

## **Solutions to the Lack of Taxonomy and Policing for Responsible Investment Products**



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The growth of investment products pursuing of environmental, social and governance (ESG) objectives is well documented, and it is estimated that funds with an ESG component now amount to approximately one quarter of assets managed globally, with it being a leading consideration for young investors, who are themselves a growing market. It is an exciting and varied market, and the broad class spans dedicated vehicles putting principles before profits through to more traditional investment strategies adding ESG overlays.

However, the industry sits in a precarious stage in its development, where there is no immediate differentiation between types of approach to the pursuit of ESG objectives. This is understandable given the wide range of approaches available to the question of ESG investment, from negative screening (such as norm-based exclusion), ESG integration, positive screening (best-in-class), engagement (also called shareholder activism), thematic investing (investing in environmental or social projects/sectors) and impact investing (where investors are ready to sacrifice part of their financial performance as societal impact is more important for them). Added to which, not only do ESG products often combine several of these techniques, but they can also mean different things to different people; the subjectivity is a challenge.

The lack of any official taxonomy has created the risk of exploitation by promoters of investment vehicles who want to give their fund products the appearance of ESG while not necessarily having bona fide ESG credentials, known as “green washing”.

The rapid and global rise of the ESG investing market has far exceeded the abilities of regulators to control it, and there is a risk of bad actors exploiting the resulting weakness and causing harm which could undermine trust in the system and hurt the majority of ethical operators with good intentions. In the absence of formal rules and regulations around ESG, we recommend pursuing clearly defined ESG objectives and providing transparency of performance against those, with

independent validation.

This article explores the current state of play regarding the question of taxonomy in the ESG market.

## **The UN Fired the Starting Pistol**

While the concept of ESG was first recognised in 2005, the most meaningful step towards an ESG taxonomy started in January 2015, when the UN General Assembly began the negotiation process on its post-2015 development agenda. By September 2015 it adopted the 2030 Agenda for Sustainable Development, with 17 Sustainable Development Goals (SDGs) at its core. These SDGs form the foundation of the majority of ESG investing philosophy and reporting that has followed and, more fundamentally, fund marketing.

However, while the UN's 17 SDGs are a huge step in the right direction and valuable international goals, they were not designed with investment funds in mind, and are too broad and loosely drafted to be a useful taxonomy.

It falls upon fund promoters to determine how -and how far- to apply the SDGs to their offering and, in the absence of any formal requirement, whether their performance against these SDGs is independently verified. Furthermore, even where a fund has an independent audit against its performance against any of the SDGs, in the absence of any quantifiable targets, it could easily pass the audit without meaningfully achieving any progress towards its chosen goals.

As such, taken in isolation, there are clear limitations with the SDGs in the context of fund management and promotion.

## **The Temptations of Self-certification**

With the ESG fund market growing at such a considerable rate, and given the ability to self-certify ESG credentials in the absence of any standardised certification methodologies, the temptation for promoters to apply the most rudimentary of ESG filters (such as a non-quantified vaguely drafted investment policy) is significant, particularly as we are at a stage in the business cycle where it is increasingly difficult for promoters to raise assets. Green washing a fund by promoters to make it more attractive to investors presents a risk area.

There is clearly a value of funds that incorporate ESG factors into their wider investment decision-making processes, rather than pursue ESG objectives as their core investment strategy, but advisers need to work with promoters to ensure that these funds are in fact as ethical as they are marketed as being. Core to this should be an approach of transparency and verification against a set of quantifiable targets.

Allowing products to enjoy the benefits of a green label without facing the investment constraints of a more tightly worded ESG mandate to sit in a complex and crowded marketplace with no

universal taxonomy or policing alongside those that have a core ESG philosophy ultimately risks limiting flows of capital to genuine ESG projects and undermining the UN's objectives.

The lack of policed standardisation has also created a consumer risk, as it is difficult for investors to directly compare ESG funds; an issue that is further compounded by the fact that some providers are less than willing to supply a complete run-down of all the investments in their funds. Finally, where there is no requirement for these funds to have their ESG performance independently verified, many simply do not.

### **Limitations of Ratings Agencies**

A number of credit ratings agencies have taken the opportunity to fill the void left by a lack of harmonisation from regulators, and now have their own ESG ratings. However, the standardisation problem persists as they vary hugely in their approaches, such as what type of legal system in the country of origin should drive good governance.

While the average correlation between credit ratings of Standard & Poor's and Moody's is typically around 0.9, a 2019 study by the Geneva Finance Research Institute found that the correlation between ESG ratings from six prominent rating providers is about 0.45. Furthermore, in its annual survey of users of ratings agencies, SustainAbility found that the number one issue in 2019 (as in previous years) was a lack of standardisation.

So, investors seeking standardised ESG data will be unlikely to be better off if they seek to rely on a third-party credit rating.

### **The EU's Forthcoming Regulatory Tsunami**

The global success of the UCITS brand is illustrative of how pragmatic fund regulation originating from the European Union can have a wider global appeal. However, progress is often slow - nobody could call UCITS an overnight success- and in an area as challenging and diverse as ESG the EU's task is significant.

In March 2018, the European Commission published its Action plan on Financing Sustainable Growth, targeting all financial market participants, cutting across every aspect of financial services and beyond. It aims to introduce measures to clarify asset managers' duties in integrating ESG factors and risks into investment, as well as to clarify and standardise transparency duties and ESG reporting requirements. Furthermore, as retail investors are a regulatory priority for the Commission, a consideration of their ESG preferences as part of investor suitability assessment is also planned.

“Sustainable finance is about making sure our money works for our planet as well as our bottom line. There is no greater return on investment.”

Jean-Claude Juncker

There are now a series of initiatives at an EU level that are at varying stages of progress.

In terms of the reach of the proposed measures, the EU recognises, for example that ESG information transparency starts at the root of the issue, and it will ensure that all enterprises provide reliable and complete ESG data so that this can be evaluated up the food chain.

In terms of the question of taxonomy, the EU recognises the complexity of the challenge and that the question of definition is a recurring debate amongst the industry, and it therefore needs to consider the full range of ESG approaches. Its initial proposal includes a phased agenda to define the activities fitting under the EU environmental objectives. This is intended to run from June 2020 to December 2022 with climate change mitigation and adaptation in the first phase (a recognition of climate change being at the heart of the Commission’s entire agenda due to its commitments under the Paris Agreement).

We can expect a staggered implementation of the EU’s Action Plan on Financing Sustainable Growth, but is significant movement in the right direction is occurring and we are already seeing the introduction two types of climate benchmarks (the ‘EU Climate Transition’ and ‘EU Paris-aligned’ benchmarks), but we are still a long way from a universal taxonomy and system of international regulation.

### **Until then, where does the Solution Lie?**

In the absence of international initiatives, there are solutions to regulate and promote ESG products. Recently the, the Chamber of Deputies in Luxembourg introduced a draft law to modify its implementation of the UCITS rules to reduce the annual subscription tax rate from 0.05% to 0.01% for certified funds with ESG investment strategies.

In terms of work towards a goal of a more global taxonomy with independent verification against targets, an interesting solution comes from LuxFLAG, which is an independent and international non-profit association created in Luxembourg. Its objective is to give investors more confidence about ESG products and counter 'greenwashing', which it aims to achieve by awarding a series of labels to eligible investment vehicles. LuxFLAG currently recognises five different categories of responsible investing that it makes subject to differing qualification assessment criteria: Green bonds, climate finance, an environment label, an ESG label, and a microfinance label. What is interesting about the LuxFLAG approach is that it ties into the UN's 17 UN SDG's, so each particular label assesses a product's efficacy against the particular SDG's for that area. Each of these have quantified metrics subject to independent verification through an external audit process.

Despite what its name suggests, it is not limited to Luxembourg funds, and applicants for a LuxFLAG certification may be domiciled in any jurisdiction that is subject to a level of national supervision equivalent to that available in EU countries.â€

While promoters may choose not to opt for a rating or certification for their ESG fund, the approach that should be taken is that it is no different to that which should be pursued for the wider universe of funds i.e. a sound practice of transparency of performance against a set of clearly defined and quantified objectives, independently verified.

### Final Thought

The UN's SDG's remain central to the design, operation and marketing of any ESG fund. However, it is clear that they should be treated as what they are – a set of goals – and work from there.

While we sit in something of a regulatory void, promoters will have to continue to take it upon themselves to ensure that they act responsibly in the design and operation of their ESG funds. It is a sad irony that the lack of a clear taxonomy around ESG funds risks allowing bad actors to bring disrepute to an area of investing that otherwise has doing the right thing at its core.

Ultimately, the negative PR of an issue around an ESG fund issue will not only cause irreparable damage to your client, but also harm the wider industry that is in a critical stage of maturity.

Wildgen works with fund promoters to ensure that they consider ESG factors properly in terms of their implementation, monitoring and reporting.