Cases on Ethics in Sustainable Investments

SELL SIDE ANALYSTS

CFA Society
United Kingdom

SELL-SIDE ANALYSTS

Sell-side analysts may now need to collect, handle and process ESG data as part of their role or be able to understand and incorporate the conclusions of ESG analyst colleagues in their recommendations. Some clients will place great value on their ESG conclusions and knowledge, and others will place less or no importance on it. ESG data currently has limited influence on short-term market price movements but increasingly sell-side analysts handling ESG data will need to consider whether it is MNPI before disseminating more widely.

1) Sustainability Context:

ESG data is often qualitative and therefore may be disputed, partial or interpreted differently. In such situations, sell-side analysts need to be clear in their reports how much of their recommendations are based on opinion or interpretation, and not fact.

Personal and commercial bias can also enter their investment recommendations and invalidate them if adequate steps are not taken to retain both independence and objectivity. The evolving nature of ESG data could allow analysts to more easily 'fit the data to the story' and make a commercially or personally preferred, rather than appropriate recommendation. Firms should embrace peer review and other oversight practices to minimise these risks.

Sell-side analysts must interrogate ESG data just like all other data inputs into investment decisions. This means not taking data at face value, identifying the source, and taking a view on its reliability even when it comes from an in-house ESG expert. It also means looking at whether certain data fits with other inputs and actively searching for relevant data and opinions that present an opposing view.

2) Key CFA Institute standards relevant to institutional marketing roles:

CFA INSTITUTE STANDARD	RELEVANT ISSUE
I(B) INDEPENDENCE & OBJECTIVITY	Sell-side analysts can face commercial pressures from multiple directions: the corporate they are covering, sales staff, corporate finance staff and investor clients. The qualitative nature of much ESG data means that the risk of succumbing to outside influences and losing independence and objectivity is perhaps even greater.

II (A) MATERIAL NON-PUBLIC INFORMATION	As sustainability related information is becoming increasingly relevant and material for capital markets participants, the risks are increasing of it being MNPI. Whilst a change in a company's credit rating is recognised as MNPI, currently markets do not view a change in an ESG rating in the same way – but with many funds increasingly lined up to follow ESG indices and regulation progressing, this may not long continue to be the case.
V (A) DILIGENCE & REASONABLE BASIS	Much sustainability related information is currently vague, incomplete, disputed, or wrong. Analysts need to be careful to establish the veracity of the sources and the quality of any sustainability related data before they use it in their recommendations.

APPLICATION OF THE CFA INSTITUTE STANDARDS (9 cases)

Issue 1: Fair treatment of ESG-interested clients and other clients

Example

Mikelsen, CFA is a sell-side research analyst at Mifidia brokers covering the consumer goods sector. Through her own research she discovers some local press articles about one of their coverage companies, Unscrupulous Plc, highlighting widespread human rights abuses in their supply chain, including slave labour and the trafficking of underage workers. The articles include a quote from the local regulator indicating that Unscrupulous Plc could be subject to a material fine and is being investigated. Mikelsen proceeds to do more due diligence and discovers that initial paperwork has been filed by the local regulator on this matter, thus confirming to Mikelsen that this is not rumour or gossip. Mikelsen writes an update note on this discovery for clients with analysis around the possible size of a potential fine; she revises her ESG assessment of the company from AAA down to BB but leaves her investment recommendation as a Buy. Mikelsen has two distribution lists for clients, a general distribution list, and an ESG-focused distribution list for those clients with an interest in big picture ESG topics. Mikelsen decides to send the update note to only the ESG-focused distribution list since this is a big picture ESG topic and she has made no change to the investment recommendation, retaining this as a Buy.

CFA UK Comment

We believe that Mikelsen is in breach of CFA Institute's *Standard III(B) Fair Dealing*. Standard III(B) requires members and candidates to treat all clients fairly when disseminating investment recommendations or making material changes to prior investment recommendations or when taking investment action. We think that Mikelsen should disseminate this change in rating to the full distribution list, recognising that this discovery and the change in ESG rating could be of material importance to the general distribution list, irrespective of whether the non-ESG investment recommendation has changed.

Issue 2: Applying the mosaic theory to ESG analysis

Example

Simons, CFA is a sell-side research analyst in the energy industry analysing companies which have an advanced climate change strategy. He is intending to initiate recommendations on these stocks. He is meeting with the CEO of NorthStar Energy Co. Ltd., a fast-rising listed power generation company, which claims to be at the forefront of the sector's decarbonisation activities. The CEO admits to Sam that despite the company's bold general statements, decarbonising a small fraction of their operations may be more challenging than for some of its closest competitors. After the meeting, Simons conducts a detailed analysis and comparison with NorthStar Energy's sector peers and concludes that the measures to target net-zero so far announced by NorthStar Energy are less impressive than those of its major competitors. Therefore, Simons issues a report suggesting that the company will underperform the sector in reaching sustainability goals and disseminates the report to his clients.

CFA UK Comment

We believe that Simons arrived at his conclusions by piecing together both public and non-material non-public information that could affect NorthStar Energy Co. Ltd. Therefore, under the mosaic theory, Sam has not violated CFA Institute's *Standard II(A) Material Non-Public Information* in disseminating his note. The statement comes from the CEO but is sufficiently vague (he uses the word "may"), lacks detail and pertains to "a small fraction" of their operations for it be considered material. Moreover, Simons could find sufficient detailed, specific information on NorthStar Energy and its peers in the public domain to substantiate this view.

Issue 3: Maintaining ESG research independence

Example

Doridoff, CFA is the Head of Research at a well-known investment bank. The bank's Technology team have been vocal supporters of a European manufacturer selling a technology seeking to reduce GHG emissions from shipping vessels. As a result of one of her team's onsite research visits, she starts to suspect that the company may be significantly overstating the GHG emission reductions achieved outside of laboratory conditions once the equipment is installed on ships, possibly to the extent that these ships might no longer comply with current emissions regulations. If true, this news would negatively impact the company, its reputation and its 1-3 year sales targets. When Doridoff calls the company's management for an update they remain extremely enthusiastic about their prospects. They are positive about the sales outlook and very dismissive of any suggestion that the product is ineffective in the real world and of any potential litigation.

Digging deeper, Doridoff discovers a recent scientific research paper, throwing further doubt on the efficacy of the technology assessed in a real world setting. Doridoff reads these papers and decides to seek out expert advice. She next receives a call from the Head of Global Sales, who has a good relationship with one of the company's board directors, asking her how her team's research is coming along.

CFA UK Comment

We think that Doridoff needs to finish her research and her outreach to technical expert advice. Doridoff should also consult her company's policies and compliance before entering any in-depth talks with the Head of Global Sales. Such conversations may be a breach of internal information barriers around research and the Head of Global Sales would seem to have a potential conflict of interest. If Doridoff's research concludes that the company's claims are questionable, Doridoff should be prepared to ignore any pressure from the Head of Sales not to publish her conclusions.

Issue 4: Misrepresenting valuation of environmental technology

Example

Vorhol, CFA, is an equity analyst at Urban Capital (UC), an investment bank. Sitting on the sell-side of the bank, Vorhol specializes in nature-based solutions to address climate change and is updating his valuation of Iron Inc., a major steel manufacturer. Iron has recently announced a JV with Smart Trees Inc, with the purpose of planting trees to produce CO2 credits which Iron can then use to offset its Scope 1 emissions (i.e., emissions caused primarily in the steel manufacturing process). Smart Trees is a little known private company claiming groundbreaking tree planting technology, but with only a short-lived commercial track record. Public announcements show that the JV intends to invest $50million and will be established on a 50/50 equity basis by both partners, whereby Iron contributes all capital investment and Smart Trees its tree planting intellectual property. While discussing the case with his manager, Vorhol finds out that Smart Trees was recently founded by his manager's old friend. Smart Trees' tree-planting technology could be promising, but UC's IP lawyers have yet to complete their valuation assessment. The IP valuation is a requirement of the bank's procedures, but Vorhol's manager insists they should not wait for the lawyers to complete it and asks Vorhol to state in his report that the IP valuation was confirmed and Smart Trees' contribution to the JV done at fair market value. Concerned about possible repercussions from his manager, Vorhol issues a positive recommendation on Iron, stating that Smart Trees' IP contribution was made at fair market value, as supported by IP lawyers.

CFA UK Comment

We think that Vorhol is likely in violation of CFA Institute's Standard *I(C) Misrepresentation*, as he knowingly stated false information about the valuation of Smart Trees' tree planting technology, thus potentially manipulating a higher valuation for Iron. Vorhol's manager pressured his employee to state false information about the target's partner, thus also violating the same standard. Vorhol should have reported the situation to UC's compliance function and sought to disassociate himself from the valuation of Iron.

Issue 5: Handling material ESG non-public information

Example

Dr.Samuels , CFA is a sell-side analyst covering the water and wastewater sector. He has recently visited a sewage plant to discuss and assess the parallel production of a sustainable fertiliser. This fertiliser has been in the market for years, but it has been difficult to verify the veracity of its sustainability claims. In discussions with local environmental activists, they showed Dr.Samuels how they had been able to access meta data records proving the fertiliser had serious carcinogenic components. They also told him that several local environmental associations were about to launch a class action lawsuit against the company that owns the waste treatment centre and produces the fertiliser. Dr.Samuels had suspected that the fertiliser had side effects but had unearthed no hard evidence to date. He concluded the meta data and threat of pending lawsuits were the final pieces in his research jigsaw and so he decides to quickly write up the issue and discuss the matter with his clients before the environmental groups launch their class action lawsuits.

CFA UK Comment

Although Dr.Samuels believes he can claim that the mosaic theory can cover him, we think that the information concerning lawsuits is MNPI, as the outcome may be substantial in terms of both money and reputation. Its materiality is linked to its role in making a previously presumed possible reputational risk and potential product liability case much more certain. The information is both non-public and material. As a result, we think Dr.Samuels will violate CFA Institute's *Standard II(A) Material Non-public Information* if he publishes his report or discusses this with his clients before the legal action is launched. We think he should instead prepare a research note and seek compliance clearance to launch the report and discuss it with his clients as soon as the information becomes public.

Issue 6: Updating a client mandate for ESG preferences

Example

Ravi, CFA has family office clients for whom he manages discretionary portfolios based on long-standing founding family trust guidance. In recent years many of his clients have increasingly discussed their attitude to sustainable and responsible issues reflecting the changing attitude of the trust beneficiaries. He decides to reflect these discussions at review meetings in how he manages the portfolios even though the conversations have not been defined in a formal mandate change. He is confident that his clients will be happy with this and indeed at their quarterly meetings they are full of enthusiasm for the new direction.

CFA UK Comment

We think that Ravi should document and keep records of the client changes to their investment mandates to fulfil his responsibilities under CFA Institute's Standard *V(C) Record Retention*. Although he may be recording and documenting individual investment decisions within the portfolio he manages, he has not formally documented a change to the family office IPS. He needs to document the change in the governing mandate with the family office to ensure both that (i) the change is legal within the foundation or trust documentation and (ii) he can demonstrate that his clients have understood the change to the investment process and any material changes to outcomes that may result from it. A clear agreement is required when a 'Sustainability' element is added to a client's mandate to ensure the client has understood and agreed the adjustment to their IPS.

Issue 7: Failure of ESG analyst to maintain independence and objectivity

Example

Johnson, CFA is an ESG Analyst covering energy and utility stocks within the sell-side research department of an investment bank. Johnson attends a meeting with Kyle, an ESG analyst at the market leading ESG ratings provider, Ecoratings, who is also an old friend from university. Kyle updates Johnson on a revised ratings methodology just announced by Ecoratings. The revised methodology rebalances the weightings of E,S & G factors within their scoring system, increasing the weighting of certain 'E' factors at the expense of some 'S' & 'G' factors. After the meeting and some further analysis and research, Johnson deduces that Ecoratings' new methodology will lead to several rating downgrades of stocks in his sectors. Johnson initially intends to publish a research note right away but then he learns that one of the bank's traders, Larson, CFA is heavily long of three stocks likely to be downgraded by Ecoratings; one of the companies is also a client of the corporate finance department and he sees no benefit in making himself unpopular with colleagues there. He decides not to publish the research note and continues with his existing buy-recommendations on the stocks until Larson, CFA sells down the long positions over the next few days.

CFA UK Comment

We think Kyle has not given Johnson material non-public information and Johnson has applied mosaic theory through further research and analysis to conclude likely future selloffs in several utility and energy stocks. However, by not changing his existing buy recommendations, because of the banks' long positions and corporate relationships, we think Johnson has breached CFA Institute's *Standard I(C) Misrepresentation*. By continuing with his existing buy- recommendations he has misrepresented his true opinion of several stocks he covers.

Issue 8: Cross selling ESG analysis without proper disclosure and compliance

Example

Tone, CFA, is working at Newvision Investment Advisory Ltd as a senior manager. He has recently received requests from several clients to add an ESG analysis section to their quarterly investment review. Tone thinks this would be a great opportunity to cross-sell Newvision's new SaaS ESG ratings product for clients to monitor their ESG exposure and the ESG ratings of their portfolio holdings. Tone next arranges client meetings and runs through this new software. However, most clients say they only need the ESG report with their portfolio rating added to their quarterly report, i.e. only partial outputs from the new product. These clients say that they would pay additional compensation for this additional service if these ESG ratings could be added to the report. Since Tone is remunerated on a percentage of his fee generation this is an attractive enough outcome for him as he sees the clients would not pay for the full SaaS service. To allow other Newvision employees to promote this new ratings software in front of clients, any of them can access the platform to present and demonstrate the software to potential clients. Given the clients had asked for ESG analysis and agreed to paying for this additional service, Tone decides to personally add the product's ESG rating result directly to the relevant clients' investment quarterly reports, without informing his employer. Tone receives the additional fee income brought by the ESG section in the report but attributes it to his negotiating a higher fee rate based on his excellent service and client satisfaction.

CFA UK Comment

As the new software was developed by Tone whilst working at Newvision, Newvision is the owner of the new ratings product. As an employee, Tone owes loyalty to his employer, and we think he should not unilaterally make an unauthorised sale of a new service that the firm has not yet officially offered to its clients. We think that this is therefore likely a breach of CFA Institute's *Standard IV(A) Loyalty*. To avoid a breach of this standard, we think that Tone must work with Newvision to approve new products and services for Newvision clients.

Issue 9: Due diligence for green bond investments

Example

GreenEthica, a boutique investment firm specializing in ESG portfolios, recently recommended a corporate bond issued by GreenFlow Corporation to its clients. The bond was labelled as a "green bond" and certified by a third-party green rating agency. GreenEthica's investment committee based its recommendation on this certification without conducting additional due diligence on the proposed use of proceeds, underlying renewable energy project and the issuer's overall sustainability practices. Several months after the bond was included in ESG-focused portfolios, it was revealed that GreenFlow Corporation had ongoing environmental violations related to its core operations, which contributed to significant carbon emissions and deforestation. The area included the site where the renewable energy project was located. Despite the bond funding a renewable energy project, the impact of the core operations and broader environmental concerns were not considered.

CFA UK Comment

Standard V(A) of the CFA Institute Code of Ethics and Standards of Professional Conduct requires members and candidates to exercise diligence, independence, and thoroughness in analysing investments, making recommendations, and taking investment actions. GreenEthica relied solely on a green bond certification from a third-party agency without conducting its own assessment of the proposed project and the environmental practices of GreenFlow Corporation and therefore failed to form a reasonable basis for its recommendation, especially as the issuer was involved in harmful environmental activities that directly contradicted the ESG focus of the firm's clients. GreenEthica should implement an independent analysis process to align the firm’s practices with both Standard V(A) and Standard III(A), ensuring that the investments recommended meet the sustainability expectations of their clients.

In 2019, a study of over 70 green bonds found that about 15% of them failed to meet basic ESG criteria, despite being marketed as green bonds. While the voluntary EU standard for green bonds (considered the global benchmark) allows for third-party certification, the EU has also added a requirement to show how green bond investments feed into the transition plans of the company as a whole and for the company to be engaging in a general green transition.