Insight INVESTMENT

NAVIGATING DYNAMIC LEGAL ISSUES IN A WARMING WORLD

A DISCUSSION ON GREENWASHING AND FIDUCIARY DUTY WITH ELLIE MULHOLLAND, EXECUTIVE DIRECTOR OF THE COMMONWEALTH CLIMATE AND LAW INITIATIVE

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ELLIE MULHOLLAND

Ellie Mulholland is Executive Director of the Commonwealth Climate and Law Initiative (CCLI), where she leads a radical collaboration between partner organisations across the globe, including Oxford University, environmental law charity ClientEarth and commercial law firm MinterEllison.

Since its launch by His Royal Highness the Prince of Wales in 2015, the CCLI has been at the forefront of legal research and stakeholder engagement on the intersection of climate and biodiversity risk, and companies and securities laws.

As an Australian-qualified lawyer, Mulholland is a Senior Associate at MinterEllison, the largest commercial law firm in Asia Pacific, where she advises government entities and corporations across a diverse range of sectors on climate change liability risk management and disclosure.

Mulholland is on the Steering Committee of The Chancery Lane Project, a global initiative to re-wire contracts and laws for climate action, and on the Technical Working Group for the Climate Disclosure Standards Board.

She assisted the World Economic Forum with its effective climate governance initiative, authoring the legal chapter of the white paper that was launched at Davos in January 2019. Other recent publications include a chapter in Sustainability and Financial Markets published by the Dutch Central Bank and the Rabound University OO&R Business and Law Research Centre, and a chapter in the second edition of the Wiley Handbook on Board Governance.

Mulholland was Editor of volume 36 of the Monash University Law Review, which included a special issue on climate change. With degrees in law, finance and philosophy from Oxford University, Monash University and the Australian National University, she brings an inter-disciplinary skill set to complex challenges.

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WE ASK ELLIE MULHOLLAND, EXECUTIVE DIRECTOR OF THE COMMONWEALTH CLIMATE AND LAW INITIATIVE, TO SHARE HER THOUGHTS ON GREENWASHING AND FIDUCIARY DUTY.

UNDERSTANDING THE NEW INVESTMENT ECOSYSTEM

Since the global financial crisis of 2008, the investment world has had to grapple with increasing layers of red tape. From the Retail Distribution Review to the evolution of MiFID, compliance departments have been, rightly, kept on their toes as the regulators, and the industry more generally, continues to rehabilitate their image.

However, in recent years, a green tint has been added to the red tape, as the advent of environment, social and governance (ESG) factors as a focus has given rise to sundry additional requirements and regulations.

Far from a trend or fad, ESG represents a structural shift for the entire financial services industry.

These concerns are neither sheer altruism nor profiteering alone. They are financial and economic responses to something predating those impulses – the science. We are already witnessing disruption as our safe climate unravels, and the law is responding.

Planet Earth is, at present, the hottest it has been in 125,000 years and human causation is unequivocal. Such is the scale of the issue that even if we were to stop emitting carbon today, the residual global warming would continue until at least mid-century.

Our grasp of climate science has rapidly increased. For example, we now know that every additional tonne of carbon dioxide and every fraction of a degree of warming matters. We understand that stabilisation of our climate to any temperature will require net-zero emissions, and that any reduction in emissions en route to this target will result in fewer climate impacts, meaning we are less likely to reach negative tipping points.

As an industry, and more widely as a society, we know that rapid emissions reductions are required.

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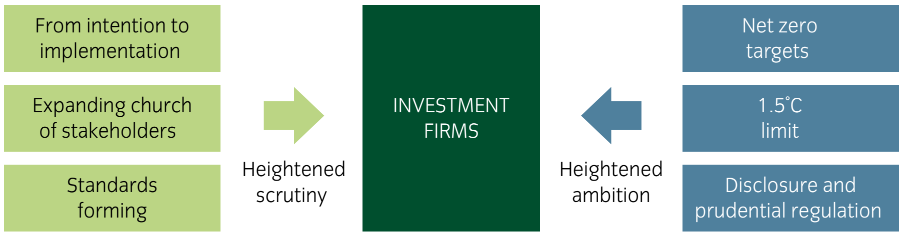
THE TENSION BETWEEN SCRUTINY AND AMBITION

The evolving climate scenario has resulted in a tension that is being faced throughout the industry, as policymakers, regulators and investors alike each respond to the challenges of a warming world.

Investment firms are in many ways within the eye of the storm (see Figure 1). They are responding to the heightened demands and increased ambition that accompany the net-zero targets established by nations, particularly following COP26, but also pressure from investors themselves.

Figure 1: Both ambition and scrutiny with regard to climate action are growing



With this pincer movement of regulatory and investor demand in mind, investment companies are increasingly setting their own net-zero targets. An ambition of 1.5°C is where many are coalescing, to ensure that warming is limited to a situation where we would see fewer catastrophic impacts.

Then there is the heightened demand and ambition that is coming from disclosure and prudential regulation, and the myriad acronyms that spring from within it.

For example, firms will, at this point, be all too aware of the Task Force on Climate-Related Financial Disclosures (TCFD) and its required reporting, and the Sustainable Finance Disclosure Regulation (SFDR) and its impact on the investment universe. In addition to these considerations, the UK government is preparing legislation that would require financial institutions to publish their own net-zero transition plans by next year.

So, the tension experienced is a result of heightened demand for action being met by firms with an increased ambition, all the while under ever greater scrutiny.

The transition from words to action is being monitored closely and is playing out amid a developing set of standards. There are data and methodology gaps around net zero, among other areas, not to mention the recent addition of a biodiversity standard at COP26.

It is clear that many firms recognise the urgency of climate change and want to do more. But while such chasms in understanding remain, so do pitfalls and potential wrong turns.

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THE SCOURGE OF GREENWASHING PLAGUES INVESTMENT MARKETS

Greenwashing is broadly defined as an organisation publishing misinformation to present an environmentally responsible corporate image, or product.

It is challenging for businesses and investors to navigate greenwashing, particularly over the short to medium term while the gaps in data and definition remain.

There are significant reputational risks attached to greenwashing, for clients, beneficiaries and even employees. In addition, overstating climate credentials can expose a business or individual to litigation for misleading disclosures (in line with consumer and securities laws).

As greater levels of regulation are applied, any breach of financial regulation or advertising standards within this arena can also lead to regulatory enforcement.

This has been witnessed prominently in the UK, where the Advertising Standards Authority (ASA) reportedly judged that HSBC has misled customers in two separate adverts, by promoting its green initiatives while neglecting to state its continued financing of businesses with considerable greenhouse gas emissions[1].

While the bank has stood by its claims, data from the Rainforest Action Network places HSBC among the 10 largest financers of fossil fuels globally, with upwards of $87bn provided to fossil fuel companies since the Paris Agreement was established in 2016.

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Overstating climate credentials can expose a business or individual to litigation for misleading disclosures.

[1] HSBC faces greenwashing accusations from UK advertising watchdog, 29 April 2022, FT.com.

INVESTORS HAVE A FIDUCIARY DUTY TO CONSIDER ESG FACTORS

When considering an organisation's fiduciary duties, it is important to understand the basis from which it is approaching the law.

The question organisations must ask themselves is whether they consider their fiduciary duty to be a barrier or an enabler of their ESG approach. Or, if their approach remains in its infancy, how understanding risks and liabilities can help guide firms as they develop their strategy.

As with greenwashing, failure to live up to fiduciary duties can result in significant reputational risks, all the way through to litigation exposures.

Under existing law, there has been an evolution of our understanding of investor fiduciary duties. Between 2005 and 2021, the expectation level on investors with regards to ESG considerations and impacts have multiplied.

Research supports this analysis. In 2005, Freshfields was asked if ESG was permitted to be considered, to which it responded: "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions"[2].

Moving forward to 2015, a report from the PRI and UNEP FI found that "failure to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty"[3].

Later, the question around 'impact' arose, looking beyond financially material ESG issues to how investment activities, stewardship engagement, integration and exclusion were being handled to achieve positive sustainability impacts. Freshfields agreed in a recent report that investors could seek such influence[4].

Perhaps the most interesting aspect of the most recent Freshfields report was the focus on the way in which sustainability risks and impacts created systemic and systematic risks.

A risk such as climate change is systematic because it impacts the breadth and depth of the economy. But it is also systemic due to the risk of financial contagion and the revising of asset prices.

So, because of these systemic and systematic risks, there is an opportunity to look beyond the alpha of a single asset class, to instead look at portfolios across long-term horizons and to pursue these positive impacts consistent even with, or permitted by, fiduciary duties.

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> Failure to live up to fiduciary duties can result in significant reputational risks… Between 2005 and 2021, the expectation level on investors with regards to ESG considerations and impacts have multiplied.

[2] A legal framework for the integration of environmental, social and governance issues into institutional investment, October 2005. [3] Fiduciary duty in the 21st century, September 2015. This introduced a work programme conducted over 2015-2019, culminating in the Fiduciary duty in the 21st century final report, October 2019.
[4] A legal framework for impact: sustainability impact in investor decision-making, July 2021.

AN EXAMPLE OF FIDUCIARY DUTIES IN THE COURTS

Perceived breaches of fiduciary duties seldom make it to the courtroom, but there have been some notable exceptions. These include a recent case in Australia, whereby a pension fund member brought a claim against a pension fund trustee (a corporate entity) for breach of statutory duties of prudence and best interests with regards to climate risks.

Mark McVeigh, a 23-year-old landscape gardener, wrote to his pension provider asking for details on its plans for managing climate risks to his investments.

McVeigh considered the trustee's response less than satisfactory, so he took the matter to the courts. His claim was well received.

The response from the court judge went as follows: "Presumably, in due course, the Respondent [fund] will argue that whether it [invests in businesses with high carbon footprints] or not is not germane to the financial performance of the fund to which he will respond that the fund will not perform very well if its investments are under water.[5]"

The two parties reached a settlement in November 2020, with the fund conceding that climate change did pose a "material, direct and current financial risk" to the fund's investments, with the fund committing to reporting in line with the TCFD's recommendations and to reaching a net-zero portfolio by 2050.

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[5] McVeigh v. Retail Employees Superannuation Trust, 2018, Global Climate Change Litigation database.

HOW TO AVOID GREENWASHING

When considering whether a claim is greenwashing, it is worth referring to our earlier question on framing as relates to the law: Is the business asking a legal question because it wants to know what to do, and you are trying to figure out where the risks and liabilities lie before deciding your path forward? Or do you have a strategy in mind, and wish to understand whether the law is an enabler or barrier to it?

Understanding from which direction you are approaching the legalities of ESG will ultimately help expedite your process and, in turn, focus the mind.

When considering current market practices to avoid greenwashing, it is important to be extremely cautious around representing targets and trajectories as 'science-based' or 'Paris-aligned'. Language is crucial when communicating targets – sustainability credentials should be considered akin to financial management credentials.

As the bar for sustainability grows higher, and the requirements more specific and measurable, performing 'truth to label' will become increasingly important.

Other points to consider include sustainability credentials as an employment consideration and being open to seeking regulatory guidance on green advertising. Above all, it is crucial to be specific but not selective with any ESG-related claims.

Figure 2: Tips to successfully navigate the tension[6]

TO AVOID GREENWASH

- Care must be taken in representing targets or emissions reduction trajectories are 'science-based' or Paris-aligned'.
- Target setting is only the first step. Credible implementation is critical.
- Language is important when communicating targets. Relevant caveats must be clearly stated alongside the targets that they purport to limit, and be given proportionate emphasis.
- Sustainability credentials are financial management credentials.
- As the bar of 'sustainability' becomes higher, more specific and more measurable, 'truth to label' is increasingly important.
- Sustainability credentials are an important employment consideration.
- Consider regulatory guidance on green advertising. Avoid making general claims. Be specific, but not selective.

TO FULFIL FIDUCIARY DUTIES

- Minimising risks and capturing opportunities requires contemporary understanding, proactive inquiry and critical evaluation on a forward-looking basis.
- How robust are scenarios and assumptions used in investment strategy, planning and disclosure? How will the decisions we make now position us to continue to survive and thrive in this disruption?
- Analysis based on historical norms instead of current facts and future scenarios is a red flag.

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Language is crucial when communicating targets – sustainability credentials should be considered akin to financial management credentials.

[6] Source: MinterEllison, Spotlight on Greenwashing, October 2021. Available on request. For more information see: https://www.minterellison.com/climate-risk-governance

HOW TO FULFIL FIDUCIARY DUTIES

Fulfilling fiduciary duties, by minimising risks and capturing opportunities, requires a contemporary understanding of rules and regulations.

This is an evolving landscape. The information available today will likely differ vastly from the information available in 12 months' time. As such, firms should be minded to be proactive in seeking, and understanding, the latest information.

A reaction-based approach opens the door to falling short on fiduciary duties and, in turn, the loss of reputation and potential litigation.

With this in mind, investors should consider the robustness of their investment processes as they relate to their sustainability targets, and the adaptability of such practices to new and increasing information.

Finally, on a more practical note, be wary of your datapoints. Analysis based on historical patterns, instead of current facts and future scenarios, should be considered as a red flag for what firms are deciding to do today.

Quite simply, firms must ensure they are looking ahead because we know from the data that the future does not look like the past.

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IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

FIND OUT MORE

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