays a major role in protecting businesses and people against climate-related catastrophe losses by swiftly providing the necessary funds for reconstruction," said Petra Hielkema, chair of EIOPA. "To efficiently protect our society, we need to address the concern of the increasing insurance protection gap by proposing and finding appropriate solutions."

In some E.U. member states, catastrophe insurance is as low as 5%, even as Europe suffered disastrous forest fires and flooding in 2023. The European Environment Agency said that the economic damage resulting from weather and climate-related events had cost a collective €111 billion between 2021 and 2022.

The ECB and EIOPA advocate that insurers build features into their catastrophe products to reward those businesses that took action to mitigate their exposure to climate-related events.

## Climate and social issues — fiduciary duty for boards and management

Volumes have been written about the purpose of the corporation. Traditionalists argue that maximizing shareholder returns should remain the sole focus, and companies should avoid getting into the business of politics or broader societal concerns, which is the role of government. The more recent, dare one say, progressive view, is that companies have an obligation to many stakeholders, not just shareowners.

The question is whether the two can be reconciled. It appears that recent events in the environmental and social realm may be prompting a reckoning; a need for companies to consider whether forces outside the walls of the boardroom — climate change being the most pressing — are material to the continuing financial health and longevity of their organizations.

ESG critics have argued that a focus on such non-material risks distracts from the business at hand — making money. But what if such non-material risks become material? What if they already are?

What if delivering increasing revenue and profits in the future requires one to pay attention to opportunities unleashed by the changing environment and social norms?

As a recent report from the Aspen Institute argues: "The board's fiduciary duty includes clearly understanding current and future material risks, vulnerabilities, and dependencies. In a noisy environment, fiduciary duty can refocus boardroom discussions on what matters most."

**Some of the questions that boards might want to consider include:**

- Do directors understand how social norms, environmental trends, regulations, and public expectations are changing in key markets? Are there opportunities in board meetings to discuss these trends? Do directors understand how these changes could impact business results now and in the future?
- Does the board's understanding of materiality help reveal where the firm needs to focus its energy and commitments regarding employees, sustainability, and the supply chain?
- What is the board's role in monitoring progress against these long-term commitments? How frequently does the board need to assess progress against goals? How are gaps between execution and intentions addressed?
- Are executive incentive plans structured to hold leaders accountable for managing these risks and meeting commitments that extend into the future?
- Are board incentives aligned with long-term value creation?

## Where to focus limited resources and bandwidth going forward

In the ever-evolving landscape of business and sustainability, companies are faced with a myriad of challenges and opportunities. To thrive in this complex environment, it's essential to distill the multitude of actions into five key strategies that can serve as a compass for success.

**Strategic integration and transparency:** At the heart of any successful ESG strategy lies the integration of ESG considerations into the core of a company's operations. This is more than a compliance exercise; it's about redefining business strategy to embrace sustainability as a fundamental driver of long-term success. Transparency in reporting is equally crucial. Being forthright about ESG metrics, performance, and goals builds trust with stakeholders and demonstrates a commitment to accountability.

**Compliance and risk management:** As ESG regulations continue to gather pace worldwide, it's imperative that companies stay in compliance with these evolving standards. Beyond compliance, mitigating greenwashing risks is paramount. Companies must substantiate their ESG claims with verifiable data and avoid misleading statements. In a world where greenwashing can lead to significant reputational damage, authenticity is key.

**Stakeholder engagement and education:** Engaging with stakeholders—be they investors, customers, employees, or communities—is more than a mere checkbox. It's a vital step in understanding the concerns and expectations surrounding ESG. Furthermore, investing in ESG education for employees ensures that the entire organization is aligned with ESG goals and can effectively implement initiatives.

Additionally, continuously improving ESG performance based on feedback, evolving best practices, adhering to ESG regulations and standards while considering independent audits or verifications of ESG claims to ensure compliance builds trust with stakeholders while reducing litigation risk.

**Climate resilience on the journey to net zero:** Climate change presents both risks and opportunities for businesses. Managing climate-related risks is particularly critical for industries susceptible to weather events. Meanwhile, embracing innovation aligned with ESG goals not only reduces environmental impact but also opens doors to new revenue streams and efficiencies.

As it relates to ensuring trustworthiness of carbon offsets, companies must accurately measure and report emissions reductions, ensuring data integrity and consistency, while employing recognized methodologies and third-party verification to enhance credibility. To ensure ongoing oversight and governance, purchase high-quality carbon offsets from reputable projects that can be verified in person to adhere to recognized standards. Consistent and thorough due diligence are essential to ensure offsets represent real emissions reductions and contribute to genuine climate impact.

**Governance and fiduciary duty:** Recognizing ESG as a fiduciary duty for boards and management is a seismic shift in corporate governance. It underscores the importance of ESG considerations in decision-making and long-term planning. Boards must actively participate in integrating ESG considerations into the company's strategic planning process. This involves aligning ESG goals with the company's broader business objectives and ensuring that sustainability is a core driver of long-term success. They need to collaborate with management to establish clear, measurable ESG targets and key performance indicators to include environmental impact reduction, diversity and inclusion, and ethical governance. Boards must also consider linking a portion of executive compensation to ESG performance.

Companies that understand the risks posed by the outside environment to long-term shareholder value creation have already taken action in these areas. In their view, the issues are not about being on the right or wrong side of politics. It Is about doing what is in the best interest of their firms, their people and other stakeholders — it is about what makes good business sense.

## Credits


This paper was authored by the
**Thomson Reuters Regulatory Intelligence group:**

**Editor:**

Alexander Robson in London

**Reporters:**

Henry Engler and Antonita Devotta in New York
Lindsey Rogerson in London
Yixiang Zeng in Singapore

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