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Caroline Bradley[1]
Asset Management and Greenwashing: Materials for Class on Thursday April 4

In the asset management world, Blackrock made a very visible commitment to addressing climate change in Larry Fink's letters to CEOs and investors in 2021. At that time he wrote: "I believe that the pandemic has presented such an existential crisis – such a stark reminder of our fragility – that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives. It has reminded us how the biggest crises, whether medical or environmental, demand a global and ambitious response... We know that climate risk is investment risk. But we also believe the climate transition presents a historic investment opportunity."[2] Fink noted that it was easier in 2021 to build a portfolio of sustainable investment options than had previously been the case, and that, as investors chose to emphasize sustainability this would have imnplications for corporate managements. Here's an excerpt from the letter:

> "There is no company whose business model won't be profoundly affected by the transition to a net zero economy – one that emits no more carbon dioxide than it removes from the atmosphere by 2050, the scientifically-established threshold necessary to keep global warming well below 2ºC. As the transition accelerates, companies with a well-articulated long-term strategy, and a clear plan to address the transition to net zero, will distinguish themselves with their stakeholders – with customers, policymakers, employees and shareholders – by inspiring confidence that they can navigate this global transformation. But companies that are not quickly preparing themselves will see their businesses and valuations suffer, as these same stakeholders lose confidence that those companies can adapt their business models to the dramatic changes that are coming.
> It's important to recognize that net zero demands a transformation of the entire economy. Scientists agree that in order to meet the Paris Agreement goal of containing global warming to "well below 2 degrees above pre-industrial averages" by 2100, human-produced emissions need to decline by 8-10% annually between 2020 and 2050 and achieve "net zero" by mid-century. The economy today remains highly dependent on fossil fuels, as is reflected in the carbon intensity of large indexes like the S&P 500 or the MSCI World, which are currently on trajectories substantially over 3ºC.2
> That means a successful transition – one that is just, equitable, and protects people's livelihoods – will require both technological innovation and planning over decades. And it can only be accomplished with leadership, coordination, and

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[2] *See*, *e.g.*, Larry Fink's 2021 letter to CEOs at https://www.blackrock.com/corporate/investor-relations/2021-larry-fink-ceo-letter.

> support at every level of government, working in partnership with the private sector to maximize prosperity. Vulnerable communities and developing nations, many of them already exposed to the worst physical impacts of climate change, can least afford the economic shocks of a poorly implemented transition. We must implement it in a way that delivers the urgent change that is needed without worsening this dual burden.
> While the transition will inevitably be complex and difficult, it is essential to building a more resilient economy that benefits more people. I have great optimism about the future of capitalism and the future health of the economy – not in spite of the energy transition, but because of it.
> Of course, investors cannot prepare their portfolios for this transition unless they understand how each and every company is prepared both for the physical threats of climate change and the global economy's transition to net zero. They are asking managers like BlackRock to accelerate our data and analysis capabilities in this area – and we are committed to meeting their needs."[3]

By the beginning of 2024 news stories noted that Blackrock, and other large financial firms were stepping back from their promises to emphasize sustainability because of political opposition and legal risks.[4] A number of financial firms which had joined a group with the name Climate Action 100+[5] withdrew after the group "shifted its focus from pressuring companies to disclose their net-zero progress to getting them to reduce emissions."[6] The withdrawing companies claim they are still committed to sustainability. Blackrock, for example is shifting membership in Climate Action 100+to an international entity,[7] and now describes its investment

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[3] *Id.*

[4] *See*, *e.g.*, David Gelles, *More Wall Street Firms Are Flip-Flopping on Climate. Here's Why*, NY Times (Feb. 19, 2024). The article says this about legal risks: "Some states, including Texas and West Virginia, banned banks from doing business with the state if the firms were distancing themselves from fossil fuel companies. And late in 2022, Mr. Jordan began an antitrust investigation into the group, calling it a "climate-obsessed corporate 'cartel.'" But increased focus by regulators on greenwashing is an additional legal risk.

[5] *See* https://www.climateaction100.org/.

[6] Andrew Ross Sorkin, Ravi Mattu, Bernhard Warner, Sarah Kessler, Michael J. de la Merced, Lauren Hirsch & Ephrat Livni, *Wall Street's Climate Retreat*, NY Times (Feb. 16, 2024).

[7] *Id.*

strategy as transition investing.[8] Critics argue that asset managers' promises are not meaningful.[9]

In thinking about asset management I am going to focus on issues relating to pension fund investment and then think about issues relating to how firms that sell managed investment products such as mutual funds (regulated in the US as investment companies) describe their products.

One issue in thinking about climate change and finance relates to timeframes. Commentators on climate change issues for banks sometimes note that bank lending is not a very long-term phenomenon, and that banks can adjust the way they lend as the physical and transition risks associated with climate change evolve. But some investments are longer term investments. In some senses pension fund investing is a long term exercise, although the investments may change over time.

Pension Funds

In Why (and Why Not) Climate Finance? I wrote about the Trump administration Department of Labor rules which were designed to restrict the ability of pension funds to use ESG measures in making pension fund investment decisions.[10] The Biden administration then proposed a new approach which would allow pension fund administrators to take account of ESG considerations, emphasizing that "climate change and other ESG factors are often material and that in many instances fiduciaries to should consider climate change and other ESG factors in the assessment of investment risks and returns."[11]

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[8] *See* Jack Pitcher & Amrith Ramkumar, *Step Aside, ESG. BlackRock Is Doing 'Transition Investing' Now*, Wall Street Journal (Mar. 3, 2024) ("BlackRock is still wagering that fighting climate change will be a generational investment opportunity—but the company is no longer pushing for changes in corporate behavior, talking about hard-to-quantify social issues or actively promoting ESG investing criteria. Instead, it is directing billions of client dollars toward infrastructure projects that will help speed the transition from fossil fuels.")

[9] Universal Owner Initiatives, *Failure by Design: Is the Net Zero Asset Managers Initiative Broken?* (Oct. 2022) at 3 ("This report reviews the 43 targets released by the Net Zero Asset Manager's Initiative (NZAMI) released in May 2022. We break down these targets and assess potential effectiveness against emissions reduction goals and suggest areas to improve alignment. The analysis of the targets builds on our November 2021 report2 analyzing the NZAMI's first progress report. Asset managers have overwhelmingly set 2030 targets to either reduce their 'portfolio emissions', or to increase the share of their assets under management (AUM) invested in companies with 'net zero targets'. We call these 'portfolio emissions' targets and 'transition plan' targets, respectively. But neither actually tracks real-world emissions reductions, which is what ultimately matters most.")

[10] Department of Labor, Financial Factors in Selecting Plan Investments 85 FR 72846 (Nov. 13, 2020); Department of Labor, Fiduciary Duties Regarding Proxy Voting and Shareholder Rights 85 FR 81658 (Dec. 16, 2020).

[11] Department of Labor, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights 86 Fed. Reg. 57272, 57277 (Oct. 14, 2021). See also Department of Labor, Request for Information on Possible Agency Actions to Protect Life Savings and Pensions from Threats of Climate-Related Financial Risk, 87

A number of states challenged the rule in Utah v Walsh,[12] and the court (Judge Kacsmaryk) found that the rule did not violate ERISA and that it was not arbitrary and capricious:

“ERISA provides that a fiduciary must discharge his duties concerning a plan "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose or providing "benefits" to them. 29 U.S.C. § 1104(a)(1). The term `benefits" in the provision "must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries." Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420-21 (2014).

The question of whether the Rule violates ERISA invokes the analytical framework outlined in Chevron USA Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984). That framework "proceeds in two steps." ... At step one, courts ask "whether Congress has directly spoken to the precise question at issue," in which case courts "must give effect to the unambiguously expressed intent of Congress and reverse an agency's interpretation that fails to conform to the statutory text." ... But if the statute is ambiguous, courts reach step two, and may not disturb an agency rule unless it is "arbitrary or capricious in substance, or manifestly contrary to the statute." ... Thus, "[t]he fact that the agency has from time to time changed its interpretation" does not mean that "no deference should be accorded the agency's interpretation of the statute." Chevron, 467 U.S. at 863.

Here, Plaintiffs argue DOL loses at either step because "the plain text of ERISA forecloses consideration of non-pecuniary factors, including for tiebreakers."... But that is not so. Because ERISA does not contemplate the possibility of a "tie" between two financially equivalent investment options, Congress has not "directly spoken to the precise question at issue." ...

DOL also wins at step two. That is because the reasonableness of DOL's interpretation is supported by its prior rulemakings — including the 2020 Rule which Plaintiffs approvingly hold out as "reflect[ing] ERISA's focus on financial benefits."... Indeed, since at least 2015, DOL has posited that ESG factors "may have a direct relationship to the economic value of the plan's investment." 80 Fed. Reg. at 65136, And likewise, the 2020 Rule stated that failing to consider ESG-related risk-return factors could constitute a violation of the duty of prudence in some circumstances: "For example, a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations." 85 Fed. Reg. at 72848. But in any event, Plaintiffs concede that ESG factors can he considered for risk-return purposes in appropriate circumstances.... (ESG are permissible factors "when the fiduciary reasonably concludes the factor will benefit the beneficiary directly by improving risk-adjusted return of a particular investment" and "the fiduciary's exclusive motive is to obtain this direct benefit").

Fed Reg 8289 (Feb. 14, 2022); Executive Order 14030, Executive Order on Climate-Related Financial Risk, 86 FR 27967 (May 25, 2021). A number of states have challenged the rule and are appealing the district court’s decision upholding the rule to the 5th Circuit.

[12] ND Tex. 2023

The 2022 Rule changes little in substance from the 2020 Rule and other rulemakings. Where the 2020 Rule explained that collateral factors may be considered when a fiduciary is "unable to distinguish" between two investment options based on Financial factors alone, the 2022 Rule allows the same when the two options "equally serve the financial interests of the plan." 87 Fed. Reg. at 73836-38. And while Plaintiffs aver that the 2022 changes loosen restrictions on fiduciaries, there is little meaningful daylight between "equally serve" and "unable to distinguish."

The Rule also explains that fiduciaries remain free "to determine that an ESG-focused investment is not in fact prudent," 87 Fed. Reg. at 73831, and stresses that a "fiduciary's determination with respect to an investment ... must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis," .. Hence, "[r]isk and return factors may include [ESG] factors on the particular investment," hut "[w]hether any particular consideration is a risk-return factor depends on the individual facts and circumstances,".. And even where collateral benefits are considered as a tiebreaker, a fiduciary may not "accept expected reduced returns or greater risks to secure such additional benefits." ...

Additionally, the Rule's statement that risk-return factors "may include" ESG factors differs from the "may often require" language of the proposed rule. 87 Fed. Reg. at 73830. As DOL clarified, the proposed language "was not intended to create an effective or de facto regulatory mandate" or "an overarching regulatory bias in favor of ESG strategies." ... To the contrary, the Rule "makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating an incentive for a fiduciary to put a thumb on the scale in favor of ESG factors." ...

The Rule seeks to achieve "appropriate regulatory neutrality and ensures that plan fiduciaries do not misinterpret" the Rule "as a mandate to consider the economic effects of climate change and other ESG factors under all circumstances." ... And "nothing about the principles-based approach should be construed as overturning long established ERISA doctrine or displacing relevant common law prudent investor standards." ... This includes Dudenhoeffer's holding that fiduciaries must act "for the exclusive purpose" of "providing benefits to participants and their beneficiaries" and that the term "benefits" "must be understood to refer to ... financial benefits."...

To summarize, an ESG factor could be worth consideration even under prior rules if it "is expected to have a material effect on the risk and/or return of an investment." 85 Fed. Reg. at 72884. Similarly, the 2022 Rule states that risk and return factors may include ESG factors under some circumstances, hut those factors must still reflect "a reasonable assessment of its impact on risk-return," 29 C.F.R. § 2550,404a-1(h)(4). In other words, the 2022 Rule "provides that where a fiduciary reasonably determines that an investment strategy will maximize risk-adjusted returns, a fiduciary may pursue the strategy, whether pro-ESG, anti-ESG, or entirely unrelated to ESG,"... And like prior rules, the 2022 Rule allows consideration of collateral factors to break a tie. Thus, after affording DOL the deference it is presently due under Chevron, the Court cannot conclude that the Rule is "manifestly contrary to the statute." ...

Under the APA, courts must "hold unlawful and set aside" agency action, findings, and conclusions found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). "The scope of review under the arbitrary and capricious standard is narrow and a court is not to substitute its judgment for that of the agency."

Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983). Instead, courts should recognize that agencies "have expertise and experience in administering their statutes that no court can properly ignore," Judulang v. Holder, 565 U.S. 42, 53 (2011), and must not "impose upon agencies specific procedural requirements that have no basis in the APA," Pension Ben. Guar. Corp. v. LTV Corp., 496 U.S. 633, 654 (1990). That said, the agency must nevertheless "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." State Farm, 463 U.S. at 43; see also Sw. Elec. Power Co. v. EPA, 920 F.3d 999, 1013 (5th Cir. 2019) (judicial review of agency action "is not toothless").

While an agency need not "address every comment," it must "respond in a reasoned manner to those that raise significant problems." Reytblatt v. U.S. Nuclear Regul. Comm'n, 105 F.3d 715, 722 (D.C. Cir. 1997). In review, courts then "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." State Farm, 463 U.S. at 43. For these purposes, an agency's action is "arbitrary and capricious" if it "entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." ...

Similarly, "an agency's decision to change course may be arbitrary and capricious if the agency ignores or countermands its earlier factual findings without reasoned explanation for doing so." F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 537 (2009). At the least, the agency must "display awareness that it is changing position," and "show that there are good reasons for the new policy." ...

Here, Plaintiffs argue: (1) the Rule does not rebut DOL's prior finding that "strict" regulations are necessary; (2) the alleged need for the Rule is inadequate because DOL never identified "who specifically was confused," the "source of confusion," or that "any such confusion or negative perceptions reduced financial returns for participants and beneficiaries"; and (3) many of the Rule's provisions are "unreasonable, internally inconsistent, fail to consider relevant factors," and rely on factors "Congress has not intended it to consider."...

These arguments all fail to establish an APA violation. To begin, DOL explained its position that the 2020 Rule had a chilling effect on fiduciaries' consideration of pertinent information when making investment decisions. 87 Fed. Reg. at 73826. And DOL expressly replied to comments that argued the agency "did not articulate what confusion it had created." ... The Department identified specific comments speaking to that issue, cited literature from the Harvard Law School Forum on Corporate Governance and the United Nations Principles for Responsible Investment, ... and considered eliminating the tiebreaker test before ultimately retaining it due to reliance interests...

Plaintiffs then take issue with the Rule's authorization of fiduciaries considering "participants' preferences" — a "euphemism for considering nonpecuniary factors such as climate change and other ESG factors." ... But Plaintiffs again fail to distinguish the 2022 Rule from the 2020 Rule. Indeed, nothing in the 2020 Rule "preclude[d] a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments." 85 Fed. Reg. at 72864. And likewise, the 2022 Rule merely states that participant preferences can be considered when they are "relevant to furthering the purposes of the plan" and "consistent with" a

fiduciary's investment duties. 87 Fed. Reg. at 73842. Further, the Rule clarifies that "fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them."...

Next, Plaintiffs point out that the Rule deleted the proposed rule's prohibition on exercising proxy rights to "promote non-pecuniary benefits or goals unrelated to those financial interests of the plan participants and beneficiaries" — a command "designed to promote ERISA's focus on financial benefits."... But the Rule's "removal of the clause at issue does not constitute a rejection of this principle." 87 Fed. Reg. at 73848. Rather, DOL concluded that other provisions in the Rule already require fiduciaries to act "solely in accordance with the economic interests of the plan" and that the clause therefore "serve[d] no independent function."...

The Department further agreed with commenters that "the clause is easily misconstrued" as imposing on fiduciaries duties "above and beyond" the duties contained in other paragraphs... Because DOL saw no reason to "impose such additional duties, with their attendant costs and potential for litigation" when other provisions "arc fully adequate to protect the interests of plan participants," it found that ERISA's duty of prudence was sufficient in protecting plan beneficiaries... Accordingly, the Department saw no need in imposing "additional burdens" on the use of the tiebreaker test or creating "incentives that discourage, rather than promote, proper fiduciary activity."...

Similarly, Plaintiffs argue the Rule wrongly eliminated specific restrictions on qualified default investment alternatives ("QDIAs") to allow fiduciaries "to select funds that expressly prioritize nonpecuniary benefits." ... But DOL explained that "most commenters on this issue" considered the restrictions unnecessary. 87 Fed. Reg. at 73842.

Commenters also expressed concern "that funds may be excluded from selection as QDIAs solely because they expressly considered climate change or other ESG factors, even though the funds arc prudent based on a consideration of their financial attributes alone" or are "even best in class,"... DOL agreed with these comments but noted that QDIAs would continue to be subject to "the prohibition against subordinating the interests of participants and beneficiaries in their retirement income to other objectives." ...

Plaintiffs then fix their attention on the proposed rule's disclosure requirement "that would apply whenever a fiduciary considered a collateral benefit in selecting an investment for a participant-driven individual account plan" and assert the "2022 Rule eliminated this provision but remarkably does not clearly state why."... However, DOL did explain the "limited support" for this disclosure requirement and the "substantial concerns" raised by the public. 87 Fed. Reg. at 73839. Among these concerns were that the disclosure requirement: (1) is "inherently ambiguous"; (2) is unnecessary and requires disclosure or content "of no economic significance"; (3) "disproportionately emphasize[s] one part of the fiduciary decisionmaking process over other more relevant factors in a way that could mislead participants"; (4) is "contrary to the principle of neutrality" because it has "a chilling effect on the proper use of climate change and other ESG factors"; and (5) "would effectively act as an invitation to litigation."...

Some commenters took issue with the "necessary consequence" that a disclosure violation "would constitute a per se breach of ERISA's duty of loyalty."... Others pointed out various "technical issues with the proposed disclosure requirement." .. DOL responded that its decision was based on these concerns hut also emphasized that "the decision against adopting a collateral

benefit disclosure requirement in the final rule has no impact on a fiduciary's duty to prudently document the tiebreaking decisions in accordance with section 404 of ERISA." ...
Additionally, Plaintiffs assert the Rule fails to consider the alternative of issuing sub-regulatory guidance instead of amending the regulation itself. But as an initial matter, an agency "need not consider every alternative proposed" — especially where the alternative was not a serious issue raised by commenters. 10 Ring Precision, Inc. v. Jones, 722 F.3d 711, 724 (5th Cir. 2013). And regardless, DOL explained the 2020 Rule was plagued with "contradictory statements" and "overly stringent language."... Hence, the Department maintains that interpretive guidance "could not have cured the chilling effect" of the 2020 Rule and would "not have the force and effect of law."...
Finally, Plaintiffs aver that the Rule is the product of "prejudgment" because it "does not meaningfully rebut the strong evidence that DOL had already decided what to do in this rulemaking before it reviewed the public comments." ... But the Supreme Court has held that an "open-mindedness" test violates the "general proposition that courts are not free to impose upon agencies specific procedural requirements that have no basis in the APA." Little Sisters of the Poor Saints Peter & Paul Home v. Pennsylvania, 140 S. Ct. 2367, 2385 (2020).
For all these reasons, the Rule does not violate the APA. And while the Court is not unsympathetic to Plaintiffs' concerns over ESG investing trends, it need not condone ESG investing generally or ultimately agree with the Rule to reach this conclusion. Rather, "all that is necessary is a `minimal level of analysis' from which the agency's reasoning may he discerned," "regardless of whether the court finds the reasoning fully persuasive." Brackeen v. Haaland, 994 F.3d 249, 357-58 (5th Cir. 2021), rev'd in part on other grounds, No. 21-376, 2023 WL 4002951 (U.S. June 15, 2023). DOL has provided that here."

The states have appealed the decision. The Manhattan Institute has, together with the National Center for Public Policy Research and Professor Allen Mendenhal, filed an amicus brief in the case, [13]

The UK Department for Work and Pensions established a Taskforce on Social Factors to consider how pension schemes should think about social risks and opportunities, after a public consultation on this issue.[14] The then Minister[15] wrote in an introduction to the government response:

The UK is a world-leader in the occupational pension schemes industry. Our work

[13] *See* https://manhattan.institute/article/amicus-brief-utah-v-su.

[14] Department for Work and Pensions, Government Response: Consideration of Social Risks and Opportunities by Occupational Pension Schemes (Jul. 15, 2022) at https://www.gov.uk/government/consultations/consideration-of-social-risks-and-opportunities-by-occupational-pension-schemes/outcome/government-response-consideration-of-social-risks-and-opportunities-by-occupational-pension-schemes.

[15] At the time, Minister for Pensions and Financial Inclusion. *See id.* Subsequently Minister for Roads and Local Transport https://www.gov.uk/government/people/guy-opperman.

> on environmental, social and governance ("ESG") factors is rightly lauded and we are the first country to introduce landmark regulations on climate change, which will require trustees of UK occupational pension schemes in scope of the regulations to consider, assess and report on the financial risks of climate change within their portfolios.
> It is important for schemes to also consider broader sustainability risks and opportunities. The "S" of ESG is one area in which the risk management of pension schemes can be strengthened. In my view, trustees who do not factor in financially material social factors are at risk of not fulfilling their fiduciary duty.[16]

The Task Force published a guide on these issues, which include "workforce conditions, remuneration practices, bribery, health and safety, and modern slavery."[17] Notice that these core examples of social factors actually involve binding legal responsibilities. Bribery is a crime,[18] and modern slavery can involve offences relating to slavery, servitude and compulsory labour and human trafficking.[19] Workforce conditions and health and safety are matters which are also regulated.[20] So, a significant proportion of the social issues that the Taskforce was concerned with relate to legal compliance rather than voluntary actions by businesses to act in a socially responsible manner. Here is some of what the Task Force has written:

> "A company (and its investors) may reap some short-term benefit while causing, contributing to or ignoring adverse social impacts. But there is likely to be a longer-term cost, companies risk losing their social license to operate if they are associated with social related failures. Pension funds too may be vulnerable to 'social license' concerns, which could potentially impact scheme covenants, for defined benefit pension schemes, or reputational damage. Social impacts can also spill over into other businesses or even sectors, thereby creating systemic risk. For example, poor industrial relations may cause strike action, which can cause wider impacts on a range of businesses. Finally, there may be reputational damage on pension schemes for investing in companies causing social harm or failing to contribute to social progress.
> Historically, though there are some notable exceptions like engagement with

[16] Government Response: Consideration of Social Risks and Opportunities by Occupational Pension Schemes.

[17] Taskforce on Social Factors, Considering Social Factors in Pension Scheme Investments: Guide from the Taskforce on Social Factors, Consultation Document (Oct. 2023) at 4.

[18] Bribery Act 2010, 2010 c.23.

[19] Modern Slavery Act 2015, 2015 c. 30.

[20] *See*, *e.g.*, Working Environment at https://www.unison.org.uk/get-help/knowledge/health-and-safety/working-environment/.

banks in the era of apartheid South Africa, and restrictions on investing in weapons of mass destruction, many pension funds and trustees have shied away from engaging on social issues due to a lack of clarity on how to gauge materiality and a lack of knowledge or confidence to raise issues with investee companies. Events like the 2020-2023 Covid pandemic however demonstrate in real-time the multiplying effect of social issues interacting. (such as lack of access to healthcare and social support networks). It underlined that greater attention, understanding and engagement is needed across a range of social issues.

Equally, there is increasing awareness among investors and policymakers that the costs of climate inaction are falling on the shoulders of particular segments of global society. Achieving an orderly and just transition to net zero requires extensive stakeholder engagement, including on issues such as low pay, poor health, and social inequalities that leave individuals and communities more vulnerable to climate change and other social shocks. As a result, the scope of social factor analysis should not be too narrowly constrained to matters in the direct or immediate
control of a business, and should extend along the value chain. Analysis on corporate performance on social factors can also be used as a proxy indicator of poor management, indicating risk control and stakeholder management failures in the company...

Pension scheme trustees are called on by their statutory duty to integrate all financially material factors, including social factors, into investment decision-making, in line with their fiduciary duty to act in the best financial interests of members. This means that all actors and intermediaries in the pension investment chains are potentially impacted by these duties. Proactive consideration of relevant ESG issues (both risks and opportunities) is increasingly recognised as a driver of long-term economic value, risk management, and sustainability. This is aided by improving ESG analysis, which increasingly focuses on financial performance.

In 2015, the PRI, UNEP FI, UNEP Inquiry, and UN Global Compact published their Fiduciary Duty in the 21st Century report, which stated that a “failure to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty”. It cautioned that investors not incorporating ESG issues into their investment processes and activities could increasingly be likely to face legal challenges, presenting a new focus on the importance of ESG factors in complying with trustee fiduciary duties in the UK....

In the UK, trustees must invest scheme assets in the best interests of beneficiaries and exercise their powers of investment to ensure the security, quality, liquidity, profitability and diversification of their portfolio. Trustees have broad and wide-ranging powers of investment to integrate financially material ESG factors into their decisions and seek the best possible risk-adjusted returns for the duration of their investments.

As part of the Green Finance Strategy 2023, the UK government has committed to

engaging with stakeholders on how the government can continue to clarify fiduciary duty through a series of roundtables and a working group of the Financial Markets Law Committee. So for trustees keen to ensure they stay on the right side of pensions law it may be helpful to think about fiduciary duty in the following terms, which broadly reflect the Fiduciary Duty in the 21st Century report:

1. Incorporate financially material ESG factors into your investment decision making, consistent with the timeframe of the obligation. Trustees can and should take into account social factors as part of their consideration of financially material ESG factors.
2. Understand and consider incorporating the sustainability preferences of beneficiaries into your decision-making, taking into account the Law Commission's two-step test for trustees.[21]
3. Understand and recognise that certain ESG factors (and in particular social factors) may become financial factors over time and it is important to take a long-term view of investments to reflect your scheme obligations to beneficiaries.
4. Be active owners by encouraging high standards of ESG performance and management in the companies or other entities in which you are invested.
5. Support the stability and resilience of the financial system.
6. Disclose trustee's investment approach in a clear and understandable manner, including how preferences are incorporated into the scheme's investment approach.

When considering and balancing investment risks and returns to achieve the best outcomes for beneficiaries, investors including pension schemes can consider how their investment activities will facilitate a smooth, orderly and fair transition to a net zero economy and in doing so, consider the impacts of the climate transition on companies and the communities and society in which they operate.[22]

The UK's Financial Markets Law Committee[23] published a paper on fiduciary duties and sustainability in February 2024.[24] I will assign this paper as part of our readings.

[21] Law Commission, Fiduciary Duties of Investment Intermediaries, Law Com. No. 350. HC 368 (Jun. 30, 2014) at ¶6.34 ("In general, non-financial factors may only be taken into account if two tests are met: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund.")

[22] Taskforce on Social Factors, Considering Social Factors in Pension Scheme Investments at 4 and 5.

[23] https://fmlc.org/.

[24] Financial Markets Law Committee, Pension Fund Trustees and Fiduciary Duties: Decision-making in the Context of Sustainability and the Subject of Climate Change (Feb. 6, 2024).

Investment Companies[25]

In 2021 the Securities and Exchange Commission (SEC) identified a number of concerns arising out of examinations of investment advisers, investment companies and private funds offering ESG products and services, in particular emphasizing that "[a]ctual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals."[26] SEC staff had noticed during examinations of firms that although firms claimed to have policies and procedures relating to ESG investing this was not always the case.[27] For example, there were cases where portfolio management was not consistent with representations about ESG practices, firms did not manage investors' negative screens effectively, and firms may have voted proxies in ways that were inconsistent with public representations about how they would vote.[28] Because the US does not have a taxonomy for green or sustainable finance, it makes sense to focus on divergences between what firms say they are doing and what they are in fact doing.

In 2023 the SEC engaged in enforcement action against DWS Investment Management Americas, Inc. arguing that the firm had led clients and investors to believe it would apply a policy for ensuring integration of ESG factors into its ESG managed funds, and that it had failed to do so.[29] DWS agreed to settle the proceedings and pay a civil money penalty of $19 million without admitting liability.

In 2022 the SEC proposed to amend Rule 35d-1 under the Investment Company Act, which regulates materially deceptive or misleading fund names, in particular with respect to names that could "mislead investors about the fund's investment focus, such as when a fund's name suggests investment in companies that meet certain environmental, social, or governance

[25] The material in this section is taken from my draft paper, It's Not Easy Being Anti-Greenwashing.

[26] Securities & Exchange Commission, The Division of Examinations' Review of ESG Investing (Apr.9, 2021) at 2.

[27] *Id.* at 4.

[28] *Id. Cf.* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, Do ESG Funds Deliver on Their Promises?, 120 Mich. L. Rev. 393, 399 (2021) ("contrary to the SEC's concern about "greenwashing," ESG funds deliver on their promise to invest differently from other funds, and their holdings are rated more highly with respect to ESG. Because we incorporate ratings from four different providers, our findings offer reassurance that funds are not "gaming" a specific ESG index.")

[29] In the Matter of DWS Investment Management Americas, Inc., Release No. IA-6432 at p 2 (Sep. 25, 2023) ("DIMA represented that through this Policy its research analysts were required to include "financially material and reputation relevant ESG aspects into valuation model[s], investment recommendations and research reports and consider material ESG aspects as part of their [i]nvestment decision." Yet this representation was misleading because DIMA failed to adequately implement the Policy's requirements for research and monitoring compliance. Nor did DIMA adopt and implement reasonable policies and procedures to help ensure that its public representations about the ESG Integration Policy were not misleading.")

(''ESG'') criteria."[30] The names rule previously required that a fund whose name suggested a particular investment focus, including industry or geographic focus or a particular tax treatment, should have a policy that at least 80% of the value of its assets should be invested in that way,[31] although compliance with the 80% requirement would not necessarily preclude fraud liability.[32] The proposed rule would extend the scope of the 80% investment policy requirements to names suggesting investments would have characteristics such as growth, or value or would incorporate ESG factors.[33] With respect to ESG funds, if the identified ESG factors would not play a central role in the investment strategy of the fund this would be treated as deceiving and misleading investors.[34] Commentators argued that the proposed amendments to the Investment Company Names rule were unnecessary due to SEC review of summary prospectuses and FINRA review of sales material.[35] Other reactions to the proposal argued that it exceeded the SEC's statutory authority and violated the First Amendment as a content-based restriction on speech.[36] Commentators argued that the SEC's names proposal might not work well with other SEC proposals, including a proposal for enhanced ESG disclosures.[37] On the other hand, individual commentators and NGOs expressed support for the proposals.[38]

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[30] Securities & Exchange Commission, Investment Company Names, Proposed Rule, 87 Fed. Reg. 36594, 36595 (Jun. 17, 2022).

[31] *Id*.

[32] *Id.* at 36596.

[33] *Id*. at 36597.

[34] *Id*. at 36598.

[35] *See*, *e.g.*, Investment Company Institute, Re: Investment Company Names (File No. S7-16-22) (Jul. 31, 2023) at https://www.sec.gov/comments/s7-16-22/s71622-237939-498002.pdf, at 3-4. *See also id.* at 4 ("In sum, SEC and FINRA rules, accompanied by comprehensive, multifaceted staff review, serve to ensure that fund communications are clear and not misleading, making many of the proposed amendments to the Names Rule unnecessary.")

[36] *Id.* at 4-6.

[37] *See*, *e.g.*, Blackrock, RE: Investment Company Names (File No. S7-16-22) (Dec. 16, 2022) at https://www.sec.gov/comments/s7-16-22/s71622-20153128-320675.pdf; Investment Company Institute, Re: Need to Account for the Aggregated Impact of the Commission's Rulemaking (Aug. 17, 2023) at https://www.sec.gov/comments/s7-04-22/s70422-246959-547222.pdf; American Investment Council, Re: The Commission's Segregated Consideration of Interconnected Rules Is Procedurally and Substantively Deficient; The Commission Must Recognize, Analyze and Provide the Public an Opportunity to Comment on Interconnections Prior to Issuing Final Rules (Aug. 8, 2023) at https://www.sec.gov/comments/s7-16-22/s71622-245799-509842.pdf. *See also*, SEC, Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environment, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (June 17, 2022).

[38] *See*, *e.g.*, Ceres, Re: Enhanced Disclosure by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Release No. IA-6034; IC-34594; File No.

The final Investment Company Names rule, adopted in 2023, included some modifications based on comments the SEC had received,[39] and expanded the 80% policy requirement substantially as the SEC had proposed.[40] The text of the revised Rule 35d-1 states that:

> a materially deceptive and misleading name of a fund includes... A name that includes terms suggesting that the fund focuses its investments in: a particular type of investment or investments; a particular industry or group of industries; particular countries or geographic regions; or investments that have, or whose issuers have, particular characteristics (e.g., a name with terms such as ''growth'' or ''value,'' or terms indicating that the fund's investment decisions incorporate one or more environmental, social, or governance factors), unless: (i) The fund has adopted a policy to invest, under normal circumstances, at least 80% of the value of its assets in investments in accordance with the investment focus that the fund's name suggests.[41]

The 80% requirement in the SEC's Investment Company Names Rule begins to approach an idea of what constitutes greenwashing by insisting that there must be a large proportion of a fund's investments that meets the criteria the fund manager specifies in the fund's name. But the rule does not seek to define what terms such as green or sustainable in a fund name mean.

In the EU, financial firms are not merely expected to be truthful in the ESG claims they make for their products and services, they are expected under the SFDR[42] to publish information on their websites about their policies on the integration of sustainability risks in their investment decision-making process.[43] If they do not take sustainability risks into account, because they think they are not relevant, they are required to explain their reasons, clearly and concisely.[44] Financial firms are required to publish information relating to the principal adverse impacts

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S7-17-22, and Investment Company Names, Release No. IC-34593; File No. S7-16-22 (Dec. 2, 2022) at https://www.sec.gov/comments/s7-16-22/s71622-20152320-320248.pdf at p 5.

[39] Securities & Exchange Commission, Investment Company Names, 88 Fed. Reg. 70436, 70437 (Oct. 11, 2023)

[40] *Id.* at 70440.

[41] *Id.* at 70509.

[42] Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (SFDR) OJ L 317/1 (Dec. 9, 2019). *See also*, *e.g.*, Commission Delegated Regulation (EU) 2022/1288, OJ L 196/1 (Jul. 25, 2022) (specifying regulatory technical standards for the SFDR) corrected at OJ L 332/1 (Dec. 27, 2022) (SFDR Regulatory Technical Standards 2022).

[43] SFDR, Art. 3.

[44] SFDR, Art. 6.

(PAIs) on sustainability factors of their investment decisions: if they do take account of these impacts they must publish information about their policies, including their "adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting and, where relevant, the degree of their alignment with the objectives of the Paris Agreement."[45] Regulatory Technical Standards under the SFDR specify in great detail how firms should go about explaining how they assess PAIs.[46] Where firms do not take account of such PAIs they must state clear reasons why they do not do so.[47]

Firms which promote their financial products as green or sustainable must disclose information about how those products are aligned with the fund's objective. The SFDR has one provision which applies to products with sustainable investment as their objective[48] and another provision which applies to products that promote environmental or social characteristics.[49] Asset managers have referred to these provisions as distinguishing between dark green and light green products, and the decision about how to classify funds was seen as complex and problematic.[50]

The SFDR is consistent with the EU's objective of making finance focus on sustainability,[51] and the Commission saw the SFDR as a measure to promote transparency about financial products and their sustainability characteristics. In contrast, financial firms focused on issues of compliance wanted to be sure that they were presenting their products consistently with the requirements of the SFDR. Commissioner McGuinness has said that whereas the SFDR was intended to promote transparency, the finance industry had seen it as a labelling scheme, and, as such, it had gaps.[52] Gaps in the SFDR scheme resemble gaps in the development of the

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[45] SFDR, Art. 4.

[46] SFDR Regulatory Technical Standards 2022.

[47] SFDR, Art. 4. The Commission has established templates for the reporting of PAIs. *See* SFDR Regulatory Technical Standards 2022, at Annex I.

[48] SFDR, Art. 9.

[49] SFDR, Art. 8.

[50] *See*, *e.g.* Adrienne Klasa, *European Asset Managers Blame Regulatory Confusion for Downgrade of ESG Funds*, Financial Times (Nov. 22, 2022); Ian Lewis, EU Clarification on SFDR Classification Welcomed, Impact Investor (Apr. 20, 2023) at https://impact-investor.com/eu-clarification-on-sfdr-classification-welcomed/ .

[51] *See*, *e.g.*, A Sustainable Finance Framework That Works on the Ground, supra note 77, at 1 (citing SFDR as part of the progress the EU has made in its sustainable finance agenda of achieving "the transition to a climate-neutral and sustainable economy by 2050.")

[52] Opening remarks by Commissioner McGuinness at DG FISMA event, The Sustainability Finance Disclosure Regulation - What Next? (Oct. 10, 2023) at https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_23_4863 ("Market participants are advertising products as being light green or dark green – this is the so-called article 8 and article 9. But the Regulation does not set out any binding thresholds. It does not contain strict definitions for key concepts. Notably, it does not define what a "sustainable investment" is. And that was very much intentional, and with good reason – the Regulation was

Taxonomy. In both cases the EU rules are evolving over time. So, the EU Supervisory Authorities (ESAs) have been working on developing Technical Standards under the SFDR, which led to an initial set of Technical Standards in 2022,[53] and a subsequent recommendation about amendments to the Technical Standards at the end of 2023.[54] The 2023 recommendations add new indicators for PAIs relating to social adverse impacts (such as "employees earning less than an adequate wage"),[55] and adjust other indicators, metrics and definitions.[56] In addition, the ESAs have proposed simplification of the reporting templates.[57]

The Commission decided to carry out a comprehensive assessment of the SFDR,[58] and engaged in both a public consultation focusing on more general issues and a targeted consultation, both of which concluded in December 2023.[59] The EU's Platform on Sustainable Finance has identified needs for further work relating to smaller and medium sized enterprises (SMEs), investments in developing countries and development finance, and derivatives.[60] The Platform also raised some questions about the effectiveness of the SFDR in terms of achieving desired levels of transparency. Issues raised included different interpretations of key concepts , the broad range of products regulated under Art. 8 of the SFDR (the larger category of products

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negotiated to be flexible, to help market participants adapt to the new disclosures. But we do see that in practice, this lack of binding thresholds and strict definitions can lead to uncertainty. And investors find it harder to know if the product they want to invest in is really sustainable. So based on how the Regulation is being used, there is a risk of greenwashing and mis-selling. Another element is how does the Regulation link to other parts of the sustainable finance framework and our financial regulations as a whole.")

[53] SFDR Regulatory Technical Standards 2022.

[54] Joint Committee of ESAs, Final Report on Draft Regulatory Technical Standards, JC 2023 55 (Dec. 4, 2023).

[55] *Id*. at 6.

[56] *Id*. at 5.

[57] *Id*. at 17-18.

[58] EU Commission Communication, A Sustainable Finance Framework That Works on the Ground, COM (2023) 317 final (Jun. 13, 2023) at 5.

[59] *See*, *e.g.*, EU Commission, Implementation of the Sustainable Finance Disclosures Regulation (SFDR) Consultation Document, p 3, at https://finance.ec.europa.eu/document/download/602155f2-f429-47a9-bc91-b5a55145724b_en?2023-sfdr-implementation-consultation-document_en.pdf.

[60] Platform on Sustainable Finance, Platform Briefing on EC targeted consultation regarding SFDR Implementation (Dec. 2023) at https://finance.ec.europa.eu/document/download/b29f4421-79bf-4dbc-9732-cf3456c8189f_en?filename=231215-sustainable-finance-platform-response-sfdr-consultation_en.pdf at p. 7.

taking sustainability into account),[61] and whether the information provided was comprehensible to retail investors,[62] Funds reporting under Art. 8 include funds which disclose no commitment to sustainable investing,[63] and may still be significantly invested in fossil fuels.[64] The SFDR has not yet succeeded in achieving real comparability of funds. More work is needed to develop the SFDR and Taxonomy regimes, in part because of the need to achieve an objective assessment of greenwashing allegations, seen as an issue for regulators and a reputational issue for financial firms.[65]

The SFDR regime, like the EU Taxonomy and other EU measures focused on sustainable finance, is a work in progress. This is understandable because of the complexity of the issues involved, but uncertainty about how the rules are developing involves complexity for firms focused on regulatory compliance, while not yet achieving the expected benefits of a comprehensive sustainability regime. And, as the Platform on Sustainable Finance has noted, one of the issues relates to how we can think about what claims by financial firms constitute greenwashing which should give rise to regulatory enforcement in an environment where different firms are using different methodologies and criteria for products which look very similar to investors who are unable to understand the differences.

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[61] *Id.* at 11 ("In terms of financial relevance, however, in particular funds disclosing under Article 8 have become very widely used and represent the most prominent product type as of Q3 2023 at 53%, whereby products disclosing under Article 9 add 3.4% to a total of 56.6% of assets invested with a minimum consideration of good governance in the EU.")

[62] *Id.* at 9-10.

[63] *Id.* at 12 ("Generally, products disclosing under Article 8, can report a 0% commitment to Sustainable Investment (SIO), which means that they do not invest in sustainable activities classified by the Taxonomy or in line with the product providers` approach to SI and neither apply DNSH tests. They are surprisingly common, possibly indicating that some asset managers disregard the SIO percentage. This group appears quite heterogeneous, suggesting that several of these managers could report higher percentages if they chose to do so.")

[64] *Id.* at 14.

[65] *Id.* at 22-23.