CFA SOCIETY UNITED KINGDOM

WE GROW TALENT

Cases on Ethics in Sustainable Investments

SPECIALIST ESG ROLES

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ESG analysts perform an important role in the investment process across many asset classes ranging from public equities and corporate bonds to private credit and infrastructure assets. In their key function of researching and interpreting ESG data they encounter many ethical issues.

1) Sustainability Context:

In many respects the role of an ESG analyst is similar to that of a traditional financial analyst. They provide an opinion, which is the outcome of an investment decision making process and arrive at this through data analysis.

The nature of the data which ESG analysts use, however, and the framework which they may use to analyse it, is different from that used in traditional financial analysis. Whilst equity and credit analysts alike must use subjective judgements when evaluating the investment prospects of a given corporate security there is typically a common understanding of what information the analyst requires and how it will be used. With ESG ratings, both facts are not necessarily true. Information may not be fully available and currently providers of ESG ratings use a wide range of different frameworks which may produce contradictory conclusions.

ESG analysts work at a variety of organisations with different functions. They may work for a firm providing public ESG ratings; they may work at an investor providing such ratings internally; they may be hired by a corporate to provide an assessment of the company or they may be paid directly or indirectly by investors. It is important to understand the commercial and political influences that might be at play on an ESG rating and/or data, whether it comes with or without a grading.

ESG standards and regulations are evolving rapidly, covering reporting and disclosures of climate-related financial risk, ESG data and ratings, investment labels and carbon markets. The US SEC 'Name Rule', requiring that 80% of a fund's portfolio matches the asset advertised by its name, was adopted 20 Sept 2023. The EU Greenwashing Directive was endorsed by the EU Parliament on 17 Jan 2024. The UK anti-greenwashing rule was effective on 31 May 2024. Currently, ESG ratings are unregulated in most jurisdictions, unlike credit ratings which are regulated in many countries. Ethical standards are therefore currently the only barrier to poor practice. Regulation is however not far away; IOSCO has set down four principles to guide all ESG ratings and data service providers, regulation is expected to be introduced in the EU, and in the UK the Treasury has confirmed its desire for the FCA to regulate ratings providers, following the voluntary code of conduct introduced by the FCA earlier.

2) Key CFA Institute standards relevant to specialist ESG roles:

CFA INSTITUTE STANDARD	RELEVANT ISSUE
I(B) INDEPENDENCE & OBJECTIVITY	The ESG analyst's role is typically to provide an opinion – one that may be pivotal - in an investment process. They may therefore come under pressure to change the integrity that opinion in a variety of ways from different stakeholders and interested sources.
I(C) MISREPRESENTATION	Making judgements on ESG matters is currently much more subjective than making judgements on financial data and investment professionals' knowledge of ESG issues is lower. It is therefore easier for ESG issues to be inadvertently or deliberately misrepresented by ESG analysts.
II(A) MATERIAL NON-PUBLIC INFORMATION	The investment world is still getting used to handling and processing ESG data. There is perhaps less precedence and automatic understanding about which ESG data should be treated as price sensitive information.
V(A) DILIGENCE & REASONABLE BASIS	ESG data is often imperfect or incomplete, and often proxy data is used, extrapolating trends from related data where real data is absent or incomplete. ESG analysts need to ensure that the data they use in this way is done so with reasonable basis, be satisfied that real data is unobtainable and clearly explain in their reports where proxy data has been used and how it has been compiled.
VI(A) CONFLICTS OF INTEREST	ESG analyst opinions are often an important component of investment decisions. Providers of ESG ratings can be either investor- or issuer paid or be exposed to other commercial or political interests. These should be declared so that the ESG rating or opinion can be scrutinised with that potential bias in mind.

APPLICATION OF THE CFA INSTITUTE STANDARDS (12 cases)

Issue 1: Lack of transparency in allocation of proceeds of sovereign green bonds

Example

David Sirius, CFA, works for Green World Investments, a firm that specializes in advising on and arranging sustainable finance capital raising. Recently David has focussed on sovereign green bonds as a prominent opportunity, given that they account for around 11% of the total sustainable debt market, and he secures a mandate to market the new sovereign green bond issued by the country of Valerdevia. The bond is marketed as supporting renewable energy projects, but David knows that a portion of the funds will be directed toward improving the energy efficiency of coal plants, a fact that is not highlighted in the promotional materials. David feels that energy efficiency also indirectly contributes to sustainability, and as the Government of Valerdevia has a wide portfolio of projects and fund raising, funds raised effectively go into the same pot and a Government has discretion on spend. Sarah, a potential investor, and long-time client, asks David if the funds raised from the bond will be used to promote renewable energy projects, as she is keen to ensure the allocation is consistent with marketing of the bond as a vehicle for climate-positive investments. David reassures her that the bond is dedicated to environmentally friendly projects without specifically mentioning the coal-related investments.

CFA UK Comment

We think David breached *Standard I(C) – Misrepresentation*, failing to disclose that part of the funds will go to coal-related projects. He provides incomplete information, leading Sarah to believe that all the proceeds will fund renewable energy, which is not the case. Also, *Standard III(D) – Performance Presentation* was likely breached; by not mentioning the full details of how the funds will be allocated, David is not providing fair and accurate information, violating the ethical requirement to present the investment's performance and characteristics honestly and transparently. He is also likely to have violated accepted principles for green bonds issuance, which require proceeds are genuinely allocated to well defined projects and align with broader sustainability goals. David's actions resemble real-world situations where greenwashing has been alleged in sovereign green bonds. For example, Poland's sovereign green bond issuance in 2016, and Mexico's issuance faced scrutiny due to a lack of transparency in how funds were allocated to projects, some of which had questionable environmental impacts. These examples emphasize the importance of ensuring that green bond transparency and accurate representation are maintained throughout the process.

Issue 2: Corporate misreporting of emissions data

Example

Ewans, CFA works as an ESG analyst for a credit rating agency and is conducting a review of his rating of Ocean Cruises, a listed company. Ocean Cruises is headquartered in a country where there is no regulation or stock exchange requirement to audit climate change related data in corporate disclosures. During his due diligence, he notes that some of Ocean Cruise's sustainability disclosures cannot be properly reconciled with the global warming targets of the Paris Agreement with which they claim to be aligned. Ewans notes that his calculations produce much higher emissions figures than those disclosed by Ocean Cruises. Having talked to the company's sustainability team, he receives Ocean Cruise's emissions calculation methodology

(on a confidential basis) and realises that it does not include all types of emissions recognised in the Paris Agreement methodology. Ewans decides to have further discussions with the company's sustainability team on this issue, but he now only receives very vague answers without an appropriate explanation that can help him reconcile his calculations.

CFA UK Comment

Given the potential materiality of this situation, we think that Ewans should inform his supervisor to help determine the best way forward. This may include pausing the issuance of the credit update, expressing concerns to the company, and giving them time to provide further information to reconcile the calculations. If Ewans continues to disagree with the company, rather than withdraw the credit rating, we think he may have to publish his report detailing the differences between his view and the company's view on the disclosures. The materiality of his finding may be such that it leads to an ESG rating downgrade – both 'E' and 'G' scores look challenged by the situation. Given the possibility that the information Ewans is holding may become material price sensitive information at this stage, he should also check with his firm's compliance department or appropriate legal counsel to determine whether there are applicable securities or local stock exchange regulations that would require disclosing this situation to any relevant authorities.

Issue 3: Managing situations when internal firm rules conflict with overseas regulations

Example

Dell is the sustainability analyst at ABC asset management; he is tasked with recommending sustainable investments and advising on ESG risks across ABC's fund range. A few years ago, ABC adopted ESG practices, and an in-house sustainability methodology based on current science and best commercial practice. The methodology stipulates exclusions and a set of core metrics for all funds to follow and monitor. Dell developed a spreadsheet to apply these rules and monitor ESG and sustainability issues at the company level. He uses the output of this to provide data to his legal and marketing departments to ensure compliance of ABC's fund reporting and product labelling. Some of ABC's funds are invested in utilities with exposure to nuclear projects since the fund manager has identified nuclear power as part of a climate change positive energy solution. The fund also excludes investments in oil & gas companies that are undertaking new fossil fuel developments but makes an exception for those investing heavily in transitioning to renewables. Contrary to the view of ABC's fund management team, Utopia, one of their target markets announces its decision to classify all nuclear and gas related revenues as unsustainable in its Green Taxonomy.

CFA UK Comment

ABC asset management is subject to local market reporting regulations for the funds it sells in multiple jurisdictions. The change in fund reporting rules in Utopia creates a conflict with ABCs in-house methodology for the purposes of their fund reporting to clients in Utopia. As a result, the process Dell uses to provide data internally is no longer consistent with Utopian local law on disclosures and we believe Dell is likely to be found to be in breach of CFA Institute's *Standard I(A) Knowledge of the Law* if ABC continues to market the fund there.

Issue 4: Data integrity in assessing ESG impact on valuation

Example

Johns, CFA, is an ESG analyst at Rainbow, an EU based ESG rating agency. Johns is asked to make an investment valuation and issue an ESG rating for. Green Trees, a newly established forestation company in the MENA area. This region is a harsh environment for forest growth and there is no local regulated carbon market so any carbon credits generated can only be realised for cash within the global voluntary market. While assessing Green Trees, Johns believes that the two major factors impacting its valuation are (1) the cost of planting trees and (2) the price of carbon credits. Johns decides to use proxy assumptions for tree planting costs from a few recent projects in Indonesia rainforests, where conditions are perfect for forestation. Johns also decides to use the average price of the EU regulated market as a proxy for carbon credit prices, as he is very familiar with it.

CFA UK Comment

We conclude that Johns has not used proper diligence in developing the fundamental assumptions and benchmarks for the project. He should perform further due diligence and analysis to make sure the key proxy input assumptions he proposes to use are appropriate. For the tree planting costs, these could be high due to the harsh climate conditions and very likely will be much higher in the MENA Region than in Indonesia. For the carbon credit price, the fundamentals of the voluntary global carbon market may be completely different from the EU regulated market and render invalid his valuation model. We believe Johns is in danger of violating CFA Institute's *Standard V(A) Diligence & Reasonable Basis* unless he revisits the key proxy input costs and prices in his valuation model.

Issue 5: Manager research and selection of sustainable funds

Example

Brown, CFA works at a UK based wealth manager in the manager research team. His primary responsibility is the research and selection of mutual funds to be used in the firm's sustainable investment portfolios. One of the funds he has been analysing scores very well on third-party ESG metrics, having top-quartile ESG scores based on its holdings. Some members of the portfolio management team are keen to add this fund to the firm's portfolios: it is run by a very well-known asset manager, has the desired risk-return profile, and would improve the overall scores of the portfolios based on the third-party ESG metrics. However, after further analysis, Tom discovers that there are no mechanisms in the investment process for this fund to maintain a its high ESG score, i.e. the positive scores of the portfolio's current holdings are purely coincidental and not an intentional outcome of the investment process. Additionally, he does not believe that the third-party ESG scores being used are a good measure of sustainability, and consequently, on both counts, the fund does not actually meet his firm's policy for selecting sustainable investments.

Accordingly, he decides to not recommend the fund for inclusion in the firm's sustainable portfolios, much to the frustration of some of the portfolio managers.

CFA UK Comment

We think that Brown has met his diligence responsibilities under CFA Institute's *Standard V(A) Diligence and Reasonable Basis*. He conducts thorough due diligence on the fund, and despite pressure from other internal stakeholders, does not think it meets the minimum acceptable standard for a sustainable fund. As such, he has no reasonable basis to recommend the fund.

Issue 6: Failure to identify the real client

Example

Berry, CFA is an ESG fund rating analyst at Green Ratings. She is called by Wallis at Great Investments who asks her to issue a fund rating on his flagship institutional 'Bluebottle' impact fund. Berry is pleased that she has been assigned to this as she has previously rated several other Great Investments funds and Great Investments are a prestigious client for Green Ratings. In the process she has come to know Wallis well over a few years. When Berry conducts her analysis, she concludes that the fund is on the borderline between a '7' (lower) and an '8' (higher). Deciding to determine the precise rating later she sends a draft over to Wallis for checking with an '8' earmarked in the rating box. Wallis sends an email back with relatively minor comments and attaches the legal documentation for commissioning the rating. Reading this, Berry learns for the first time that the rating is private and is being paid for by Spider Investments, a large institutional investor looking to take a substantial position in the Bluebottle Fund. Wallis' additional feedback is immaterial to the rating, but when Berry double checks the rating score, she spots a miscalculation she made earlier and realises that the Bluebottle fund's rating overall is now definitely more of a '7' than an '8'. However, she is reluctant to change this to a '7' as she does not want to have to explain the reasoning to Wallis and disappoint him. She feels embarrassed about her miscalculation and worries it might damage their relationship and lead him to not use Green Ratings in the future. She does not stop to think that her actions could damage Spider Investments, who may invest in the Bluebottle Fund on the premise it is rated '8' rather than '7' and submits the report to her firm's ratings committee as an '8'. As the rating is private, she concludes that there is little risk that anyone will notice it, though she will obviously need to be available for questions from Spider Investments once they receive her rating.

CFA UK Comment

We think Berry has probably violated CFA Institute's *Standard III(A) Loyalty, Prudence & Care, Standard VI(A) Failure to disclose a Conflict of Interest and Standard I(B) Independence & Objectivity*. She has allowed the commercial interests of her relationship with Wallis and Great Investments to cloud her impartiality and consequently has also overlooked who her actual client is in this transaction i.e. Spider Investments. Wallis had a conflict of interest in 'commissioning' the rating which he either should have declared at the outset or had Spider Investments contact Berry directly and would have been in breach of CFA Institute's *Standard VI(A) Conflicts of Interest.*

Issue 7: Inadequate records of how ESG criteria are applied

Example

Pink, CFA works as an ESG manager for a leading equities global asset manager. As part of her role, she is responsible for compiling ESG assessments as part of the firm's ESG integration process for its global equity strategy. These assessments do not always follow a pre-defined format or formal process, but typically involve the merger of qualitative analysis from external equity research analysts with some quantitative ESG scores and metrics prepared by Pink. The broader investment team uses Pink's reports extensively in all aspects of the management of the fund, which they believe allows them to refer to the fund as "ESG Integrated". Pink diligently conducts this work over the years, and ESG assessments are conducted on each investment taken into fund portfolios. However, when the firm's internal audit asks to see evidence of this, they uncover that much of this work cannot be verified because of the informal nature of Pinks's work and record retention process.

CFA UK Comment

To comply with her responsibilities under CFA Institute's Standard V(C), we think Pink should document and retain the evidence of her ESG assessments. Members and candidates must retain records that substantiate the scope of their research and reasons for their actions or conclusions. We take the view that this record retention requirement applies not only to decisions to buy or sell a security, but also to reviews that do not lead to a change in position. Prominent examples of regulatory actions and fines in this area also indicate the importance that regulators attach to record keeping.

Issue 8: Encouragement and sponsorship of continuous learning

Example

Barden, CFA is the newly appointed Head of Sustainable Equities at Euro Invest who have just rebranded half their funds with Sustainable and ESG labels. He inherits a team of established analysts and portfolio managers. On reviewing their job descriptions and remuneration packages he observes that, whilst his own job description and objectives have been structured to appropriately reflect the firm's product evolution and broader mandate, his teams have not. Although reviewed recently, his team's job descriptions are unchanged and contain Euro Invest's standard appraisal targets, focused solely on the financial performance of funds and no reference to sustainability objectives. Several of his team, aware of and planning for the likely relabelling of the funds, had requested relevant training. However, the appraisals have been signed off as "training to be reviewed in 12 months" and any other training was to be offered "depending on performance".

CFA UK Comment

If Barden does nothing about this situation, we think that he will be in breach of CFA Institute's *Standard IV(C): Responsibilities of Supervisors*, which requires that he promotes all activity (including training) to ensure that employees under his supervision comply with applicable laws,

regulations, and firm policies. Given the re-branding of half of the funds to carry Sustainable or ESG labels it is his responsibility to ensure his staff understand the product change and have been upskilled to deal with it. Clearly Euro Invest and Barden's predecessor in the role did not prepare the team for the product transition. We think Barden should instigate adequate training and education programs to up-skill his team either by internal training or arranging for external training. We also think Barden should consider aligning his team's incentive remuneration structures with the firm's new product offering,

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Issue 9: Misrepresenting technological innovation to manipulate markets

Example

Paris, CFA is a hedge fund trader. She has recently built up a large stock position in a young and fast-growing biofuels company. She was attracted by the company's profile and its claims that their products are environmentally friendly and almost carbon neutral, therefore suggesting that the company has a huge upside potential. However, after speaking later with several industry experts, Paris found out that the products of this company are not as "green" and "sustainable" as they claim, and that eventually environmental regulators will start taking actions against this company to align these claims to real data and facts. Wishing to avoid reporting large losses on her position, Paris decides to start disseminating in the market the notion that this company has recently patented a new novel biofuel mix which will disrupt the market. The stock price of this company goes up and KK sells her stock pocketing a decent gain from her position.

CFA UK Comment

We think that Paris is in likely violation of CFA Institute's *Standard II(B) Market Manipulation*. She misled others into believing false information to profit from the market's reaction to her report. This is also likely to be illegal under local laws such as under the UK Fraud Act and under US laws.

Issue 10: Unintentionally abusing positions in one market to manipulate another market

Example

Benson, CFA works for Huge Hedge Fund ("HHF") and is based in the nation of Offshoria. HHF has accumulated a large set of short positions in the shares of high-emitting industrial companies in the Group of Central Eurasian Nations, which are subject to the CEN Emissions Trading Scheme. Part of the investment thesis is that available carbon emission allowances are currently under-priced. Until the full negative externality of carbon emissions is correctly priced, the market price of carbon emission allowances should shift upwards thus reducing the profit of the companies which have to buy them. To capture the full alpha from their view, Benson also buys carbon emission allowances in the Group of Central Eurasian Nations. The trade is moderately successful and so Benson decides to continue to buy further allowances. As the price of carbon increases, the shares of the high emitting industrial companies start to experience a consequential price decline. Risk management at HHF is poor and it later transpires that HHF has unwittingly

come to own a significant position in carbon allowances, of which they were not aware. On seeing the price spike in the market, and before HHF can close out its positions, The Group of Central Eurasian Nations decide to release reserve emission allowances, thus reducing their market price, and the share prices of the industrial companies then recover.

CFA UK Comment

It is possible that Benson is not in breach of CFA Institute's *Standard II(B) Market Manipulation* as there seems to be no deliberate intent to manipulate either market. Benson was executing transactions in two different markets in line with their hedge fund's views. However, both the industrial company share prices, and the carbon emission allowances have clearly been impacted by their market activity and potentially the market in carbon emission allowances may have been cornered inadvertently. Benson needs to check with the Compliance and Legal teams as to whether 'intent' is required for there to be market manipulation in both Offshoria as well as the markets in which i) the companies' shares and ii) the emissions allowances are traded. Although HHF did not realise a profit from this set of transactions, this may not preclude market manipulation from having potentially taken place in the eyes of one of these regulators. In this case, Benson may have breached CFA Institute's *Standard I(A) Knowledge of the Law* as they should have been aware of the definition of market manipulation in the markets in which they were actively trading.

Issue 11: Failure to research the differences in regulations between two countries

Example

Singh, CFA is advising Tacto, a major industrial conglomerate based in Country A. As a major manufacturer of industrial goods, Tacto has significant scope-2 emissions from using electric power generated from fossil fuels. Tato has recently made serious commitments to reduce its GHG scope-1 and -2 emissions throughout its global operations. As one measure to meet these commitments, Tacto plans to purchase RECs from renewable power generators in Country A, where most of its manufacturing is concentrated. Additionally, Tacto is planning an M&A transaction to acquire a smaller industrial company based in Country B. The M&A target currently uses fossil-powered electricity, and Singh advises Tacto that it can purchase RECs from a local solar plant in Country B. This plant, however, is not connected to the grid, and as such, is a captive producer. Whilst RECs from captive producers may be used in Country A, Country B's regulations do not allow it, requiring that RECs should come from a renewable power producer connected to a grid.

CFA UK Comment

We think that Singh, CFA has failed to adequately research the regulations of Country B and assumed that they are the same as those of his home market in Country A. Singh has therefore provided poor advice to his client, and we believe he is likely in violation of CFA Institute's *Standard V(A) Diligence and Reasonable Basis.*

Issue 12: Conducting proper ESG due diligence

Example

Mitchell, CFA, is a project finance manager working at a commercial bank which is focusing on developing new projects in Southeast Asia. His team is currently evaluating a large mining project in the Philippines which is expected to significantly boost the profile of Mitchell's bank in project finance in the region and help his performance and career. The team still needs to complete several due diligence workstreams, including getting the full mapping of the labour sourcing and supply chain. Mitchell feels confident the workstreams, when completed, will show the project passes the due diligence supply chain tests. One of the suppliers has been slow to provide information on their labour sourcing, citing difficulty in completing paperwork. Mitchell has felt under pressure as his bank recently announced restructuring plans which may reduce headcount in his department. He is then worried about being fired for not generating sufficient new business.

CFA UK Comment

Given his involvement in a transaction in a sector with high environmental and social risks, we think Mitchell should complete the appropriate due diligence processes with his team. This may involve hiring external consultants to ensure specialist expertise is used where necessary and any red flag identified with relevant consideration for risk mitigation / management. We believe this would help Mitchell to be compliant with CFA Institute's *Standard V(A) Diligence and Reasonable Basis*. Until the due diligence is completed, Mitchell should not rush to commit the bank to the transaction.