Cases on Ethics in Sustainable Investments

CORPORATE ISSUERS

CFA Society United Kingdom

Corporate issuers around the globe and across all industries are adapting their strategy and business model to more sustainable pathways. They may be seeking out revenue streams from new products better designed to reduce their clients' emissions, they may be reducing their own exposure to climate change transition risks, or they may be adapting their product range to better address more diverse demographics in their target customer base. At the same time investors are looking for evidence of these developments in corporate disclosures.

Deciding what ESG-related data to publish, and how to communicate it in a clear and compliant manner, is a critical component in the sustainable investment chain. It involves several different role types within corporates, from the Chief Executive Officer and Chief Sustainability Officer to the Board and through to analysts in the corporate's finance, risk, and treasury functions.

1) Sustainability Context:

There is societal, political, and financial market pressure on corporates to present as green or sustainable an image as possible. The same is of course true of projecting financial strength or soundness, but there is a well-established reporting infrastructure for financial disclosures and most important disclosures are audited. These rules, standards and established practices serve to provide guardrails within which corporates must work.

For sustainability reporting, however, corporates currently face less in the way of specific rules or standards. There is a lack of agreed definitions that in turn can easily lead to investors making inaccurate comparisons or conclusions. As ESG data is new and evolving in nature, external stakeholders' understanding of a corporate's disclosures can be shallow and more easily manipulated. More data is not necessarily better data, either. Corporates can tell a positive story on lots of meaningless data and gloss over problem areas and avoid negative sustainability narratives.

Charter holders employed within corporates have a duty to fairly present their company's sustainability performance to investors and analysts. This means exercising rigour in researching new data, diligently ensuring its relevance to the company's sustainability narrative, and ascribing the right level of importance to it. In the long run, the equities, bonds and other financial instruments of those companies presenting a fair and accurate picture of their sustainability should have a far more stable market profile than those that seek to flatter and deceive.

A company can misrepresent its greenness not only in its non-financial disclosures to its investors but also in its general corporate communications and in its product and brand advertisements. Such statements can back-fire and corporate reputations come under pressure if their claims are scrutinised and found to be misleading. Equally there are growing instances of "green hushing" where companies refrain from making valid ESG related claims, as they fear the risk of regulatory scrutiny or legal challenge is not worth the positive impact.

2) Key CFA Institute standards relevant to corporate issuer roles:

CFA INSTITUTE STANDARD	RELEVANT ISSUE
I(C) MISREPRESENTATION	Companies are keen to promote their sustainable strategies to win positive publicity both in the investment community and in their marketplace for their products. While the rules around corporate financial disclosures have been developed over many years, sustainability disclosures are evolving and will continue to do so. There are several emerging standards on what must be disclosed, for example SASB standards, IFRS S1 and S2, CSRD in Europe, CCDR and SDR in the UK, and SEC requirements in the US. Companies can elect to over-promote positive sustainability information whilst down-playing or staying silent on negative sustainability data.
II(B) MARKET MANIPULATION	Taken to extremes, false statements around green credentials by corporates at times of bond, equity, or IPO issuance amount to market manipulation.
V(A) DILIGENCE & REASONABLE BASIS	Just as buy- and sell-side analysts have an obligation to thoroughly research and analyse data before commenting or opining on it, so too should analysts employed at corporates that are preparing the data. As the publication of ESG-related data is a new and rapidly evolving field, the range of metrics and methodologies is broad and not necessarily consistent, and data often does not need to be verified or audited, it is easier for confusing or false pictures to be advertently or inadvertently presented.

APPLICATION OF THE CFA INSTITUTE STANDARDS (9 cases)

Issue 1: Exploiting inadequacies in scope-3 data collection

Example

Srikanth, CFA works on the capital markets team within the treasury of TB Bank, a mid-sized retail and commercial bank. He is leading the project to issue TB Bank's inaugural Sustainability Linked Bond. As with most banks, over 80% of TB Bank's emissions relate to its loan exposures to borrowers and are classified as scope-3, rather than scope-1 or scope-2. Because of this dominance of scope-3 data in TB Bank's emissions profile, Srikanth knows that the SLB will not raise much investor interest (and therefore attract a "green premium" to their normal bonds) if only scope-1 and scope-2 data is disclosed in the issuance materials. Srikanth reviews the bank's historic and current emissions data and is unsurprised to find that the scope-3 data contains some significant gaps for large sectors of the loan portfolio. Knowing that scope-3 figures are notoriously unreliable he cherry-picks favourable proxy data from several peer banks to in-fill the scope-3 data gaps. The verification agent fails to robustly query the methodology behind the proxy data. TB Bank's SLB is welcomed by the market and achieves a premium of 10bps compared to TB Bank's normal bond curve. Srikanth is congratulated by TB Bank's Treasurer for the successful debut issuance.

CFA UK Comment

Srikanth is likely to have violated *CFA Institute's Standard I(C) Misrepresentation* and improperly encouraged investors to buy TB Bank's debut SLB issue at an inflated price, potentially also breaching *CFA Institute's Standard II(B) Market Manipulation* in the process. The use of proxy data to some extent to fill gaps in scope-3 data is unavoidable but it is probably not accurate to have cherry-picked the data from different peer banks for different sectors unless there was a strong underlying rationale. The selection rationale appears to have been to choose the most favourable proxy data; TB Bank's disclosure of the basis on which the proxy data was chosen is inadequate and has contributed to the verification agent's failure to query the basis of the data. Whether a company is required to report scope-3 data depends on the countries where it operates and the company type (by size and revenue), for example required in the EU, in the process of being adopted by the UK and excluded in the US SEC climate-related disclosure final rules.

Issue 2: Performance reporting and inclusion of one off items

Example

Pearson, CFA works for ABC Plc, a listed company in the nation of Ultramania. Pearson is Head of Sustainability and responsible for all sustainability related corporate reporting, including disclosure of the firm's Scope 1,2,3 emissions. Pearson's remuneration KPIs are significantly related to the firm's carbon intensity per unit of revenue, and its consistency in reduction has contributed to sell-side analysts giving the firm a consistently high 'E'-score for their performance on environment. When assessing the latest annual carbon intensity numbers to be published in the firms' annual report, Pearson notices that the carbon intensity per unit of revenue is materially up this year compared to last year. Pearson decides to make some adjustments to the carbon intensity figures to account differently for one-off items this year which she believes have artificially inflated the numbers. Pearson is very aware of how important the trend in the carbon intensity number is, both for her own personal KPIs, and to sell-side analysts' valuations and opinions of ABC. The annual report is published with no disclosures around how the carbon intensity number has been adjusted for one-off items nor any footnotes to indicate it is an adjusted number. There is no regulation or policy covering adjustments to ESG disclosures in the nation of Ultramania. The report shows a continued downward trend in carbon intensity, and Pearson is praised by the ABC board for her good work which is factored into her variable remuneration for the year.

CFA UK Comment

Pearson is likely in violation of *CFA Institute's Standard I(C) Misrepresentation*. In adjusting ABC's emissions numbers without full disclosure, Pearson is giving the impression to stakeholders that ABC's emissions performance continues to improve. The full figures should be disclosed in the corporate reporting, with the appropriate footnotes to discuss any adjustments made to the figures to aid comparability.

Issue 3: Misrepresentation of ESG ratings to potential buyers

Example

Fleur, CFA oversees investor relations for her company Renew Energy Ltd. Before a scheduled major investor meeting, she performs background checks on the potential investors attending and finds that, unsurprisingly, a majority of these potential investors have a heavy ESG focus. Hence, Fleur decides to hire an ESG rating agency to assess Renew Energy's business and anticipates a good ESG rating to boost the company's share price. However, the overall ESG rating is only 5 on a scale of 1-10 due to a very low '2' rating on Governance dragging down high '8' and '9' scores for Environment and Social, respectively. Fleur believes the Governance assessment is unfair and so contacts a second ESG rating agency for their ESG rating of Renew Energy. This second ESG rating is also a mid-range score, due to both Social and Governance mid-range scores. Selectively lifting criteria from the two ESG agency rating reports, Fleur presents Renew Energy's ESG rating as 'High' overall, using and averaging the high Environmental and Social scores from the first agency and the middle Governance score from the second agency.

CFA UK Comment

To promote her company with new potential investors at an investor meeting, Fleur cherry-picks the most favourable assessments and omits the least favourable assessments from the two different reports and combines them to create a misleading impression of the company. This appears to be a breach of *CFA Institute's Standard I(C) Misrepresentation*. If Fleur is going to proceed with any disclosure of these ratings, then as a minimum, Fleur should disclose the different ESG rating agency sources when presenting the breakdown of Renew Energy's ESG scores and acknowledge that the agencies had different scores and disclose their respective full scores.

Issue 4: Making exaggerated ESG claims in corporate advertising

Example

Bell, CFA is the Chief Sustainability Officer at Big Oil, a multi-national oil company. Responding to the direction from his board to help create a more sustainability friendly public image he, together with Big Oil's marketing department, designs and approves a new marketing campaign for Big Oil, with billboard logos stating: "The Future of Energy? Big Oil is now significantly scaling up its bio-waste business to fuel a sustainable energy future". Big Oil has tripled its capital investment into bio-waste plants this year, but it still only represents 2% of its total sales. Investment into traditional fossil fuel projects has declined in the same period but still accounts for over 85% of Big Oil's total capital investment. Big Oil's oil production continues to increase year on year. A journalist from a leading newspaper highlights the duplicity of the company's claims, suggesting they may constitute greenwashing.

CFA UK Comment

In approving the advertising campaign, Bell may have breached *CFA Institute's Standard I(C) Misrepresentation*, even if the campaign is legal under advertising standards. The advertising campaign could be misinterpreted to read that Big Oil is pursuing a "sustainable energy future", whereas, in fact, the company is increasing oil production, which dominates its business. It may have been more accurate to state that Big Oil is "increasingly investing in lower carbon energy solutions". By making exaggerated claims based on a small part of its business, Bell has attracted the interest of a journalist trying to expose corporate greenwashing practices. As a result, the advertising campaign may do more damage than good to Big Oil's reputation and sustainability credentials, as well as risk fines (e.g. up to 10% turnover proposed under UK Digital Markets, Competition and Consumers Bill, and up to 4% turnover proposed under the European Green Directive)

Issue 5: Restating historic public disclosures in line with new rules

Example

Zanders, CFA works for a publicly listed company and is preparing their semi-annual sustainability report for the company's stakeholders and investors. Her company's board recently decided to change its rules for measuring its performance towards meeting its climate goals. Starting this year, off-setting carbon credits from renewable energy projects (typically purchased from external parties to offset their own carbon emissions) are no longer to be considered as valid offsets and included in the company's published GHG emissions figures. However, Zanders discovers that several of the company's regional offices have continued to buy carbon credits from third-party renewable energy projects as they were not properly notified of the revised rules.

CFA UK Comment

Despite the ongoing purchases of carbon credits by some regional offices, Zanders should not continue using the same calculation methodology from previous years. If she does not revise her methodology in line with the company's new rules, she may be in violation of *CFA Institute's Standard I(C) Misrepresentation*. Ideally, she would calculate the company's performance under both the old and the new carbon accounting recognition criteria and show the difference. Her report should also explain the company's motivation in switching its recognition criteria. A failure to do this would obscure her company's real performance against its stated aim of limiting its contribution to global warming and meeting the goals of the Paris Agreement. It may also make peer comparison analysis between companies in its sector misleading. The International Financial Reporting Standards (IFRS) International Sustainability Standard Board (ISSB)'s sustainability reporting standards also require disclosure of the old criteria, the new criteria, and the difference. The UK plans to broadly adopt these standards, after a period of consultation.

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Issue 6: Misleading disclosures in IPO documentation

Example

Previn, CFA is the CEO of the company S-Tech, which manufactures hydrogen-electric and battery-electric heavy-duty commercial trucks and energy infrastructure solutions. It claims to have developed a functional zero-emission hydrogen electric truck and posted a video showing a hydrogen electric truck driving down a level road at speed. It also claims a high-density battery and hydrogen production capability. This leads most analysts and investors to believe that the technology is proprietary, highly advanced, and ready for widespread rollout across customers. The company subsequently lists on a U.S. exchange, following a reverse merger with a Special Purpose Acquisition Company (SPAC) and achieves an 'ESG premium.' A few months after listing, through some investigative journalism, it is alleged that S-Tech's technology is not what the company led the investment community to believe. For example, in its video the company towed a motorless truck up the hill and rolled it in neutral down a 3% grade. The SEC opens an investigation and multiple investors and the investment bank open lawsuits against S-Tech and Previn.

CFA UK Comment

We think that Previn, CFA is in breach of *CFA Institute's Standard II(B) Market Manipulation (information-based)*. If what is alleged turns out to be accurate, Previn disseminated false and misleading information surrounding the company's technology, and its advancement and readiness for rollout. This could be considered to have contributed to the company achieving an ESG premium' upon listing and distorted the price setting mechanisms in the market. Further, if it is confirmed that the company committed fraud by giving a significantly misleading impression of the advancement and readiness of their technology, Previn and others involved in the company risk fines and imprisonment.

Issue 7: Making recommendations based on vague and ambiguous sustainability claims

Example

Dunn, Investor Relations Officer at Big Oil, a multinational oil company, is holding an investor update meeting. During the presentation, she states: "Big Oil is committed to achieve net zero in its operations by 2050". This is the first time that Big Oil has made a public pronouncement of this strategic goal. Schulz, CFA, an analyst at Wella Pensionsfond, attends the presentation and immediately sends an email to his portfolio manager to buy Big Oil as this claim breaks new ground and he believes it will improve the outlook for Big Oil shares.

CFA UK Comment

Dunn's statement was grandiose and aiming to support and redefine Big Oil's sustainability credentials. However, it was also ambiguous and insufficiently qualified with necessary details. We think that Schulz, CFA, may have breached *CFA Institute's Standard V(A) Diligence & Reasonable Basis* as a result. Whilst the initiation of a net-zero target for the first time may be in and of itself sufficient to support a change of recommendation on Big Oil's stock, Schulz should really go further and properly interrogate the added information. Without for example i) ascertaining whether scope-3 emissions are included in the target (these probably represent a dominant share of Big Oil's emissions) and ii) clarifying whether "operations" in this statement referred only to the majority-owned domestic subsidiaries and not to any overseas, JV or minority-owned projects, he neglects to obtain important further definition behind his net-zero claim. He also fails to establish any detail regarding the key emissions reduction target milestones on the route to reach net zero-2050. Any immediate positive share price reaction to the initial news could quickly be reversed depending on the answers to these subsequent questions. Also note the possibility of regulatory breaches, for example the UK anti-greenwashing rule requires that claims be correct and capable of being substantiated, while the EU Green Claims Directive requires companies to substantiate claims about environmental aspects or performance using robust, science based and verifiable methods.

Issue 8: Providing material non-public information (MNPI) and publishing a recommendation

Example

Cowell is the Finance Director of Rotate Inc., an S&P 500-listed wind-farm operator. Reading the pack for his board meeting next week he finds a very recent study from their engineering department which warns that the rotor blades in the oldest offshore turbines are deteriorating more quickly than anticipated, rendering the company's accounting assumptions for the asset lives of its turbines overly optimistic and making an impairment likely. To prepare for the board meeting and to determine the impact this might have on Rotate's stock price Cowell calls Rotate's broker's sell-side analyst, Davidson, CFA and asks how the stock might react to the announcement of an accounting impairment of c.EUR100 million, without saying why. Davidson responds that it would depend on the reason for the impairment and Cowell says he would rather not conflict Davidson and so ends the conversation. Davidson returns to his work continuing to read an article in a science research journal on the long-term impact of salt spray on galvanised steel joints in first-generation offshore wind turbines which is written by Edwards, a former university research colleague and friend of his. He calls Edwards who excitedly discusses his findings and the importance of an additional protective nickel coating now routinely applied in newer installations. He concludes that Rotate and several other companies are bound to be affected. Davidson rushes out a SELL note on Rotate and four other wind-farm stocks with significant old off-shore portfolios, citing the research article and urging investors to underweight the stocks.

CFA UK Comment

It is likely that Davidson received sufficiently material NPI on his call with Cowell even though Cowell did not provide a reason for his question. Cowell should have indicated the information (even though incomplete) was MNPI. Similarly, Davidson should have confirmed with Cowell if the information was public or not, during or after the conversation, and the conversation recorded or internally logged. As a minimum thereafter, Davidson should have discussed the situation with his compliance officer and/or manager and showed them the research article. We think that both Cowell by way of disclosing MNPI and Davidson by way of publishing the SELL recommendation would be in breach of *CFA Institute's Standard II(A) Material & Non-Public Information*. In the event Davidson had received the go ahead from his compliance team by the time he has spoken to Edwards, Davidson's further conversation and research appear to be okay under mosaic theory and given that the research note was released publicly prior to any trading, no subsequent breach is indicated. Note that this assumes the call with Edwards was not an example of an analyst using an industry expert to obtain MNPI.

Issue 9: ESG criteria regarding corporate employment practices and policies

Example

Stuart, CFA, is Head of Medium-term Funding in the treasury department of MedBank and reports to MedBank's Treasurer, Jane Short, CFA. MedBank is considering issuing an ESG-linked Schuldschein*, with a tight deadline. One of the key ESG objectives is to promote diversity and inclusion opportunities as part of the issuance. One specific KPI is the increasing the share of women in the top management layer from 10% to 25% within the next 5 years. Amongst other tasks, Stuart decides to review the company's internal human resource policies to make sure they are aligned with this social objective. After a protracted period, during which he is distracted by other matters, he realises that the bank has no formally documented Diversity, Equity, and Inclusion (DEI) policy. Given the time he has taken to complete his policies review, however, Stuart realises that he can no longer address this issue and meet the target issuance deadline.

Under pressure from Short about the delay to the issuance and with market conditions threatening to become more volatile, Stuart softens the prospectus wording relating to MedBank's human resource policies and quickly approves the ESG-linked Schuldschein issuance.
**A type of private placement debt instrument used in Germany, usually with fewer legal requirements*

CFA UK Comment

Stuart's review of MedBank's human resource policies clearly highlighted the need for the inclusion of a formally documented DEI policy. We think Stuart is likely to be in violation of *CFA Institute's Standard V(A) Diligence & Reasonable Basis* as he did not complete the task with sufficient diligence and competence and, as a result, it is unlikely that the new Schuldscein is in full compliance with social bond issuance standards. Stuart should have explained the situation Short and sought a delay to the Social Schuldschein issuance until MedBank had an approved DEI policy in place. By allowing the issuance to proceed, Short may also have been in breach of *CFA Institute's Standard IV(C) Supervision* as she should have been monitoring Stuart's progress in meeting the various pre-conditions for the Social Schuldschein issuance.